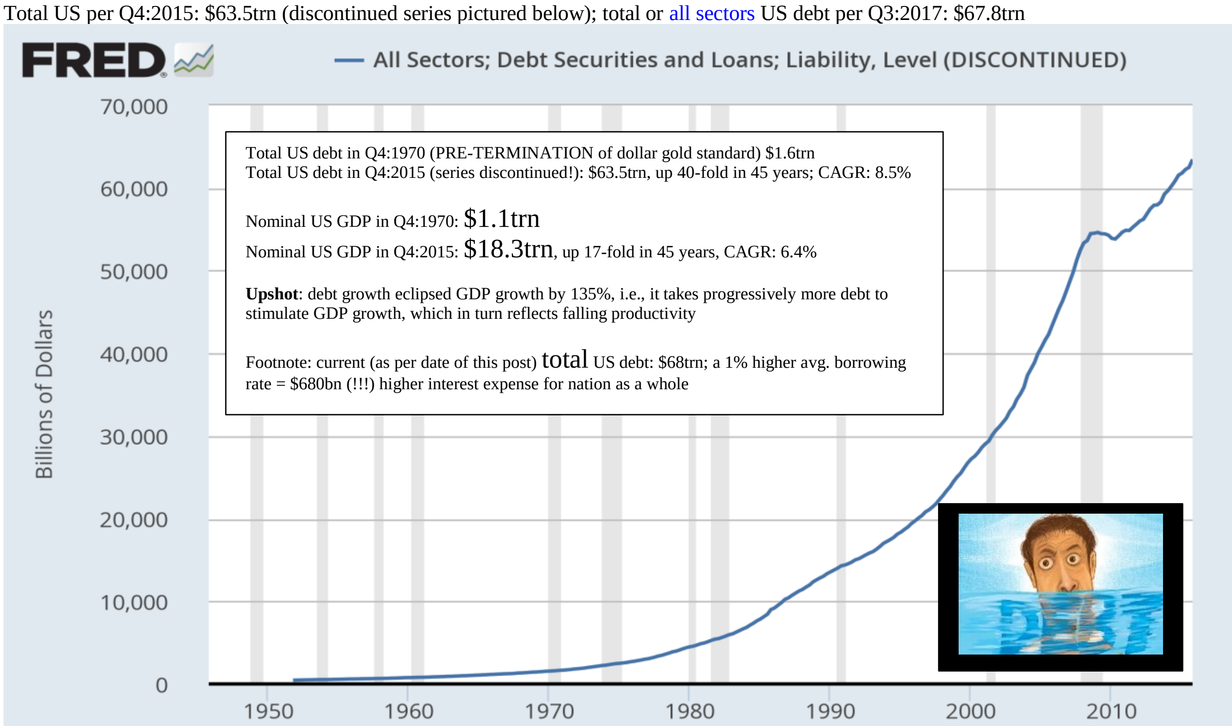
DK Analytics, Post #26: Trump's state of union -- US greatness financed by more debt 2/6/2018

Trade weighted US$: 85.20; US 10-yr: 2.79%; S&P 500: 2,695; Oil: $63.58; Gold: $1,325.60; Silver: $16.59

Total US per Q4:2015: $63.5trn (discontinued series pictured below); total or all sectors US debt per Q3:2017: $67.8trn



Source: https://fred.stlouisfed.org/series/TCMDO; grey bars represent recessions

Introduction:

President Trump displayed and communicated great patriotism very effectively during his eloquent state of the union address (the "address") on January 31st, 2018. There were lots of emotional, unifying, "rallying around the flag" callouts, which are essential if there is any hope of restoring the increasingly frayed, yet pivotal, sense of national unity. Many of his policies represent a welcome shift back to a chief executive whose first responsibility is to his country and his countrymen, notwithstanding the withering resistance from the opposition party, from establishment Republicans (RINOs), and from an increasingly lawless administrative state. And his judicial appointments show that he takes his oath of fidelity to the Constitution (the rule of law) more seriously than any president since Ronald Reagan. In short, a president that is proud of the American heritage and wants to revisit the essence of American greatness, namely a federalist, representative, constitutional republic featuring inalienable rights (natural or God-given rights that are not up for a vote). This is as long overdue as it is vital. Yet in our view there are also too many worrisome, conflicting, and frankly threatening and undermining aspects of his pivotal policies for those concerned about regaining a viable, rule of law republic featuring representative government. A decidedly mixed bag, in short.

A closer look:

As stated, President Trump has indeed fulfilled his campaign promise to elect "rule of law" judges/justices when vacancies arose. In fact, a record number of very constructive, originalist/pro-Constitution appointments have been secured in terms of federal circuit/appeals court appointments and, most obviously, via a critical SCOTUS justice appointment, namely constitutionalist Neil Gorsuch.

This portends well for a more universal return to the rule of law, i.e., when disputes or claimed unlawful actions by government or by private sector actors lead to suits and/or judicial review that are appealed to the federal level. Instead of activist judges that continue to trash constitutionally-based doctrines including separation of powers, federalism, strictly enumerated powers, and the inviolability of inalienable individual and state rights protecting Bill of Rights, we could see judges in a position to restore greater constitutional fidelity *over time*.

This would stand in stark contrast to the sustained, massive, and unconstitutional abuse of power by both elected and administrative state officials (bureaucrats) as enabled/condoned by both the SCOTUS and by federal court judges. We are referring to fifth amendment, ninth or tenth amendment eviscerating decisions, redistributionist Obamacare, the horrendous fourth amendment shredding FISA court abuses, the Tea Party intimidation tactics by the IRS, or the recent EPA land grab, which was thankfully reversed by the Trump administration -- and hopefully won't be "suspended" by "revisionist" judges.

Sobering is the fact that much more could come to light if it weren't for a colossal "conspiracy of silence" given the all too numerous beneficiaries of the status quo. In our view, way too many bureaucrats -- and not just in DC -- have hugely privileged, tenured, lucrative, high-salaried, great pension benefits lifestyles to "let go;" the huge conspiracy of silence. Think of the IRS and the witch hunt against Tea Partiers. Did any "rank and file" IRS employees step forward as "protected" whistle blowers? We don't recall any doing that. Consider the banana republic (B.R.) abuses/rampant lawlessness at the highest level of the FBI and the Department of (In)justice. Did any "rank and file" DOJ staff take on whistle blower roles to "call it out" for the benefit of the Republic in order to defend what is left of justice and the rule of law? None that we know of. No one is supposed to be above the law, else there is no rule of law. A federalist, representative, constitutional republic can morph into a B.R. or a fascist nation run for and by elitist cronies aligned with despotic, lawless elected officials and unelected bureaucrats. This, sadly, is what America has become. Unfortunately, given the status quo, getting back to rule of law terra firma and away from our "rule by might" will prove very difficult. Fortunately, President Trump has been doing what is in his power at the appointment level.

Rule of law

The most important application of the rule of law is the principle that governmental authority is legitimately exercised only in accordance with written, publicly disclosed laws adopted and enforced in accordance with established procedural steps that are referred to as due process. The principle is intended to be a safeguard against arbitrary governance, whether by a totalitarian leader or by mob rule. Thus, the rule of law is hostile both to dictatorship and to anarchy

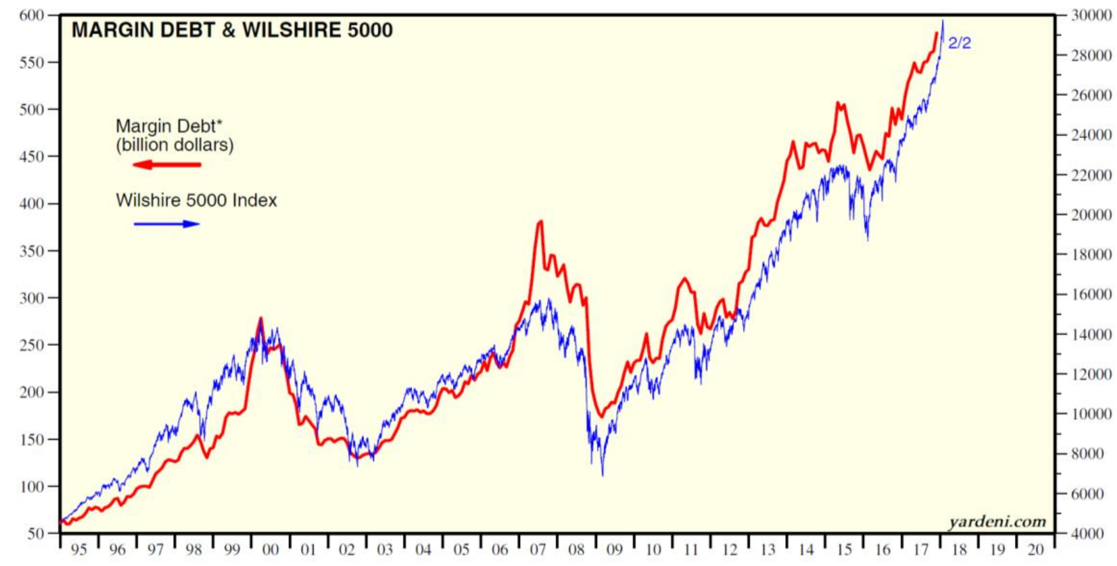
Sources: unknown. So no attributes. Sorry. But we are grateful.

In stark contrast, counterproductive and very unfortunate, in our view, are the misleading claims the president has long been making (including on the trade front), the negative impacts that policies based on same will result in, and, most disconcertingly, what we view to be reckless abandon on the deficit-expanding nature of his policy initiatives, especially given America's large, intractable government deficits, its gaping trade deficits, and its highly debt-encumbered economy. With all due respect, sometimes Trump's assertions and policies can only be described as benign ignorance at best, or "Mr. Hyde"/National Enquirer-like behavior at worst. Such buffoonery, coupled with endless "claims inflation," only serves to discredit "Dr. Jekyll's" largely constructive and sorely needed "Rx." Building and reinforcing credibility while promoting sound policies are viewed as critical to lion-hearted Trump's ability to rally enough Constitution-loving Americans to his cause while simultaneously weakening the administrative state -- and thus helping to re-establish the rule of law, very much including more robust property right protections, which in turn will stimulate growth.

Specifically, and worryingly, we see disingenuous aspects, conflicting disconnects, misleading statements, and frankly "reckless" aspects to the president's address and the related policies (less demagoguery, please!). Examples include:

1. Amnesty for 1.8m illegal aliens is a broken promise of the highest order! Meanwhile, it sends precisely the wrong signal to would-be third world immigrants. Most harmful, it promises to fuel a one-party (Democratic) government from coast to coast! This is also known as a dictatorship. For flavor, just look at Sacramento and the toxic Californian economy.

2. What used to be an ugly stock market bubble that would be pricked by higher interest rates, according to candidate Trump, is now proof that president Trump is doing a great job. Yet, the S&P 500 is currently trading nearly 25x EPS, the broader Wilshire 5000 Index has rocketed higher, and margin debt is nearly $600bn, a record:

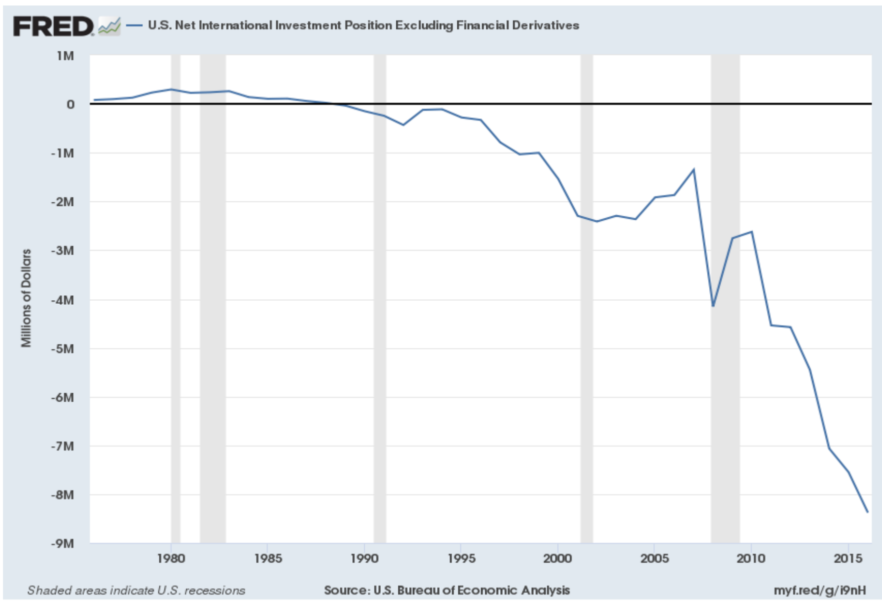


Source: www.yardeni.com/pub/stmkteqmardebt.pdf

3. In the interim, a recession, which is way overdue, will crush earnings; US aggregate debt rises between $1trn and $2trn a year; and interest rates are rising smartly, which will pummel valuations if it continues, especially with a recessionary EPS downdraft of 50% plus being likely in the near future based on precedents. (We review such a scenario in some detail in posts #25 and #24, wherein we quantify the rising interest rate impact on the S&P 500's NPV and wherein we remind investors that markets are "reversion beyond the mean" machines, respectively.)
4. What used to be a fake unemployment rate when Trump was a candidate is now lauded as the "real deal" even as the civilian labor force participation rate of 62.7% hovers near four-decade lows and two or three low-paying, no-benefit part time jobs swell the employed ranks while full-time positions continue to be culled. This is insincere.
5. During the address, Trump also stated: "under my administration, wealth is starting to return to America instead of leaving it." Mr. President, sadly the opposite has been happening, at least so far, as evidenced by a continued rise in the US's trade deficit, a substantial portion of which is due to rising oil import prices (and no, Donald Trump, we are not energy self-sufficient, we remain net importers of oil, and our gap could expand as the fracking bubble collapses). Once again, the president's claims here are misleading at best.
6. President Trump talks a lot about regulatory reform liberating businesses to hire and invest. According to the American Action Forum outfit, regulatory relief of $560m p.a. from Executive Order 13,771 (two struck for every new regulation or "reg") can be expected. While praiseworthy, this is but a rounding error compared to an estimated $2trn plus in annual regulatory compliance costs for US economy. While a sharp reduction in federal register pages (where federal rules and regs are published) from Obama's "out the door" bloat looks promising, we wonder how any true or lasting reforms can be achieved until regulatory agencies are shut down and statist/leftist bureaucrats are fired, esp. given the risk that GOP control of the federal government could prove only temporary -- which Trump himself recently warned about.
7. Trump protectionism, a disconnect. On the heels of going to Davos and touting that America is again open for business thanks to tax cuts and regulatory reform, Trump was quick to slap high tariffs on solar panels, washing machines, and on select steel imports. Three issues here: first, lots of stuff just isn't made in America anymore, so higher tariffs line government pockets and hurt consumers and producers alike -- such as those installing foreign made solar panels that stand to lose customers or those using cheaper foreign steel in high value-added finished products that are exported -- while they raise inflation. Second, raising tariffs on US imports will quickly result in higher tariffs on US exports. Third, we all know what can happen to the global economy if countries get into trade wars. It's spelled Smoot Hawley, revisited and the 1930s depression!
8. Speaking of policy destructiveness, bloated federal government spending is up 3.8% year-over-year and is set to increase faster as Trump touts various new spending initiatives from (what will sadly ultimately prove to be) pork

barrel, crony infrastructure projects to "offensive capacity" military spending growth de facto financed by the "rest of the world" (ROW)! In the interim, tax rate reductions will pressure tax receipts. Finally, weaker economic growth will dramatically increase government spending on welfare and transfer payments. Talk about a perfect deficit-widening storm dead ahead! And this is before secular challenge known as an aging society and its impact on public sector solvency! Is any of this discussed, much less addressed, in Washington D.C.?

9. As we've mentioned before both in posts and videos, we could see a $1.5trn - $2trn plus dollar federal deficit within a few years if not sooner. And if the Fed really sells $600bn of Treasuries a year, at what price -- how high of a yield -- will investors and the ROW be willing to soak up between $1.5trn - $2.6trn worth of US Treasuries possibly coming on to the market annually for a time? Does President Trump raise any of these issues?
10. The above is of particular concern as the ROW finances a US goods and services deficit that averages about $500bn a year and expanded to $600bn in 2017. Meanwhile, America is a net debtor nation to the tune of $8.4trn:



Source: https://fred.stlouisfed.org/series/IIPNETINA

In such a world, when you openly state that the US government would welcome a weaker dollar in a period of low interest rates, great external financing dependency, a weakening currency, and rising inflation, you are driving away potential investors and thus de facto raising the cost of borrowing, especially if sentiment shifts or confidences wanes! (And, by the way, if currency debasement helped to reduce trade deficits, America, having the tailwind of a dollar that has fallen about 80% since Bretton Woods dollar gold standard was terminated nearly 47 years ago, should have huge annual trade surpluses by now in place of gaping deficits!)

11. You cannot simultaneously grow a spendthrift federal government, cut taxes, and then be sanguine. You can't grow spending by $300bn plus, reduce tax revenues by an estimated $280bn, and add it to a $666bn deficit and over $21trn in debt and expect good things … Any kindergartner knows this, Mr. President!
12. In short, Trump is NOT leveling with the American people in terms of what really needs to be done for the benefit of future generations who will otherwise be hobbled by mountains of debt and the related financing costs, namely: focus on *cutting government spending, achieving a balanced budget, aggressively pursuing litigation reform (US liability costs are 2.6 times the EU average), securing long-lasting regulatory relief, and pursuing the solid money that Andrew Jackson pursued when he killed the second US central bank*. Noteworthy, the portrait of Andrew Jackson, who Trump greatly admires, adorns the oval office. A daily inspiration or "propaganda?"
13. Let us really drive the point home on Trump policy recklessness: America is some $68trn in debt when combining federal, state, corporate, and individual/family level debt. US GDP is nearly $20trn. Each one percentage point higher borrowing costs from abnormally low interest rates increases America's cost of funding by roughly $680bn p.a. (most debt, including the US government's, is not long-term in nature, thus susceptible to higher refinancing costs if interest rates keep rising). In fact, if the average cost of borrowing rose by just two percentage points -- say 10-year Treasuries yielded 4.8% -- the US's financing cost would quickly soar by $1.36trn or by 7% of GDP.

14. As we have stated and written, markets are reversion beyond the mean machines. And given the mountains of debt we have accumulated, both solvency and inflation risks (in terms of printing even much more money) suggest that we could easily have a 10-year Treasury that someday yields 7.8% or 8.8% -- recall that we exceeded 15% during Volcker's "tough love" in the early 80s with a fraction of the debt. Five percentage points higher funding costs than today would raise America's aggregate borrowing cost by roughly $3.4trn p.a. from current levels, or by 17% of current GDP. A non-starter! Our point: given the huge indebtedness, relatively feeble manufacturing capacity, and income and debt constrained consumers, *higher interest rates could easily choke off and even reverse the positive impact of lower tax rates* because they are financed by yet more debt instead of through government spending cuts.
15. Sadly, too many of Trump's policies will ultimately rely on the very printing press that has gotten us deeper and deeper into debt, into yield starvation, into huge misallocations, into cratering productivity growth, and into accelerating solvency risks and inflation risks. Inflation is the largest stealthy property thief for the average person, and especially for retired folks, who are dependent on a fixed income stream and bond investment returns.

Finally, some color on the state of the consumer and his/her "pale" ability to keep powering GDP growth:

1. Year-over-year wage growth is 2.4% overall and but 2.2% in supposedly robust manufacturing while inflation is picking up, the housing bubble has eclipsed the 2006 highs, and mortgage rates are rising briskly -- in short, housing is increasingly unaffordable for most Americans. In a related sense, we wonder how a 65-year low in the unemployment rate and low wage growth rates are possible at the same time? Fake news, anyone? Mr. President, perhaps candidate Trump needs to be consulted?!

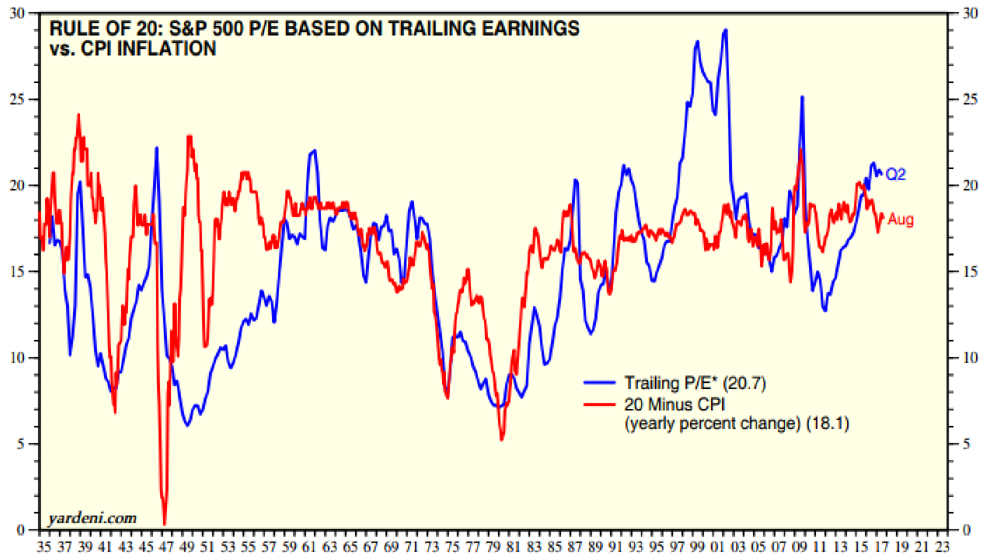
Source: www.businessinsider.com/us-cities-with-biggest-housing-bubbles-2017-12

2. The personal savings rate has plummeted to 2.4% from 5.9% two years ago as record auto loans ($1.1trn) and student loans ($1.5trn plus) suggest tapped out consumers. It also implies substantial demand has been borrowed from the future, i.e., that it won't be there this year or next. If the "consumption function" is over 70% of GDP, this isn't an academic issue.
3. Moreover, growing retail sales, when not reflecting energy, food or healthcare spending inflation, are too often indicative of greater demand for overseas products, as any shopper in big box US retailers will readily attest to.

Translation: running down savings to spend more often benefits Chinese and other overseas producers, not domestic companies or employment. So "shop until you drop," but don't expect the US economy to "pop."

February 6th, 2018 conclusion:

Against the backdrop we have outlined, we continue to think, on a global basis, that most stocks, most bonds, and certainly the US dollar, remain in a bubble, recent corrections notwithstanding. In other words, the buck, bonds, and now stocks are deflating a bit. But it is a slippery slope, especially once perception starts to catch up with reality. That reality, coupled with an overdue, likely EPS-crushing recession and an eventual return to a 1970s style "stagflation on steroids" will a) pop the stock market bubble and b) will likely keep it from reflating by virtue of pressuring P/Es (please see the "Rule of 20" chart below) for some time. Credit our long-standing toxic public policy stew, very much including our 47-year old move away from sound money. Also consider fiat money's progeny: falling productivity and unparalleled increases in debt of all sorts, which ironically require progressively more QE to "paper over" or to sustain. Not necessarily a "virtuous circle" or a "wealth of nations" trajectory. But, like anything, it can be capitalized on.



Source: www.yardeni.com/pub/cc_20170918.pdf

Speaking of which, at the portfolio allocation level, consider taking profits. Where? In overvalued stocks and in very overvalued bonds. Reduce exposure! Also consider reducing dollar exposure, especially the "bond kind." The easiest way to achieve this is to use sales proceeds to buy essential, sanely-priced scarce real assets (led by ag and dense energy investments) or to buy currently very undervalued physical precious metals, especially silver, held in your possession. And don't shun cash. Safe cash. T-Bill kinds of cash. If you hold T-Bills, you can't be bailed in, you don't have any interest rate risk, the government can print the money to pay you back if necessary, and you'll have wonderful "dry powder" to possibly purchase "once in a lifetime" stocks trading at single-digit P/Es, such as in the depiction above in the '70s. While you'll have to be patient, and will likely buy "too early," you'll get paid to wait. We're referring to high single-digit Blue Chip dividend yields that will resurface thanks to P/E compressions. The "stuff of outsized strategic gains" potential and good income prospects will once again beckon. In the interim, you can talk about other things than huge incurred losses at cocktail parties, such as how relaxed and confident you feel, knowing how hard the laws of constructive ROI and capital preservation are working on your behalf as you sip on that Gin & Tonic!

Greetings,
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