AUGUST 2024

MARKET INSIGHTS

James Thorne, *Chief Market Strategist*

WELLINGTON-ALTUS

TRUMP'S FISCAL FRENZY:

Godfather of Modern Monetary Theory Warns of “Drunken Sailor” Spending

At this very moment, the U.S. faces a fiscal predicament which urgently calls for proactive measures following the 2024 presidential election. The nation's mounting debt crisis demands immediate attention, yet neither party has outlined a clear strategy to address this pressing issue. This election cycle has had no shortage of historic events, from the attempted assassination of Former President and Republican Nominee Donald Trump to Vice President Kamala Harris replacing President Joe Biden as the Democratic Nominee. Yet the underlying fiscal dilemma, if left unaddressed, risks triggering an economic crisis that even Wall Street may be underestimating—dismissing U.S. debt concerns as mere cautionary tales.

IN THIS ISSUE

- Mosler’s Warning
- The Fiscal Health of the U.S.
- Spending Track Records
- A Global Impact
- A Balanced Approach to Avoiding Economic Crisis
- What’s at Stake
- What Investors Need to Watch For

> Neither a borrower nor a lender be; For loan oft loses both itself and friend, and borrowing dulls the edge of husbandry.
>
> - William Shakespeare, *Hamlet*

For more insights from James Thorne, please visit wellington-altus.ca/market-insights
You can also follow him on LinkedIn and X.

Mosler’s Warning

Warren Mosler's evolving stance on Modern Monetary Theory[1] (MMT) has sparked a crucial debate that challenges conventional wisdom. As the godfather of MMT, Mosler's recent views surprisingly align with the non-consensus thesis I've advocated since late 2021. Simply put, deficits matter when policy enables spending money like a “drunken sailor.”[2] This convergence of thought carries significant implications for the economic landscape, particularly as we approach 2025.

Mosler now emphasizes two critical points central to my argument:

1. Rate hikes are inflationary: Contrary to traditional economic thinking, raising interest rates in our current high-debt environment can actually fuel inflation rather than combat it.

2. Drastic rate cuts are the solution: To effectively fight both inflation and deficits, Mosler advocates for significantly lowering interest rates, a strategy that aligns with my long-held position.

As we look towards the 2024 election and beyond, a pressing question emerges: Does Trump understand these economic dynamics? The risk for 2025 lies in the possibility of him winning the election and implementing policies reminiscent of the 2016 approach. Have Trump's economic views evolved in tandem with Mosler's, adapting to the post-pandemic economic realities? The same question now applies to Harris.

The potential for a credit event like that which took place in the era of Former U.K. Prime Minister Liz Truss looms large if a new administration fails to grasp these nuanced economic principles. As investors and policymakers navigate uncertain terrain, understanding the shift in economic thought championed by Mosler and echoed in my analyses becomes not just academically interesting but crucial for economic stability.

The convergence of Mosler's recent statements with my long-held position isn't just a vindication—it's a warning. As we stand at the precipice of potential economic upheaval, the question isn't whether change is coming, but whether those in power will heed these warnings before it's too late.

The Fiscal Health of the U.S.

The 2024 presidential election is shaping up to be a pivotal moment in American history. Looking beyond the personalities involved or immediate policy implications, the looming fiscal predicament threatens to overshadow the next administration's tenure. Both major parties have thus far failed to offer focused, comprehensive policies to deal with America's unsustainable fiscal situation. This oversight sets the stage for a potential economic crisis that Wall Street is largely ignoring, comfortable in its long-held belief that U.S. debt concerns are perennial warnings that never materialize.

Total U.S. federal debt now stands at a staggering 122% of gross domestic product (GDP), more than double its level in the early 1990s. Recent years have seen annual deficits averaging 9% of GDP, a level that would have been inconceivable just a few decades ago. The Congressional Budget Office's latest projections paint a grimmer picture—without corrective action, federal debt held by the public is expected to surge to 116% of GDP by 2034. This trajectory is not just unsustainable—it's potentially catastrophic.

The gravity of the situation is underscored by recent actions from credit rating agencies. Fitch Ratings downgraded U.S. long-term foreign currency debt in August 2023, citing fiscal deterioration over the next three years and erosion of governance. This followed a similar downgrade by S&P Global Ratings in 2011. These actions serve as stark warnings that the international financial community is growing wary of America's fiscal health.

[1] Macroeconomic theory that countries which spend, borrow and tax in a currency they fully control (such as the U.S. the U.K., Canada and Japan) are not constrained by federal government spending as they can simply print more money.

[2] Warren Mosler Warns the U.S. Government is Spending Like a Drunken Sailor, *Odd Lots* podcast, Bloomberg, July 8, 2024.

This fiscal trajectory bears an uncomfortable resemblance to the U.K.'s "mini-budget" debacle under Truss in 2022. Her government's announcement of unfunded tax cuts led to market panic, a plummeting pound, and skyrocketing government borrowing costs. The crisis culminated in Truss's resignation after just 45 days in office, marking one of the shortest premierships in British history. America now faces its own potential "Truss moment" in 2025-2026 if drastic action isn't taken to curb spending and reform entitlements.

The market's complacency in the face of these warnings is reminiscent of past seemingly minor events triggering larger crises. Many on Wall Street dismiss the risk, suggesting they've heard warnings about U.S. debt for decades with no consequences. This attitude, however, ignores the lessons of history and the potential for a tipping point where global financial markets suddenly lose confidence in U.S. fiscal management.

Spending Track Records

Both Republicans and Democrats have contributed significantly to the current fiscal predicament during their respective terms. According to the Committee for a Responsible Federal Budget, Trump approved US$8.4 trillion of new 10-year borrowing during his full term, including US$4.8 trillion excluding COVID-19 relief. Major debt increases under Trump included the *Tax Cuts and Jobs Act* (US$1.9 trillion), *Bipartisan Budget Acts* (US$2.1 trillion), and COVID-19 relief bills.

Biden, for his part, has approved US$4.3 trillion of new 10-year borrowing in his first three and a half years, including US$2.2 trillion excluding the American Rescue Plan. Major increases came from appropriations bills (US$1.4 trillion), the infrastructure law (US$439 billion), and student debt actions (US$620 billion). While some of this borrowing was justified by the pandemic and its economic fallout, much of it was unrelated and represents a continuation of fiscal irresponsibility.

Neither candidate nor party to date has presented a clear, comprehensive plan to address the looming fiscal predicament. Their campaign rhetoric has focused on other issues, leaving this critical threat to America's economic future largely unaddressed. This silence is particularly concerning given the potential consequences of inaction.

A Global Impact

The true peril of inaction extends beyond the upcoming election, reaching into late 2025 and 2026. While issues such as trade relations with China, immigration policy, and conflicts in Europe and the Middle East are undoubtedly important, they must not overshadow the existential threat posed by America's potential debt crisis. Unless bold actions are taken to curb spending, increase revenues, and reform entitlement programs, the U.S. could soon confront a bond market upheaval, currency crisis, and economic collapse that would dwarf the 2008 financial crisis in severity and global impact.

The potential for a U.S. "Truss moment" is not just a theoretical concern. The market reaction to Macron's snap election announcement in France demonstrates the sensitivity of financial markets to political shifts. French government bond yields rose sharply, and the spread between French and German 10-year bonds widened significantly. This episode of volatility did not seriously impact the cohesion and stability of the European Union—however it echoes past instances where seemingly minor events triggered larger crises.

Given America's larger debt burden and central role in the global financial system, the repercussions of fiscal mismanagement could be far more severe and have a truly global impact. The U.S. dollar's status as the world's primary reserve currency, while providing significant advantages, also means that a loss of confidence in U.S. fiscal management could trigger a global financial crisis of unprecedented proportions.

The rapid market rejection of Truss's plan led to its swift abandonment, underscoring the dangers of such policies in today's economic landscape. Initially praised by some American conservatives, Truss's supply-side initiative drew direct comparisons to Trump's strategies. However, the disastrous failure of Truss's

economic plan, which caused a sharp decline in the pound and a spike in government borrowing costs, stands as a clear lesson for U.S. policymakers.

Should Trump revive similar policies today, he may trigger his own "Truss event"—a sudden economic upheaval leading to market turmoil, increased borrowing costs, and potential policy reversals. The Truss experiment illustrates how populist economic ideals can collapse dramatically when confronted with economic realities, particularly in a setting characterized by the current extreme debt levels.

A Balanced Approach to Avoiding Economic Crisis

According to the Congressional Budget Office, the scheduled expiration of the *Tax Cuts and Jobs Act* provisions at the end of 2025 could alleviate some fiscal pressure by increasing tax revenue, potentially reducing the deficit by about US$1.5 trillion over a decade. However, this could also slow economic growth and affect job creation. The approach to these expiring cuts will be a significant debate point in the 2024 election, with some politicians advocating for extension and others for expiration or alternative tax policies. It's important to note that while expiring tax cuts may boost short-term revenues, they won't address the underlying structural issues of the long-term deficit.

Former U.S. Secretary of the Treasury Larry Summers has expressed deep concern about the U.S. national debt and fiscal deficit, calling it potentially the most serious problem in American history. He highlights the unsustainability of the current situation, exacerbated by demographic pressures and increased spending needs. Summers advocates for leveraging opportunities like the 2025 tax cuts expiration for serious deficit reduction efforts. He suggests strengthening International Revenue Service (IRS) enforcement to collect taxes owed from wealthy individuals and corporations as an initial step before considering broader tax increases or spending cuts. Summers stresses the need for a balanced approach, careful spending priorities, and revenue increases to tackle the deficit comprehensively, underscoring the urgency and severity of this fiscal challenge.

I side with Summers and firmly believe that a balanced approach is needed. Mosler's pivot also suggests that advocacy for extreme progressive left MMT policies is losing support. Furthermore, extreme right supply-side economic policies are a no-go. A balanced approach that focuses on growth and deficit reduction is essential. The time for extreme economic policies is over—the debt problem is real and requires pragmatic, measured solutions. The credit markets' positive response to the U.K. Labour Party’s historic victory and economic platform developed with the help of Former Bank of England Governor Mark Carney, signals the roadmap.

Addressing the debt will require a multi-faceted approach beyond simple spending cuts or tax increases. The next administration needs to implement a balanced strategy that includes slower growth expectations, higher taxes, controlled spending, and strategic budget cuts. This approach must be carefully calibrated to avoid triggering a recession while making meaningful progress on debt reduction.

The U.S. can draw valuable lessons from other countries that have faced similar debt crises. Japan, for instance, has managed high debt levels through a combination of low interest rates, high domestic savings rates, and a strong export economy. However, this model may not be entirely applicable to the U.S. due to differences in economic structure, demographic trends, and the global role of the U.S. dollar.

The European debt crisis of the early 2010s also offers important insights. The austerity measures implemented in countries like Greece and Spain, while controversial and painful, demonstrated the challenges and potential repercussions of sudden fiscal tightening. The U.S. must find a balanced approach that avoids the pitfalls of both excessive austerity and unchecked fiscal expansion.

What’s at Stake

The global implications of a U.S. debt crisis cannot be overstated. As the world's largest economy and issuer of the primary reserve currency, U.S. fiscal policies have far-reaching effects on global financial stability. A failure to address the debt could lead to increased volatility in global markets, higher borrowing costs for emerging economies, and disruptions in international trade and investment flows.

Investors must remain vigilant in the face of these challenges. Rather than relying on historical patterns or assuming warnings about the consequences of U.S. debt will never materialize, investors should demand clear and actionable plans from political leaders to address this looming concern. If no such plans are forthcoming, recognition of a significant credit event in the very near future should prompt the development of strategies to preserve capital and navigate potential market turmoil.

The stakes have never been higher, and the time for decisive action is now. The next administration, whether led by Trump or Harris, will face an immense challenge in addressing the national debt. The need for a comprehensive, balanced approach to fiscal policy is paramount. By learning from past mistakes, both domestically and internationally, the U.S. can develop strategies that promote long-term economic stability and growth.

However, the window for action is rapidly closing. The 2025-2026 timeframe emerges as a potential inflection point, where the consequences of fiscal mismanagement could come to a head. The ability of the next administration to navigate this challenging landscape will determine not only the economic future of the U.S. but also its continued leadership role in the global financial system.

As voters focus on personality-driven politics and short-term concerns, they risk overlooking the bigger picture. The true narrative of the 2024 election hinges on whether the elected leader can successfully navigate the challenging financial landscape awaiting in 2025 and beyond. Addressing the debt problem may lead to a substantial slowdown in economic growth, mirroring past instances of fiscal consolidation. However, the alternative—a full-blown fiscal crisis—would be far more devastating.

The era of kicking the fiscal can down the road is coming to an end, and the consequences of continued inaction could be severe. As the election approaches, the question remains: will America face its fiscal challenges head-on, or risk a "Truss moment" that could reshape the global economic landscape for generations to come?

What Investors Need to Watch For

The intersection of politics and financial markets has always captivated investors and analysts. The theory of the presidential election cycle, first proposed by author and creator of the *Stock Trader’s Almanac* Yale Hirsch in 1967, suggests a predictable stock market pattern tied to the president's four-year term. Historically, the first two years of a president's term often see weaker stock performance, while the latter two years tend to be stronger. An analysis of market data between 1933 and 2015 revealed that the third year of the presidency coincided with the strongest average market gains, while the mid-term election year produced the weakest returns. If the four-year cycle holds, risk assets should perform well into late 2025. But investors need to prepare for a significant correction in 2026.

That said, the current fiscal situation may render these historical patterns less reliable. The unprecedented national debt levels and the potential for a fiscal crisis could overshadow typical election-cycle trends, creating a more volatile and unpredictable market environment. Investors who rely too heavily on these historical patterns may find themselves caught off guard by the unique challenges of the current fiscal predicament. If the Trump administration ignores credit market concerns, the tail risk of a 1987 type crisis could result.

The looming debt crisis poses a critical challenge for the next administration. As Shakespeare wisely cautioned, "Neither a borrower nor a lender be; For loan oft loses

both itself and friend, and borrowing dulls the edge of husbandry." This timeless advice resonates strongly in our current economic landscape, where even Mosler acknowledges that deficits do indeed matter.

Trump's approach to this fiscal predicament will be pivotal for market stability and economic growth. Investors must prepare for potential dramatic rate cuts in 2025 as a response to mounting debt pressures. The markets are keenly watching whether either major party’s nominee will heed the warnings of fiscal responsibility or continue on a path of unchecked borrowing.

Early signs indicate that Trump is shifting towards a more centrist economic policy stance. In a departure from his previous approaches, he has expressed willingness for Jerome Powell to continue as Chair of the U.S. Federal Reserve until the end of his term in 2028. Additionally, reports suggest that Jamie Dimon, CEO of JP Morgan, could serve as Secretary of the Treasury in a second Trump term. The choice of JD Vance as a vice presidential candidate further reinforces this shift, with his pro-innovation, pro-crypto, and pro-U.S. economic views. These moves signal a potential avoidance of previous mistakes, indicating a more measured approach to address the current era of significant debt levels. However, it is important to note that it is still early days, and the full extent of these changes remains to be seen.

As we enter an era of fiscal dominance, the need for deficit reduction and sustainable economic policies has never been more urgent. Investors should remain vigilant, focusing on secular growth opportunities while preparing for increased market volatility. Flexibility and adaptability will be key in navigating the complex interplay between political decisions and market reactions in this evolving economic landscape.

The information contained herein has been provided for information purposes only. The information has been drawn from sources believed to be reliable. Graphs, charts and other numbers are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual’s objectives and risk tolerance. This does not constitute a recommendation or solicitation to buy or sell securities of any kind. Market conditions may change which may impact the information contained in this document. Wellington-Altus Financial Inc. (Wellington-Altus) is the parent company to Wellington-Altus Private Wealth Inc. (WAPW), Wellington-Altus Private Counsel Inc. (WAPC), Wellington-Altus Insurance Inc. (WAII), Wellington-Altus Group Solutions Inc. (WAGS), and Wellington-Altus USA Inc. Wellington-Altus (WA) does not guarantee the accuracy or completeness of the information contained herein, nor does WA assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Before acting on any of the above, please contact your financial advisor.

©2024, Wellington-Altus Private Wealth Inc., Wellington-Altus Private Counsel Inc., Wellington-Altus Insurance Inc., Wellington-Altus Group Solutions Inc., and Wellington-Altus USA Inc. ALL RIGHTS RESERVED. NO USE OR REPRODUCTION WITHOUT PERMISSION. www.wellington-altus.ca.