FAHNESTOCK ASSET MANAGEMENT
of Oppenheimer & Co. Inc.

Craig W. Hutchison
Managing Director
Senior Portfolio Manager
382 Springfield Avenue, Suite 400
Summit, NJ 07901
craig.hutchison@opco.com
Phone 908-273-2100
Fax 908-273-0788
Toll Free 800-522-7857

May 11, 2021

Dear Client,

We hope this letter finds your life returning to normal. Traffic on our daily commute is back to a crawl and eating inside a restaurant is no longer a quaint vestige of the past. The economic crash was significantly shorter than initially projected and housing prices and market indices are now hitting record highs. With next generation technology, pharmaceutical companies developed, tested and approved four new vaccines in under a year, way ahead of schedule. There is much to be excited about, but the return to normalcy comes with a cost.

COVID has not been cheap. In a slew of acronyms, the federal government approved additional spending of $5.33 trillion to combat the pandemic and to support struggling households. Adjusted for inflation, four years of WWII only cost the American taxpayer $4.5 trillion.

Tax increases are counterproductive in a recession so this additional spending has all been funded with more debt. In 2020 the federal government collected $3.42 trillion in revenue from individual, corporate, and payroll taxes but spent $6.55 trillion. We have run a budget deficit each year for the last 20 years, but last year was the biggest ever and the federal debt increased from $22.7 to $26.95 trillion.

The federal debt is big and it is getting bigger, but the metric that really matters is the debt to GDP ratio which compares a country's debt level to its' annual economic output. **GDP growth translates into tax revenue growth and a higher income can support a proportionally higher debt load.** For the last decade, the debt to GDP ratio has remained constant at roughly 100%. In 2011 the national debt was $14.8 trillion and GDP was $15.5 trillion. At the end of 2019 they were $22.7 trillion and $21 trillion, respectively. Debt may have increased precipitously over the last decade, but so has the country's economic output and tax base.

However, in 2020 GDP stagnated and debt swelled, ending the year with a ratio of 130%. The previous peak was 118% in 1946 when war spending slowed and the country was saddled with war debt. The ratio subsequently declined over time as taxes were raised to service the debt and the economic engine switched to manufacturing toasters and cars instead of tanks and planes. This time around spending is going higher.

Biden has proposed an additional $2.25 trillion in spending on The American Jobs Plan and $1.8 trillion on The American Family Plan. Both are pitched as debt neutral with the spending occurring over the next eight years and paid for with tax increases on high earners and corporations over the next fifteen. **With a two year election cycle we doubt the tax code will remain unchanged for the next fifteen. Taxes can only go so high and we suspect a good chunk of any new spending will ultimately be funded with more debt.**

Economists are projecting very strong GDP growth in 2021 thanks to the reopening and government spending. Many white collar workers who had the ability to work remotely received a stimulus check which they did not need and could not spend in quarantine. Expanded unemployment benefits paid many displaced lower income workers a higher wage than did their former employers. On average, household finances are in decent shape and the vaccinated masses are getting ready to go out to eat, travel and spend on experiences they missed last year. This will improve the debt to GDP ratio.

In the near and medium term, we are not too concerned with elevated levels of federal debt. Over the long term, it could become a problem if unfunded spending continues. With low interest rates and a growing economy, the country can still easily afford to service the debt. But if rates go materially higher, a larger portion of federal revenue will go to paying interest at the expense of defense, social and infrastructure spending. As the reserve currency, the Federal Reserve has the ability to “monetize” the debt and take it out of circulation by way of central banking sleight of hand. This is useful in times of crisis but if taken too far it could chip away at the prestige of the dollar. One near term consequence from the increase in debt and spending is a potential flare up in inflation.

Lumber, copper, steel, wheat, soybean and corn prices are significantly higher than they were pre-pandemic. Labor markets in some industries are competing with expanded unemployment benefits which are pushing wages higher. The things that we consume every day are likely to get more expensive. Companies can pass most of the extra costs on to consumers so owners of stocks are somewhat insulated from inflation. Industries you are invested in such as farmland, commodities trading, real estate, forestry, and precious metals, perform especially well in inflationary times. We will continue to monitor the ever evolving landscape for opportunities.

Last year was an incredibly tough year for a lot of households and had the government not responded as it did, we would all be materially worse off. Fortunes have improved, but some are still struggling and need support. We are optimistic that as the pandemic wanes so too will deficit spending, the debt to GDP ratio, and inflation.

Our whole office is fully vaccinated and if you are too we would love to see you soon!

Sincerely,

Craig

Craig W. Hutchison
Managing Director
Senior Portfolio Manager

Drew

Andrew A. Westhuis, CFA, CFP
Executive Director
Portfolio Manager