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Lost Decades and Late Payments

Happy Leap Day, everyone! Unfortunately, if you're a salaried employee, you are working for free today. But we also have good news to deliver. This morning, it was announced that the Federal Reserve's [preferred inflation gauge] continued its decline in January, clocking in at 2.8%. Woohoo!

The Japanese stock market (the Nikkei 225 Index) rallied this past week to close at the highest level since December of 1989. You read that correctly. For thirty-five years, an investment in Japan returned Zero. Nothing. Nada.

Those who are old enough can remember the 1980s, when Americans thought the Japanese were going to take over the economic world. They were on a global spending spree, specifically buying expensive marquee real estate in New York City.

But it turns out that their propensity to borrow from the future just to have fun in the present caused their future to be rather lackluster. Less than a decade later, they were selling back those buildings at a discount. Japan ceased to be an economic threat and we haven't worried about it taking over the economic world since then.

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We bring this to your attention because back in the late 1980s, as we have noted in a previous Investment Commentary, for the first time, Japan's debt exceeded 100% of their GDP. And apparently, their little spending spree cost more than they were earning and they had to borrow money to keep spending. (Sound familiar?)

What ensued was a decades-long period of virtually no economic growth . . . from which they are finally emerging.

Well, guess whose debt has ALSO recently exceeded 100% of GDP? That's right. Between Donald Trump and Joe Biden, our country has racked up unprecedented debt levels, now totaling well over 100% of GDP. And although we are fond of reminding our readers that correlation is not necessarily causation, we believe there is a high likelihood that Japan's excessive debt played a significant role in the country's economic malaise and is thus a warning sign to the United States.

And while Japan was experiencing debt-load problems in the 1980s, its stock market was defying logic (stock prices were insanely high relative to the profits the companies generated). *Combined*, these factors led to a zero-percent return for Nikkei investors for thirty-five years.

Our goal is to avoid investments in companies that are outrageously priced. Today, the U.S. stock market is expensive, but nothing like the Nikkei in 1989. And, as Japan has proven, the U.S. stock market could still get more expensive before becoming less expensive. Fortunately, we feel we can still find companies that can be expected to generate a sound return over the coming years.

Japan recently hit another milestone of sorts. In the fourth quarter of 2023, their economy actually shrunk (as measured by Gross Domestic Product - GDP). It shrunk in the third quarter, too. That's two consecutive quarters of shrinking GDP, which is called a "technical recession." You may remember that the U.S. economy did this a couple of years ago.

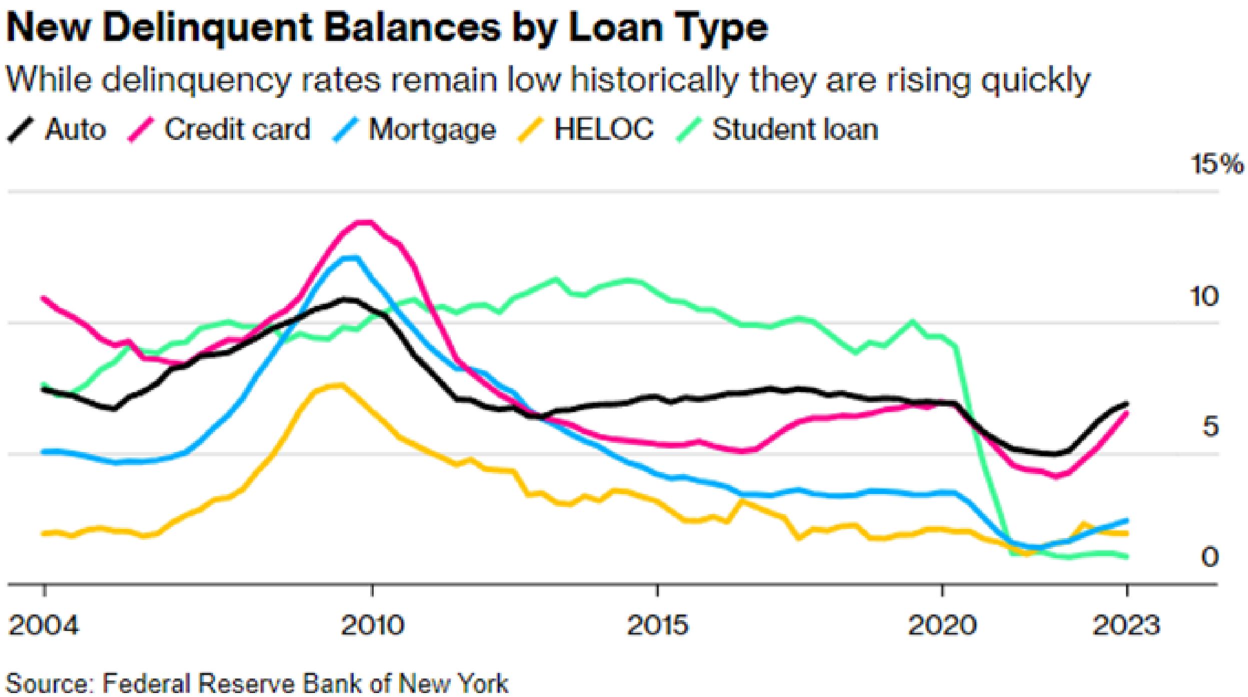
The United Kingdom is also in a technical recession right now, meaning that two of the world's six largest economies are in a recession, or whatever you want to call it. Whether you call it an official recession or not is just semantics. Those economies are shrinking and that is not a good thing.

Yet the U.S. economy has been quite resilient, and weaknesses in other parts of the world have not infected our country . . . yet. The concern that recent Fed interest-rate hikes would stall the economy has not come to fruition, and the odds of a soft-landing (inflation coming back down while avoiding a recession) have increased. That would be a good thing . . . a Goldilocks scenario.

However, we're not investing for a Goldilocks scenario. We *hope* for the elusive soft-landing, but "hope" is not a good investment strategy. We tend to be a bit more pragmatic and cynical. We focus on risk, with the aim of creating investment portfolios that can weather any storm.

And in our pragmatic and cynical opinion, the recession has merely been delayed a couple of quarters. After all, an economic slowdown could very well first look like a soft-landing before turning viciously ugly.

A common recessionary "canary in the coal mine" is when people stop paying their bills, particularly credit cards and auto loans. Recently, delinquencies for these types of loans have accelerated at a pace not seen since the Great Recession of 2008. It's not a problem (yet), but it is something to watch.



Financial stress today disproportionately affects younger and lower-income borrowers, who face higher costs without an associated rise in asset values (because they own few assets).

Young people were sold the American dream of suburban homeownership only to graduate from college with massive student-loan debt and skyrocketing housing costs.

And now, many of them are feeling "economic whiplash" in the wake of pandemic-era stimulus payments that helped them spend like there was no tomorrow. Well . . . tomorrow has arrived and now that the free money is gone, many have chosen to cope with financial stress by ignoring the problem. But if they haven't already, they will soon discover that ignoring the problem typically comes with late fees and penalties . . . you know, things that make you pay attention to issues you were ignoring.

Others have resorted to "doom spending," because the short-term gratification from spending a fortune on a Taylor Swift concert ticket is more tangible than an elusive retirement income. This will be a problem for many years to come. However, while we don't condone doom spending for cash-strapped young people, if perchance they are splurging on tickets to see Taylor Swift *at a Kansas City Chiefs football game*, we would understand. ☺