Ep. 169: Economic Outlook w/ Brad + Patti

Patti
Hi, everybody. Welcome to the Patti Brennan show. Whether you have $20 or 20 million, this show is for those of you who want to protect, grow and use your assets to live your very best lives. First and foremost, I want you to know that our director has told me skip the crap with the introduction and just get to the point. I always fast forward the intros, so I'm going to fast forward the intro, but I do want you to know those of you who are watching, we have a very different layout here. It's much more casual, because this is real life. I'm still here in my sneakers, and I've got Brad Everett, our Chief Investment Officer here with me. This is what we really do. So, Brad, welcome to the show. Let's get to it. Let's talk about what to expect going forward.

Brad Everett
Thanks, Patti. I like the key financial sign you hung up in your living room here!

Patti
Why don't we start out today talking about the macro, because that's what people are all talking about. The Federal Reserve, interest rates, the election and the amount of debt we have. So, have at it.

Brad Everett
Yeah, I think an important thing is that we don't know the answer entirely. But for this upcoming year, (which really started last year), when you think about just fed positioning, for the most part its very much expectation driven. Jerome Powell makes an announcement and then nothing really happened with the stock market, because everybody expected it. Then, he talks for an hour, and the market goes wild based on what he sees going forward. And I think that's largely what's happened recently, right? Just go back a few weeks to the middle of December. He had a Fed meeting and lost in all the hubbub was that they lowered rates by a quarter of a percent, which is exactly what everybody expected. But from there, he proceeded to say that they just kind of added a little caveat that they may not decrease rates as maybe as far and as fast as he would have suggested in prior meetings. So, a lot changed in those few days. There was a big impact on the stock market itself. I think that very day, the Russell small cap index was down about four and a half percent, the NASDAQ was down north of 3% and especially sectors that are sensitive to interest rates.

Patti
So, we had the election, and you had this great Trump bump, right? It went nuts. Then Powell talked and the market plummeted, and it really hasn't recovered. It's still digesting all that information in terms of what that really means. Isn't it interesting that he chose that time to make that announcement?

Brad Everett
Maybe, I guess that meeting is always scheduled at that time. Every year there's another one coming up. They do it all year long.

Patti
I think it's interesting only because the election was over and maybe they're feeling warm and fuzzy. The economy is humming along, and employment is full. They don't have to worry as much about lowering interest rates to prevent a recession or get us out of a recession, right? Because nobody expects a recession anymore.

Brad Everett
Yeah, so if you had an opportunity to deliver that kind of news, you would maybe want to do it when everyone was fairly optimistic.

Patti
Exactly, you got it. So, you get the Trump bump, everybody's warm and fuzzy, and the economy is doing really well. And what I think is fascinating is, to your point, they lowered rates, but mortgage rates went up. Everything else went up including the 10 year. It's all going up based on expectations, right?

Brad Everett
Yeah. So, it's funny because what most people interpret what he was saying is good news, right? The economy is stronger than they thought it would be. But what does that mean exactly in terms of predicting market prices of things. The reason that it was interpreted by a few markets as being negative is if he's saying that the economy's stronger than they thought, it means that they don't need to lower rates to help support a failing economy. A strong economy tends to be a push toward higher inflation. A lot of it came down very quickly, right? I think the last call it half or three quarters of a percent has been pretty stubborn.

Patti
It's very stubborn. It's hard to get from where we were, where we are, down to 2%. And then that begs the question, is that really all that important to get down to 2% because the economy is doing just fine based on interest rates today. Companies are still making money, even though they have higher interest costs. Municipalities are still doing fine, even though they must pay more with the municipal bonds. What's the real push to lower rates if everything's humming along, right? That's my gut feeling, Brad, I don't know about yours. I just think that they don't have to rush. And it gives them more ammunition if another crisis were to occur. Because that tends to happen. Let's say that somebody attacks us. What's the Fed going to do? It's going to lower interest rates. Well, if they're already low, how much lower can they go? Now they're pretty high so they've got more room to help.

Brad Everett
They probably prefer to be in a range where they could go in both directions.

Patti
Bingo, exactly. All right, so that's interesting about interest rates. And you mentioned something about markets and values and companies. How do interest rates impact the value of companies? Growth companies versus, say, others.

Brad Everett
So, I think there's a change in interest rates. I think it affects different kinds of companies differently, depending on, you know, their balance sheets and things like that. But in a broad sense, value versus growth is usually one that becomes fairly apparent right away. Growth companies expected earnings are 10 years down the road, right? They might not make any money right now, but they will in 10 years from now. When rates are higher, I'm not so excited about their earnings 10 years from now. I'd much rather invest in companies that make money right now like Johnson and Johnson, or somebody sells things at the grocery store.

Patti
Because you know what, why bother? Why take that risk?

Brad Everett
Then if you go up and down market cap, the bigger companies tend to be better capitalized than smaller companies. Small cap companies tend to have higher debt levels, and so they're sensitive to the cost of their debt going up a little more than a large cap company would be.

Patti
Right, and that interferes with their ability to reinvest into the company, into the things that will make them grow, because they've got higher interest rate costs.

Brad Everett
Yeah, or they may even choose just to not borrow at all.

Patti
It takes money to grow a company, that's for sure. So that's interesting; we understand the interest rates, and we understand what happened with the market based on the Federal Reserve. What about the election? What do we think about what Trump is talking about? Again, we had the Trump bump. All fantastic. He's great for business. He's going to get rid of all these cumbersome regulations for these companies. But now people are beginning to digest some of the impacts, some of the things that he's talking about.

Brad Everett
Yeah, I think the net effect has almost been close to zero, right? But like you said, you had a sharp increase, and then it just reversed for the most part. We've just kind of sat, depending on what index you're looking at, 4-5-6% off highs. And here we kind of sit.

Patti
What is it in particular? Is it the talk of tariffs? Is it the talk of immigration? Is it the deficit?

Brad Everett
I think it could be all those, right? You're still so unclear. I think you've always had to separate campaign promises from what can actually happen. I think you hit on all the big ones. I think the tax and Jobs Act will be a big one.

Patti
Let's go to the tax and Jobs Act. Let's talk about what we think and what he's going to do, and the impact on some of this other stuff.

Brad Everett
I mean, in a general sense, it's set to expire. It's a big thing, so you must figure out what to do with that, we have a pretty substantial annual deficit. Call it $1.8 to $1.9 trillion a year.

Patti
What that means is we are spending $1.8 trillion more than we're bringing in in the form of tax revenue.

Brad Everett
I think the 2025 projection is something like $7 trillion in expenses and $5.1 or $5.2 trillion in tax revenue. I think in a lot of ways, it is an interesting grand experiment. You can get economists on both sides saying…are taxes restrictive to economic growth? Maybe to some degree they are, but I think we have a good period of evidence. If you're thinking of the projections for 2025 you've got a $2 trillion gap, a deficit. That's not outrageous for us. I mean, we've been kind of doing that. So, since these tax cuts were put in place, our debt to GDP has expanded tremendously. But that's been at a time with good economic growth. If you could duplicate the last eight years, you would do it repeatedly, and you would be a big country.

Patti
What I'm hearing is, even though our economy has been growing and growing, and the debt grew faster, we still owe more than the growth that was achieved during that period.

Brad Everett
The increase in growth by not having to pay the taxes was not enough to fuel the difference between the two numbers. But that doesn't mean that it could cover a 10% or 15% deficit. We don't know. We just know it can't cover 28%, that's so high, right? Ultimately, maybe we found one thing that doesn't work. It almost seems like nobody will ever have the political will to do this, but some combination of raising taxes and lowering expenses is probably what has to be done. Unfortunately, I don't know if there's a combination of those that can happen.

Patti
And to really boil this down, Brad, basically what the government does every year when it has this $2 trillion deficit (it still has these expenses) …it issues treasuries which adds to the debt. It's like credit cards for people who aren't living within their means.

Brad Everett
I mean, think of the percentages, right? If you had $70,000 in expenses and only $50,000 in income, like you be borrowing $20,000 a year to cover your living expenses. That's a pretty that's a pretty big chunk adding up if you only make $70,000 a year. So, to put it in perspective, I think our debt is $32 to $33 trillion at this point, so that that deficit is adding to that number every year. If we had no expenses

at all and just took in the same tax revenue, it would still take us seven years to pay it off. It's a lot of money, so how does it play out? If Donald Trump is campaigning on extending that and even if he did let it lapse, it wouldn't solve it, right? I thought KPMG has a thorough spreadsheet of how they how they could probably estimate maybe over the course of seven or eight years, like a $4 trillion benefit to those things. Most of it is individual taxes, not corporate or anything else. But you know that would cover some of it, maybe 20-25% of the deficit annually. He wants to extend it. Congress obviously isn't going to get away. They're probably on his side also. So again, I don't know how you do it, but someday you must.

Patti
It is going to be very interesting to see how this unfolds, because we also have on the other side this Doge, this non-government agency, with Elon Musk and Ramaswamy. And it's going to be hard for them to cut as much as they said that they were going to cut; $2 trillion a year. I think that reality is beginning to sink in. And it will. And the question will be, how do we respond? We'll get to that in a minute. But, let's talk about some of the other things that Trump was talking about to raise capital…tariffs.

Brad Everett
Yeah. That's a, that's a vague one, right? We don't have a whole lot of detail there. If we think we understand the goal of what he's trying to do. Who are the countries who are buying more from, than we're selling to? Those would be the places that you would go if you're trying to fix trade imbalances. China is far and away, the favorite to receive tariffs.

Patti
He was talking about a 60% tariff on China. Wouldn't they retaliate and just hit us with a tariff for all the stuff that we sell to them? So, tariffs, and the issue that I think that is important as it relates back to the prior conversation with tariffs is…we're going to hit them with a tariff, so they're going to hit us with higher prices, because we're still going to buy stuff from them, right? So now we've got higher prices and there's inflation. That's going to be the Federal Reserve. The Federal Reserve, again, might see the writing on the wall. That might have been another reason why they said, you know, we're going to kind of watch things here and see how this thing unfolds. And is it really saber rattling as a negotiation tactic?

Brad Everett
If it is, what's the behavior that he's trying to get? You want to believe that it's possible, it's just total nonsense.

Patti
Okay, so I'm going to ask a really dumb question. Why are trade deficits so bad? Why is that something that needs to be fixed?

Brad Everett
I'm not sure that they do, to be honest.

Patti
It's very interesting that you say that, because I read an article that agrees with you!

Brad Everett
I think it goes back to the whole comparative advantage. In econ, doesn't China making all our kids toys just allow us to work in tech companies instead? In the short term, if you have a mismatch in skills or capital, you can't take advantage of those things. I just have a hard time believing that the United States is suffering from that.

Patti
That is interesting, from a textbook perspective…if we're buying all our stuff or toys from China, is that the reason why Toys R Us, for example, went out of business? And all those people lost jobs, so we're not as competitive. It hurts our companies and our industries because we're going overseas.

Brad Everett
Well, yeah, and not to be unsympathetic to that, right. In the short term, that kind of frictional unemployment is very painful for families to go through. If you have a toy shop here, and you sell your squeaky toys for $10 but you can buy them on Temu for $1, that obviously hurts that family. But I think if you're managing an entire economy with 330 million people in it, it's hard to do both at the same time. This is good for all of us, versus this is bad for you. I hope that it doesn't stay bad for long, and maybe we can soften the blow a little bit. But we probably should just keep buying our toys from them.

Patti
Okay, got it. I love the idea because that's what really happens. We talked about the S curve. What happens when things get uncomfortable or when things get hype and then they begin to die down. We innovate, we create new things, we have the soil here in the United States to do so, and the freedom to be creative. And capitalism, the way that we do it in the United States, does encourage it, right?

Brad Everett
It's not promised to be pain free.

Patti
No. And I think what may be in the back of his mind is a little bit of PTSD. I don't know, God only knows. Nobody knows that man, certainly not me. But I'm wondering if he's got a little PTSD from COVID, realizing that we are dependent on them for a lot of stuff, even for the chips and all that kind of stuff. You know that the saber rattling with China…their economy, is not doing well at all. They're in trouble and they're creating some trouble. So, we've talked about the impact of tariffs. It's not just a revenue builder; it's a protectionist. It's a way of keeping certain industries in our nation so we're not dependent on others, right? So, having said that, let's talk a little bit about productivity, labor supply, and immigration. What do you think about that?

Brad Everett
Yeah, I think that's the other major one. We've talked about it for years, but at a higher level, GDP growth is just a change in the labor force plus a change in productivity. Labor Force is a tough one.

Just to keep a population doesn't every family have to have 2.1 children or something like that. We're closer to 1.6 so forgetting immigration, our population would decline, right? Which obviously would cause negative changes of labor force.

Patti
Case in point… that one child policy that China had many years ago is really hurting them now. So that's an interesting example of the labor force and the importance of replacing the population.

Brad Everett
Yeah. It happens slowly, right? And you might not notice it for a while, but we've been on this track for a long time. I think if you had more restrictive immigration, it would be tough to make that side of the equation work, right? Hopefully, you have figured out some way to make legal immigration easier. Again, I'm not a politician, but we need people to work.

Patti
Yeah. And you know, the thing about it Brad is, I think about it from a practical perspective…who's going to take care of us when we all get older? We are an aging population, and people overseas come in and they take care of us. They're the nurses and nurses' aides, etc. They do the jobs that Americans don't want to do anymore. I think that that's a really important point. I don't know what the answer is, but I understand the border issue and the fact that we must keep the bad guys out, right? There's got to be some happy medium.

Brad Everett
I mean, the other thing that you would use to increase GDP would be productivity, and that one is way more volatile. It's a little less predictable. There's a period I think in the 50s, it was not north of 3% a year, just in productivity growth. The portion of GDP that was from productivity was pretty high. But so anyway, in the 50s, you have this great productivity stretch, in the 70s, less than, like, 1% of the GDP came (everybody's hippies). Really nothing goes on, it just seems to come in waves based on new technology. If you know that AI can make us all 2.5% more productive, I think we'd be in good shape.

Patti
That's interesting. The takeaway from all of this is the economy is doing better than anybody expected at this point in time, after the Fed had increased interest rates. The interest rates are probably going to stay higher for longer and it could have some impact on markets, bonds and things of that nature. The election is going to have an impact. We just don't know what. Again, it could be a lot of saber rattling, or it could have significant impact on how much we must pay for stuff from overseas, whether or not people are going to be able to come into this country, and tax laws. So why don't we end it there? Because I think that's a good way for us to kind of tie it up into a nice, neat little bow. I'm going to ask you to come back to the next podcast. You and I are going to talk about all this stuff that is going on. What are we doing about it? How can we help everybody watching and listening? Perfect. I'm going to wear the same outfit. Okay, me too. Thank you so much for joining us. Join us for the next one. Take care.