



VIEWS FROM CAMELBACK MOUNTAIN

Economic Sustainability

Over the past 20+ years it seems that the whole world has been focused on climate sustainability. Whether our incoming president believes it or not, human beings have been altering the climate on this planet for a long time. Burning carbon-based fossil fuels has increased the carbon dioxide level in the atmosphere and this has clearly caused global warming. Many leaders around the world have been busy pursuing strategies to reduce this trend. Popular solutions include solar, wind, and a wide range of other renewable energy sources. Powerful batteries, electric vehicles, carbon capture, as well as changing energy behavior are all being pushed. Expensive subsidies and costly restrictions on energy production and transportation have added enormous costs to our society. While these steps are important and necessary in the long term, they have had very little impact on carbon dioxide production in the short term as China and other developing nations build new coal fire power plants at a rapid pace. Many poor and emerging countries continue to have a terrible environmental record.

While much attention has been paid to climate sustainability, almost no one is focused on economic or financial sustainability. When George W. Bush arrived to the White House in January 2001 the U.S. government had, over its history, racked up an accumulated debt of less than \$6T. His unsustainable expenditures, exacerbated by the Obama administration, then followed by Trump and Biden have resulted in that debt now exceeding \$36T. Debt as a percentage of GDP, the annual interest expense of servicing the debt, and many other similar measures have all exploded.

Politicians justified these expenditures by claiming they were temporary or necessary to combat September 11, 2001, the Great Financial Crisis, COVID, and many other problems. We were introduced to Modern Monetary Theory by crackpot progressive “economists” who promised that debt levels no longer matter. Naive and foolish central bankers pushed interest rates to zero or even lower since inflation surprisingly was not developing (yet). Basic laws of economics and human behavior don’t often change. Sometimes foolish policies don’t result in immediate effects as other factors delay the arrival of eventual policy outcomes. Delayed, not repealed.

The arrival of serious inflation under the Biden administration was triggered by COVID, then supply chain problems and a behavioral shift in consumption from travel and in-person services to products used at home while trying to avoid COVID (computers, other technology, and home improvements). It was also caused by foolish monetary and fiscal policy from the U.S. Federal Reserve, the U.S. Treasury, and the Biden administration. It is now clear that the impact of Biden’s inflation resulted in the Democrats losing the White House and Senate to an incoming president who is at best, a scoundrel.

Financial markets, politicians, and central bankers hope inflation will fade away. If inflation is being caused largely by the national debt and ongoing deficits, inflation won’t just fade away. Bond investors will come to understand that they won’t be paid back in full because their bonds will be paid back in dollars worth much less than they invested. In this scenario, bond investors could eventually demand higher rates to compensate them for their losses.

Looking ahead, voters will see the cost of many things they buy continue to rise and when they ask themselves if they are better off than four years ago, they will vote out the folks they blame for inflation (as they did last month). Politicians from both sides will need to embrace austerity. We wish Elon Musk every success at reigning in spending, but the vast majority of government expenses are Social Security, Medicare, Medicaid, and other entitlements that are growing rapidly and are very hard to cut.

Unsustainable economic policies are a problem in the U.S., but we are not alone. Many foreign countries have even more serious problems. Generous social spending in Europe and elsewhere is even more unsustainable than the U.S. and it is helping to attract immigration unwanted by many voters. Unsustainable economic policies are a big factor in the instability of governments around the world and one of the reasons that our firm has avoided most direct foreign investments for 45+ years. This has been particularly beneficial to our clients over the past 10 to 15 years, as international markets haven't done as well as the U.S. markets. Every year we hear that valuations are lower in these foreign markets, but we believe there is a reason that valuations are lower. While the U.S. has its share of problems with regulation, immigration, and government handouts to favored industries and constituencies, these issues are far more prevalent (along with flat-out corruption) in other markets.

Intellectually, we do believe in geographic diversification, as not all economies will be impacted by the same conditions at the same time. We are happy to enjoy global diversification almost entirely through U.S.-based businesses operating in markets worldwide. International sales make up approximately 30% of the S&P 500 companies' revenues. We think that is enough exposure for most U.S. based investors.

The U.S. stock market has been red hot again in 2024 after a stellar year in 2023. This leaves markets close to all-time highs. Most current valuations now appear high and it's hard for us to find attractive stocks to purchase. We are concerned that inflation is not under control and the Federal Reserve will shortly have to stop lowering interest rates. If inflation gets significantly worse, they may have to raise rates in the not-too-distant future. That would not be a welcome development for the stock market.

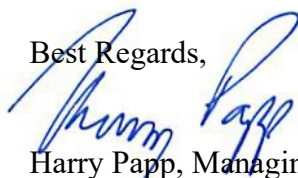
U.S. stocks have historically produced a total return of about 10% per year. Given the high level of the market, we'd be happy with a 5% to 7% annual total return on stocks for the next few years. We continue to believe it is dangerous to own long-term or even medium-term bonds. Given current bond market conditions, we believe short-term Treasury bills still offer the best mix of reasonable yield with low volatility. We expect to see serious problems with commercial real estate, particularly office buildings, that could spill into a problem for a number of regional banks.

The good news is the U.S. economy remains strong. GDP has been growing at 3% or a little better for quite a while and corporate earnings should see healthy growth in 2025. While others have consistently forecast a recession in the U.S. for the past several years, we did not. At this point, we still do not anticipate a recession in the U.S. over the next 12 months. Further out into the future we simply can't tell, but neither can anyone else.

The solution to our country's problems is restraint in the growth of expenditures, particularly entitlements. We also need a growing economy to help generate additional revenue to feed the government. Hopefully, a reduction in bureaucratic, growth-limiting regulation will help. Artificial Intelligence, medical and other technological breakthroughs can also help a lot.

We wish you a happy, healthy, and prosperous New Year.

Best Regards,



Harry Papp, Managing Partner
L. Roy Papp & Associates, LLP
December 31, 2024