***"The farther backward you can look, the farther forward you can see."*-**
WINSTON CHURCHILL

Bond Vigilantes and the Eight-hundred Pound Gorilla

When the U.S. Constitution was created by the Founding Fathers, our democracy was given three branches of government – executive, legislative and judiciary. These branches were intended to serve as a system of checks and balances to keep the republic on course and to prevent any actions that might threaten its very existence as a sovereign power.

Those individuals involved in the investment industry for more than thirty years likely remember the existence of an undefined group of investors who watched over the fiscal and monetary policies of the U.S. government and served as a check on unwise actions by elected and appointed government officials. This group became known as the *bond vigilantes*. Whenever this group observed that policies were being pursued that were not in the best interests of long term financial stability of the country, their response was almost immediately felt in the capital markets with bond prices moving decisively in one direction or another. This rather informal group served a useful function of keeping fiscal and monetary policy on a steady course consistent with the long term viability of capitalism.

Fast forward to the period beginning in 2001 and the picture has changed dramatically. Whereas in the 1990s, the U.S. achieved balanced federal budgets, the events following the 9/11/01 terrorist attacks launched the U.S. into a war on terrorism along with a build-up of our military bringing with it outsized budget deficits and a rising level of total U.S debt. This period was eclipsed by a massive economic crisis in 2007-09 that resulted in an unprecedented effort to pull the U.S. out of the greatest economic morass since the Great Depression of the 1930s. During the eight years of the Obama administration, U.S. debt doubled to more than $18 Trillion. One of the elements used by the Federal Reserve and central banks around the world was record low interest rates and the flood of massive liquidity into the economic system. One lasting result of the Bush "43" and Obama budget blowouts was that U.S debt-to-GDP ratio climbed to the highest ratio since the end of World War II.

Today, with total U.S. Debt approaching $21 trillion and U.S. GDP approximately $20 trillion, the Debt-to-GDP ratio is about 105%. There are some experts who are deeply worried about U.S. debt but there is an increasing number who believe that the debt is no problem and that on-going budget deficits should not be a source of concern. Curiously, the *bond vigilantes* of yesteryear have not been heard from and appear to have gone the way of the do-do bird.

Within this current blasé environment, the Trump Administration engineered a massive $1.5 Trillion tax cut in late 2017 cutting the corporate tax rate from 35% to 21% along with a lowering of individual tax rates. The purpose of this landmark legislation was to reignite economic growth and propel the U.S. economy out of the lethargic growth that has been in evidence since 2009. Then, in early February 2018, Congress passed a bill to spend an additional $300 billion on a combination of military and social welfare programs with no provisions for how these additional expenditures would be funded, other than simply raising the fiscal year budget deficit. As a result, it now seems likely that the 2018 Fiscal Year budget will approach $1 Trillion.

Unfortunately, the nation's federal deficit is forecast to grow significantly over the next ten years. One of the inescapable results is that as debt continues to accumulate and compound, and interest rates increase from historically low levels, net interest costs are likely to double over the next decade. As interest costs rise, these costs will crowd out important investments in our future that fuel economic growth such as infrastructure, research and development and education. Importantly, a growing debt burden diminishes our flexibility and the ability to respond to unexpected challenges while increasing the risk of a fiscal crisis.

To professionals who have worked in the U.S. investment industry their entire lives, this situation is discouraging, particularly when the lack of concern appears so widespread. The *bond vigilantes* of past decades appear to have given up the fight with no one willing to confront the *eight hundred pound gorilla* that threatens the vibrancy of the U.S. economy. In this era of complacency, one wonders if this concern about rising debt is really worth the worry. Should we ignore the issue and join the multitude of investors who have adopted the phrase popularized by Mad Magazine decades ago*……"What, me worry?"*

In answer to this important question, many noteworthy economists have studied economic history in an attempt to determine what, if any, link exists between rising levels of country debt and future economic growth. In particular, two economic professors, Carmen M. Reinhart (University of Maryland) and Kenneth S. Rogoff (Harvard University), authored a sentinel book entitled *This Time Is Different* in which they studied economic history through the ages and the financial hubris of each era. The subtitle of the book is *Eight Centuries of Financial Folly* makes it perfectly clear through countless historical and statistical information that it is hard to truly believe “this time is different”. To be brief, the publication illustrates that once countries reached higher-debt status, those countries tend to experience lower annual GDP growth. Specifically, counties averaged 3.5% growth with central government debt below 90% of GDP in the previous year and 2.3% growth among countries with debt above 90% of GDP.

Importantly, a second study by Manmohan Kumar and Jaejoon Woo of the International Monetary Fund took a slightly different approach by studying five-year averages but arrived at the same conclusion – high-debt advanced economies grew 1.3% slower annually than their low-debt counterparts. Lastly, a third study by Stephen Cecchetti, Madhusudan Mohanty and Fabrizio Zampolli of the Bank for International Settlements show generally the same negative effects on economic growth from high debt levels.

So, with U.S. debt now approximately 105% of U.S. GDP, why is this problem being totally ignored by our elected representatives and the Wall Street intellectuals? Is it ignorance, arrogance or an unwillingness to be the bearer of bad news? In truth, it is probably a little bit of all three. Surely, our elected representatives do not want to confront the electorate with the bad news for fear of being ousted when up for re-election. Similarly, those running for higher office avoid the truth at all costs and believe their electability is enhanced by making sweeping promises that are harder to fulfill with each passing year. The picture is not a pretty one, especially when our elected officials prefer to "kick the can" down the road and let someone else deal with the nagging problem of paying our unpaid bills. The problem is that the end of the road is in sight and the consequences are not pleasant. Near term, it may not be far off when the rating agencies will once again re-evaluate the U.S. credit situation and may be forced to lower the U.S. credit rating again, having lowered the rating for the very first time several years ago. On top of this, there may come a time when the major purchasers of U.S. Government debt simply decide that the U.S. is no longer being fiscally responsible and curtail their future purchases.

It should be clear to everyone that the U.S. debt problem is significant and growing worse with each year. One thing is certain, the longer we wait to address the issue, the less flexibility we have to resolve the problem and the more painful the steps will be for us and those who come after us. For now, the markets are expecting renewed economic growth spurred by the recent massive tax cut. However, given the analysis of erudite economists working independently or with renowned international organizations, it is reasonable to conclude that growth of the U.S. economy will not reach the levels forecast by the administration, meaning that corporate earnings may also fall short of rosy forecasts. In other words, the world we will be dealing with in coming years may be quite different than the one we are currently expecting.

In the interim, Metis Value Partners is well aware of the looming debt issue and will continue to pursue our investment discipline based on the teachings of Graham and Dodd. We will focus our efforts on what we can control which includes a rigorous analysis of corporate balance sheets, free cash flow, sustainability of earnings and good corporate governance. Given this discipline and our view from the perspective of business owners, our three concentrated value strategies are constantly being evaluated in light of the ever-changing economic and market environments. We are grateful for your continued support and confidence and look forward to growing with you in the years ahead. We welcome any thoughts, comments or questions about this report or our portfolio strategies.

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