VINITY

THE WALL OF WORRY

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In a Nutshell

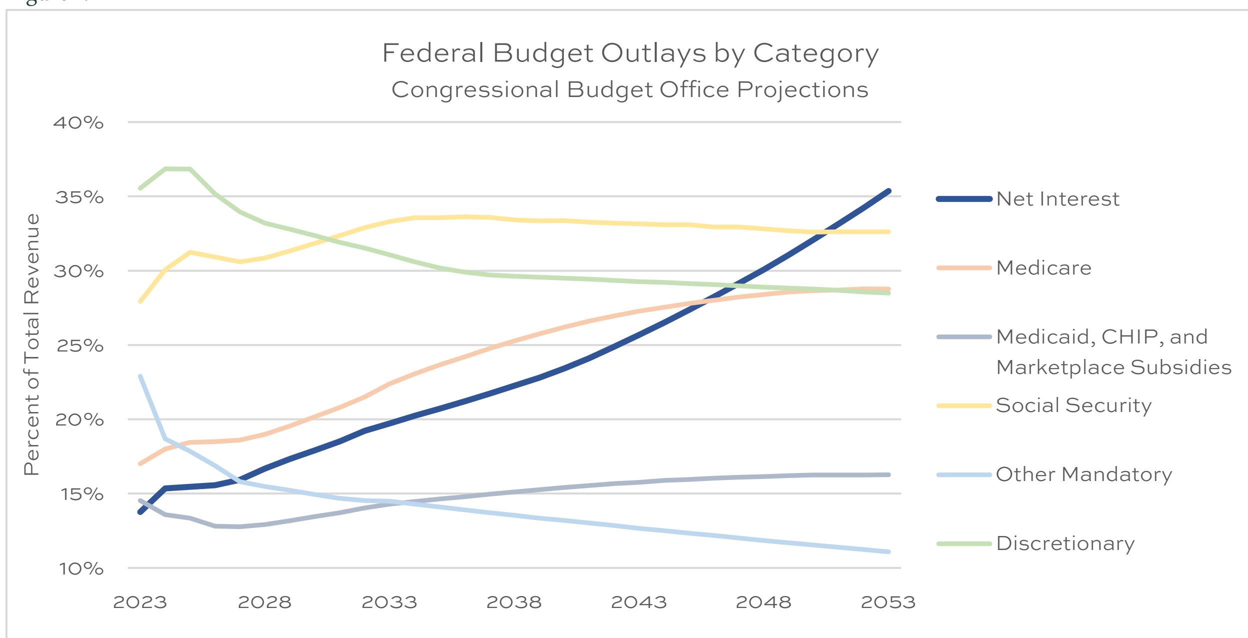
The U.S. national debt has risen nearly 50% since 2019 and now stands at $34 trillion. Compounded by the rapid rise in interest rates, the interest payments required to service the debt are up 75% over the same period. The Congressional Budget Office predicts that interest costs will grow faster than any other spending category, doubling by 2033 and becoming the largest outlay in the federal budget by 2053. The risk is that the government may need to forgo investments that could have served to boost the economy or reduce discretionary income through higher taxes to help make ends meet. Although it may appear the U.S. can borrow unlimited funds without consequence, there will come a point where the debt load will become unsustainable, leading to an undesirable outcome. On a positive note, the U.S. likely has 20 years to right the ship. However, the challenge is that politicians are chiefly concerned with getting re-elected now, and proposing spending cuts and tax increases is not a good selling point. So, naturally, the issue will only receive consideration once it is too late. On a brighter note, consumers are adapting to the prohibitively high prices of goods and services today by saving less and borrowing more. The fiscal and monetary policies of the last few years, along with structural societal changes, have disrupted the way we live, work, and play. Based on consumer surveys, households are uncertain about their financial situation, with a similar proportion of households expecting to be financially better off one year from now as those expecting to be worse off in the same time frame. This is unusual, as there is normally a clear consensus in one direction. As unique as the pandemic-era policies themselves, households' experiences were similarly distinct, resulting in a broad range of outcomes, spending habits, and consumer behaviors. As if that were not enough, investment preferences have also changed considerably. ETFs continue to gain popularity, with investors adding $2.5 trillion while pulling $2.2 trillion from mutual funds since 2019. The flows follow the trend favoring passive management over active management. Most ETF assets are passive, while the opposite is true for mutual funds. During 2023, nearly half of all flows into U.S. equity ETFs went into the top four ETFs that track the S&P 500. Investors are not just favoring passive but increasingly allocating funds to strategies that track the same index. Stock prices are a function of supply and demand, so the substantial flows into passive funds will boost those strategies. Therefore, owning a portfolio that looks different from the benchmark will not serve you well. However, with passive, what you see is what you get, including during times of market stress. Although often overlooked, mitigating losses can lead to better outcomes as one has less ground to make up. Recovering from a 50% loss requires a 100% gain, while a 40% loss requires a 67% gain. When stocks fall, you need a portfolio that looks different than the benchmark if you want to fall less than the benchmark. This is where active management can really prove its value.

On Borrowed Time

The U.S. national debt has reached a staggering $34 trillion, an increase of $10.8 trillion since 2019, representing 46.6% growth. Meanwhile, the interest payments required to service the debt have soared

by 75.3% over the same period, from $376 billion to $659 billion in 2023. The situation is compounded by the rapid increase in borrowing and the rise in interest rates to levels not seen in over a decade. Interest payments on the national debt will continue to rise and occupy an increasing portion of the federal budget. According to the Congressional Budget Office (CBO), interest costs will grow faster than any other spending category for the foreseeable future. Outlays for interest payments will more than double to $1.4 trillion by 2033, representing 19.7% of total revenues, up from 13.8% in 2023. By 2053, interest payments will represent 35.4% of total revenues and will be the largest outlay within the federal budget. The risk of outsized growth in interest payments is that the federal government will likely need to pull back on other spending categories, potentially forgoing investments that would have boosted the economy. Alternatively, the government may need to increase revenue through higher taxes to help make ends meet. In any case, policies that reduce discretionary income or limit investments will stifle economic growth.

Figure 1.



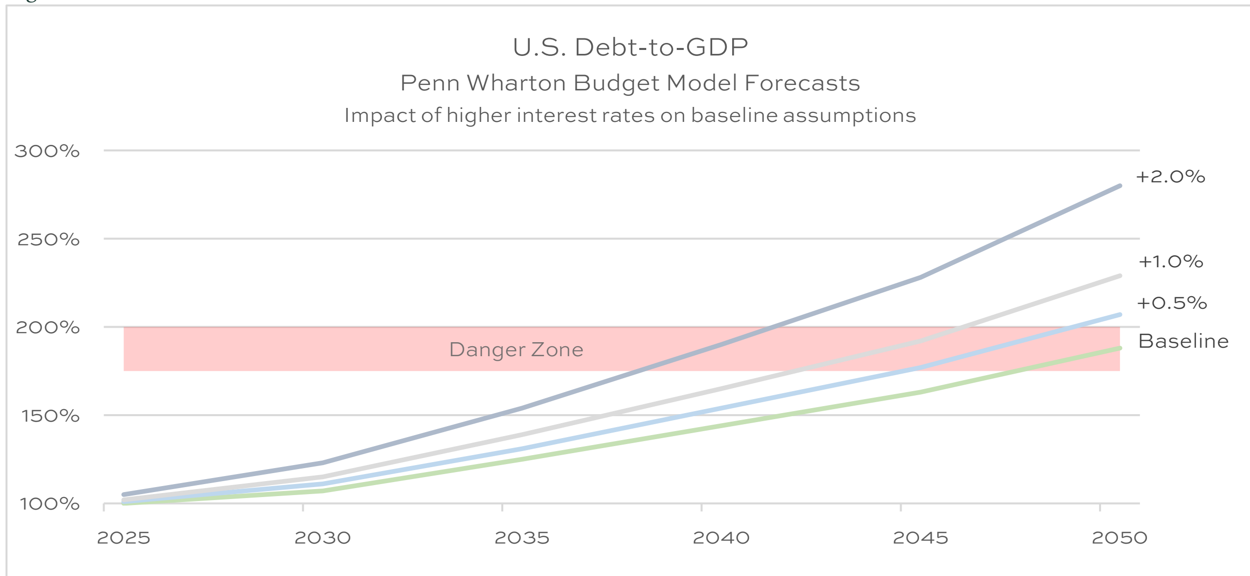
Understanding how soaring interest costs may influence the stock market is much less straightforward. Unfortunately, this alarming rise in the cost to service the debt will likely receive little attention. Simply put, voters are interested in what politicians can do for them now, and politicians are chiefly concerned with getting re-elected. It is hard to spin increasing taxes and cutting spending. So, we will inevitably see politicians kick the can down the road until it is too late, and their hand is forced, leading to undesirable consequences.

The sustainability of the U.S. national debt is a relatively new concern. Debt as a percentage of Gross Domestic Product (GDP) is a metric that measures how much debt a country can manage reasonably. From 1940 through 2007, the average debt-to-GDP ratio was 44%. By the end of 2007, the debt-to-GDP ratio stood at 35%. But significant borrowing to stem the fallout from the 2008 Financial Crisis sent the metric higher, doubling in just four years. The pandemic has further fueled borrowing, propelling the debt-to-GDP ratio to its current level of 98%. According to the CBO, this measure will reach 181% by 2053.

So, what does all this mean? According to a research brief from the Penn Wharton Budget Model (PWBM) at the University of Pennsylvania: *Under current policy, the United States has about 20 years for corrective action after which no amount of future tax increases or spending cuts could avoid the government defaulting on its debt whether explicitly or implicitly (i.e., debt monetization producing significant inflation). Unlike technical defaults where payments are merely delayed, this default would be much larger and would reverberate across the U.S. and world economies.*

Based on the modeling from PWBM, the maximum debt-to-GDP the U.S. can sustain is between 175% and 200%, a level we could see as soon as 2040. However, according to the baseline assumptions, the U.S. would not reach the danger zone until closer to 2050. Figure 2 depicts the impact of higher interest rates on the debt-to-GDP level. The stakes of ignoring this issue are high, with tremendous risk to capital markets in the event of an adverse outcome. However, any potential impact on the stock market will be felt much too far down the road for Mr. Market to be bothered by this now.

Figure 2.



Mixed Signals: The New Normal

Consumers seem unfazed by the prohibitively high prices of goods and services today. Despite the median mortgage payment doubling, median rents increasing by nearly 50%, and the average new car price advancing almost 25% since 2019, people continue spending at the expense of saving less and borrowing more. However, this trend comes at a cost, as the interest associated with rising credit card debt has reached an all-time high. The average interest rate assessed on credit cards is now 22.8%, greater than the pre-pandemic high of 17.1% set during the second quarter of 2019.

When it comes to the perception of their financial situation, consumers seem to have mixed feelings. According to the New York Fed Survey of Consumer Expectations, 25% of households expect to be financially worse off one year from now, while 31% of households expect to be financially better off one year from now. The difference between the better-off and worse-off cohorts is only 6%, much lower

than the pre-pandemic average of 24%. This suggests consumers are uncertain about their financial standing and cannot reach a consensus with much conviction.

To understand the mixed signals from consumers, we need to consider the distinct experiences of the past few years. This includes the exceptional fiscal and monetary policies, the rapid increase in digitalization trends, and the structural changes that have disrupted how we live, work, and play. Unintentionally, this has resulted in winners and losers, with some consumers benefiting and others falling behind. Housing is an evident example, as it represents the most significant expense for most consumers. Since 2019, homeowners have seen a 40% increase in the value of their homes and have had the option to reduce their monthly mortgage costs by refinancing at historically low rates. Conversely, a renter saw their monthly payment increase 46% over the same period. In this context, we can better understand the mixed signals from consumers and recognize the challenge of assessing the economic outlook. The policies and circumstances of the pandemic era were unique, and the way households experienced them was equally distinct, resulting in a wide range of outcomes, spending habits, and consumer behaviors.

The Rest of the Story

Investment preferences have transformed alongside changes in consumer behavior since 2019. ETFs have gained immense popularity, with investors pouring $2.5 trillion into ETFs since 2019 while withdrawing $2.2 trillion from mutual funds. It is evident this is part of a broader trend favoring passive management as 95% of ETF assets are passive, while just over 70% of mutual fund assets are active. Passive management involves replicating the composition and performance of a particular benchmark, such as the S&P 500. Meanwhile, active management involves a portfolio manager who decides which stocks to own and how to allocate among them, seeking to outperform a stated benchmark. The proportion of actively managed strategies has declined from 78.0% of total ETF and mutual fund assets in 2012 to 49.9% in 2023, marking the first time that assets in actively managed strategies have fallen below their passively managed counterparts. In recent years, active managers have not made a compelling case for their investment strategies. Between 2011 and 2022, only 33% of active U.S. equity fund managers beat the index on a calendar year basis, compared to 48% outperforming the benchmark from 2001 to 2010. Based on this data, some might conclude that the most skilled active managers have retired, and less qualified individuals have taken their place. However, we believe a different dynamic is taking place under the hood.

The trend favoring passive management due to active manager underperformance creates somewhat of a self-fulfilling prophecy. As investors pull funds from active strategies in favor of passive management, active managers are more frequently closing up shop. From 2020 to 2022, more mutual funds either closed or merged than have opened, resulting in a net loss of 547 funds. Conversely, ETFs experienced a net gain of 826 funds during the same period.

By definition, active strategies look different than the benchmark because managers assign different weights to the stocks in their portfolios. However, as all the positive flows go into passive strategies, replicating the benchmark, owning a portfolio that looks different than the benchmark is not poised to serve you well. Stock prices are a function of supply and demand, so an increase in demand for a particular security will cause the price to go up and vice versa. The dynamic can create a feedback loop,

where the increasing outflows from active strategies cause managers to sell positions, potentially limiting the upside or putting downward pressure on those stocks, hindering the strategy's performance. The poor performance then compels investors to withdraw more funds from active strategies and causes the cycle to start over. As passive strategies continue to receive more flows at the expense of active management, this will put further pressure on actively managed strategies, resulting in more closures and mergers.

Investors are increasingly opting for passive investment strategies that track the same index. In 2023, almost half of all flows into U.S. equity ETFs were accounted for by the top four ETFs that track the S&P 500. However, instead of choosing between active and passive, investors should focus on how to use both to build the most effective portfolios. Investors who only consider performance are missing the bigger picture. The volatility of a particular strategy and its correlation with the other positions in an investor's portfolio should receive consideration alongside performance. Passive strategies simply track the benchmark, while active strategies come in many varieties, such as those that seek to limit volatility or have a unique discipline, resulting in a fund with lower correlations to the other holdings in the portfolio. By leveraging the strengths of active and passive strategies, investors can build portfolios that deliver more return per unit of risk compared to a passive investment alone. Investors need to understand their portfolio and how it may perform during adverse market conditions more than ever. As investors continue piling into vehicles that track the same index, more and more investors end up owning the same stocks in the same proportions. Assuming stocks will only go up, what could go wrong? However, if everyone rushes for the exit at the same time, look out below.

Everyone is a genius when stocks go up. Although, the same cannot be said during times of market stress. Limiting losses can lead to better outcomes as it becomes increasingly difficult to recover from a loss as the size increases. For example, to recover from a 50% loss, you will need a subsequent 100% gain, while a 40% loss requires only a 67% gain to break even. The only way to outperform the benchmark when stocks fall is to have a portfolio that looks different than the benchmark. This is where active management can really prove its value.

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Past performance is not indicative of future results. Indexes are unmanaged and you cannot invest directly in the index.

Diversification does not guarantee a profit or protect against loss.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization.

Sources: Congressional Budget Office, Federal Reserve Bank of New York, Investment Company Institute, Morningstar, Penn Wharton Budget Model, S&P Dow Jones Indices, U.S. Department of the Treasury, Vanguard, YCharts.

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