Quarterly Newsletter

Roth FINANCIAL PARTNERS

Q1

Apr. 2021

The Boogeyman

By: Eric Johnson
Financial Advisor

My son Abe just turned fourteen months, but I know there will be a day when he will deal with the same fears that we, or our children, dealt with when we were younger: the fear of a “boogeyman” hiding in our closet or under our bed. My childhood fears were connected to a Nickelodeon television series called “Are You Afraid of the Dark?” – it turns out, I was! The specific character that haunted me at night after my parents tucked me in, prayed with me, and said goodnight was “Zeebo the Clown.” As a now thirty-something man, I am perplexed by why such a dweeby-looking clown caused so much fright. There is no denying, though, that the fear of Zeebo and other make-up wearing jokesters influenced my sleeping habits for multiple years of my childhood.

Today, we are dealing with multiple other “boogeymen” that may cause us a lack of comfort and a fear for the future, even (and maybe especially) as adults. However, if we look at the realities and turn down the emotional factor of the fear of higher government debt and higher inflation, we hopefully can calm our nerves and reduce the fear that these monsters are going to “get us” when we are not looking.

The discussion below is a bit detailed, but the main thing I hope you take away (if you decide to dive down the rabbit hole!) is that the concepts of government debt and inflation are complicated. There is still a lot we do not know about the impact of the level of government debt (there is not a magical tipping point as to how much is “too much”) and what is the main cause of inflation (and what makes it more than a transitory phenomenon.) It is important, though, not to let emotional views of the concepts to impact investment decisions, because it is when emotions are at their highest that we are liable to make mistakes.

700 Rockmead Dr., Suite 158
Kingwood, TX 77339
Phone: 281-973-8816
Fax: 281-973-8716
www.rothfinancialpartners.com

The Balance Sheet

The budget and balance sheet for the U.S. government is different than for a household. While households can fully pay off their debt (and feel great doing it!), the U.S. economy (and by extension the U.S. government) relies on debt and the assets that debt creates to have liquidity and to grow. For every debt or liability, there is a corresponding asset for someone else. If you have a mortgage, that is a debt that you are required to pay back and would be considered a liability on your personal balance sheet. Your mortgage, then, is considered an asset for the bank or lending institution that loaned you the funds for your house.

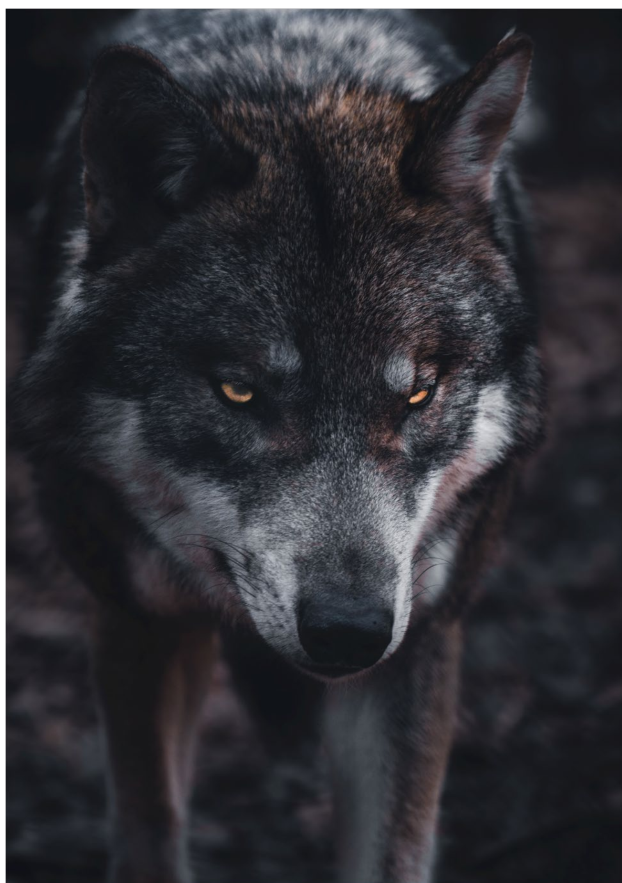
Similarly, debt incurred by the U.S. government, which is a liability of the U.S. government, is an asset on almost all our balance sheets. Whether it's in fixed income funds that we own or the pensions/Social Security that we receive, the relatively low-risk nature of U.S. government debt is helpful to us as investors. It provides the stability (in comparison to equities) to hold onto our investment plans, especially when things get choppy in the stock market (as was the case one year ago.) Though there are some foreign governments that own U.S. government debt, that amount is only roughly a quarter of total debt (with Japan being the largest foreign owner.)

Debt, in and of itself, is not a bad thing. Surely there are bad types of debt, such as overwhelming credit card debt with exorbitant interest rates, but debt can also be used for productive purposes such as starting a business or purchasing a house for your family to reside. It is important to encourage productive investment and the risk-taking that is involved in that investment. Which items and what investments are considered productive is the big question and disagreement, which is understandable but, in my estimation, will never be fully resolved and not worth fretting over.

If the U.S. government were to pay off its debt, it would either have to write down the debt (and thereby remove trillions of dollars of assets that we as investors hold while seeking secure and stable investments) or pay it off over time via a surplus. For there to be a government surplus (meaning income is greater than expenses and thereby saving money to knock down the total amount of debt), some other sector, such as U.S. households or foreign investors, would be required to be "dissaving" or spending more than they save (which as a collective of U.S. households has gotten us in big trouble in the past.)

Currently, our total U.S. government debt is about the size of the U.S. annual gross domestic product ("GDP"), or the amount of goods and services produced with the U.S. each year (equaling a roughly 100% debt/GDP ratio.) However, if GDP growth is greater than the costs of interest on the debt plus any new deficits, then that ratio will stabilize and potentially decrease. There is no magic "tipping point" of ratio that is good or bad. Right now, the U.S. government can borrow for 10 years at a negative real (or after-inflation) interest rate. That will not be the case forever. Currently, though, the true burden of debt relates more to the ratio of interest payments on the debt relative to GDP as opposed to the total debt.

Inflation Intimidation



One worry that comes from looking at the debt/GDP ratio is the fear of inflation. Some pundits state that the only way to get rid of the U.S. government debt is to "inflate it away." In their eyes, if the ratio of debt/GDP gets too high, then inflation is just around the corner, ready to strike. However, a quick counterpoint: Japan currently has a debt/GDP ratio of over 235% and they are not fighting an inflation battle, but instead one of deflation (where prices are decreasing.) The demographics of the country are considered one possible reason for this phenomenon.

The U.S. has had a complicated history with inflation. Lots of you remember the late 1970s and early 1980s when inflation soared before being trimmed by a harsh medicine of higher interest rates via Federal Reserve ("Fed") Chairman Paul Volker. Since that time, however, overall inflation has been calmed immensely (though there are pockets of expenditures, such as health care and college tuitions, which have bucked that trend.)

Decade	Average Inflation	Beginning Annual Inflation	Ending Annual Inflation	Maximum Annual Inflation
1960s	2.30%	2.10%	4.70%	4.70%
1970s	5.90%	4.70%	8.00%	10.00%
1980s	5.30%	8.00%	3.70%	9.60%
1990s	2.40%	3.70%	1.50%	4.40%
2000s	1.80%	1.50%	1.60%	2.50%
2010s	1.60%	1.60%	1.40%	2.10%

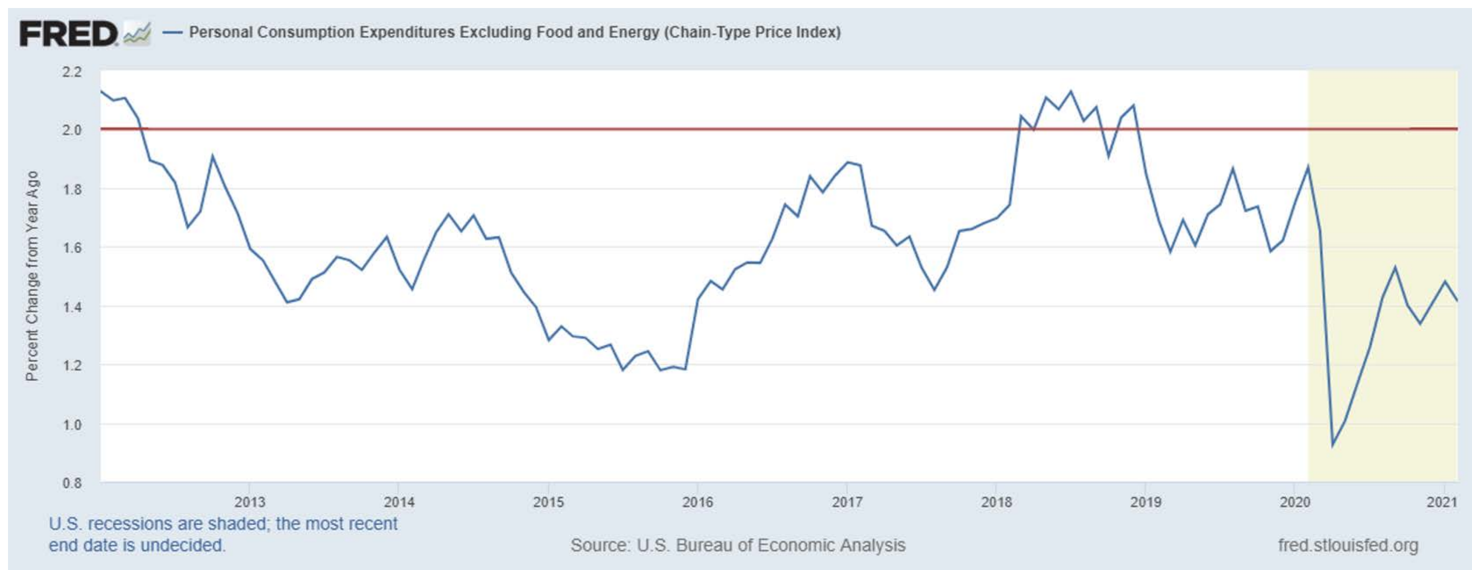
Source: Annual % change in Personal Consumption Expenditures via St. Louis Fed

Inflation has increased in stature as a "boogeyman" as of late due to the fiscal and monetary response to the COVID-19 pandemic over the past twelve months. The goal of the response was to soften the near-term impacts on the U.S. and global economy from a never-before-seen threat. One reason for the worry relates to an increase in the "money supply," also known as M2, which occurred due to multiple factors (stimulus payments made to keep the economy afloat, less spending during lockdowns, U.S. government debt purchased by the Federal Reserve, etc.)

The M2 statistic, which totals all the cash, checking deposits, savings deposits, and money market funds currently held in the U.S., increased somewhere between 20%-25% in the past year. If you have heard the phrase to describe inflation as "too much money chasing too few goods," then that statistic could alarm you. We should note a couple of things though: first, our economy is much more focused on services as opposed to goods compared to previous inflationary battles, so the easily spouted out phrase does not fully apply. Second, though the amount of money supply has never been higher, we could also say the same thing about last year and even four years ago. The money supply has not shrunk from a year-over-year perspective in the past couple of decades. Third, there is not a strong statistical relationship between the previous year's increase in M2 and the next year's inflation rate.

Do not get me wrong: inflation is important. It heavily influences employment, consumer spending, investment, and international trade (through currency and trade balance impacts.) However, it is best to think of inflation as the "lesser of two evils" compared to its more dangerous counterpart: deflation. If you think prices are going to go down, you are incentivized to wait to buy the product or service. This can cause a negative feedback loop because if many people are waiting, then products/services are not being purchased which can cause job losses to rack up, causing less and less purchases. On the other end, a slight amount of inflation can potentially propel further investment/purchasing.

Since 2012, the Fed, whose job it is to tame inflationary pressures, has been targeting a 2% inflation rate. The 2% rate has been discussed as a “goldilocks” rate: not too hot, but not too cold. The rate over the past couple of years has mostly stayed beneath that 2% target, as seen in the chart below:



The Fed recently announced that to make up for the lack of meeting that 2% target over the past couple of years, they are planning on letting inflation run a little hot (so slightly above 2%) to average out with the undershoot in the 2010s. This may mean you will see headlines about an increase in inflation and then commentators will make comparisons to the 1970s and 1980s and the inflation rates that pop out in the table above.

We fully expect that inflation will be higher in the near term than it has in the recent past (especially considering the dampening in prices at the height of the COVID-19 pandemic lockdowns last year.) However, if we look at what the fixed income market predicts as of the end of the first quarter, market participants roughly expect 2.37% inflation over the next ten years (a bit higher in the first five years of the next decade and then closer to 2% over the second half.)

It is this expectation we can use to update financial plans and map out the effects of expected inflation on the investments that you own and the spending you want to do in the years ahead. We use the information that is provided to us by market prices and expectations to test out scenarios in your financial plan. There are many unknowns in the years ahead but the best we can do is to tune down the noise and use the information and the data that is provided to us to act as a light to keep those things that tend to creep in the dark at bay.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Roth Financial Partners LLC (“RFP”), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from RFP. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. RFP is neither a law firm, nor a certified public accounting firm, and no portion of the newsletter content should be construed as legal or accounting advice. A copy of RFP’s current written disclosure Brochure discussing our advisory services and fees is available upon request. Please Note: If you are an RFP client, please remember to contact RFP, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. RFP shall continue to rely on the accuracy of information that you have provided.

Around The Office Updates

Playground Pals

After surviving the unexpected freezing weather in February, Kaylee (3 ½) and Maggie (14 months) are pumped for Springtime. Sandi takes them to a different park almost every single day, where the girls race to see who can go down all the slides first (spoiler alert: Kaylee always wins because Maggie gets distracted while crawling around). When she is not racing around the playground, Kaylee is busy attending her Tap Dance/ Ballet class or jumping on a trampoline in Gymnastics class. You would think these activities would tire her out, but her energy levels seem to know no bounds. Both girls are staying healthy and are doing awesome!

Walking!

The days of crawling are no more - Abe (14 months) is walking! Eric and Ellie now find themselves chasing him around the house as he explores each room with amazing speed. Abe is also continuing to learn some sweet dance moves at night as they crank up the music while making dinner. With each passing day, he continues to grow and make friends with every person he meets. The little guy is absolute joy to be around.

Puppy Love

With the completion of his 7th handmade acoustic guitar, Pete is already hard at work on guitar #8. Each one is different than the last and has a unique blueprint – this one will be very exciting! However, it's hard to spend all of his free time in the garage when their 8-month-old puppy, Charlie, is begging to go for a walk or a swim! Her personality is large and her love for digging in the backyard and getting into mischief keeps Pete and Carla on their toes. She's an incredibly sweet dog.

Looking Into Q2

Federal Income Tax Deadline Extension:

As you may have heard, the Treasury Department and Internal Revenue Service ("IRS") have announced that the federal income tax filing due date for 2020 returns is automatically extended from April 15th to May 17th (meaning no extension form is required to be filed for the extra month.) Further, for Texas residents, the extension is to June 15th due to the winter storms in early February.

Once you've filed your 2020 returns, we would appreciate receiving a copy (via email or by uploading to the Vault) to ensure we are as up-to-date as possible on your tax situations. Please reach out to us if you have any questions as to the most secure way to send.