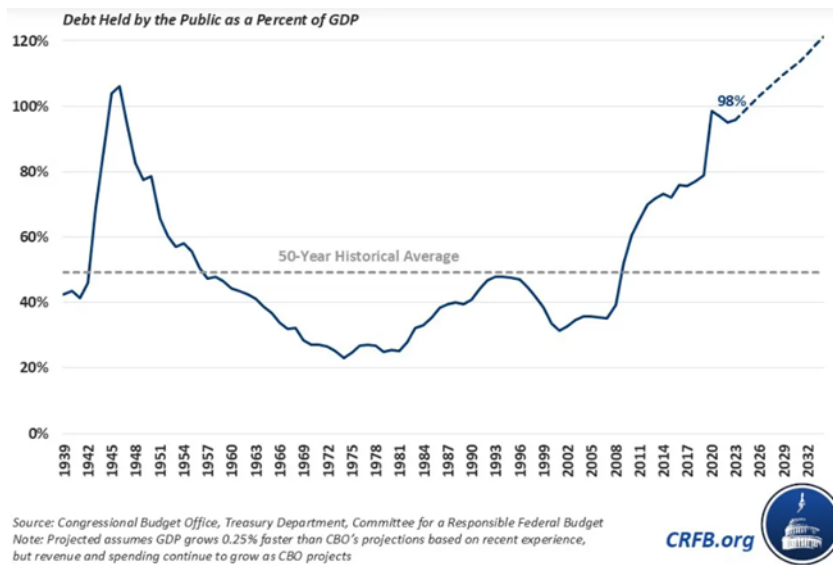
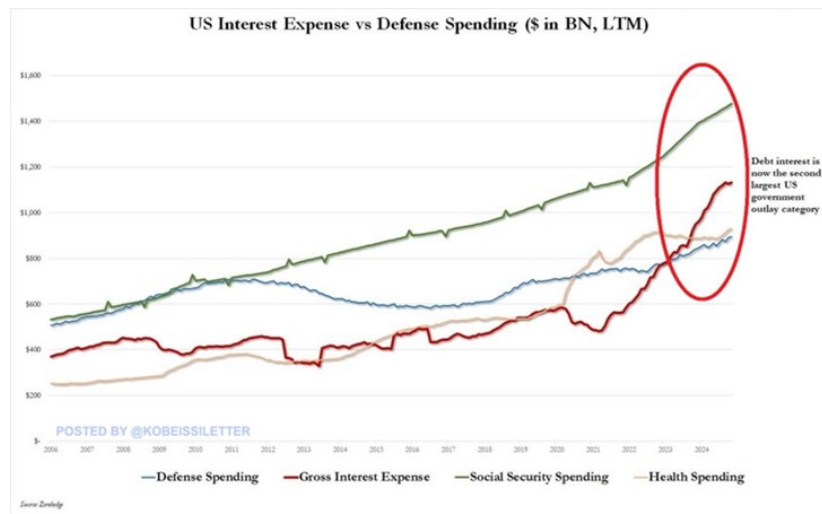


## We Have A Debt Problem. Is Yield Curve Control Coming?

The federal deficit came in at a staggering \$1.8 trillion in 2024, pushing total US debts to \$28.7 trillion, or **98%** of Gross Domestic Product (GDP). While these figures are alarming, they are widely recognized (yet generally ignored) by investors. What is less commonly known is that the nation has faced similar challenges in the past. Debt as a percentage of GDP, which has a 50-year average of about 50%, **exceeded 100%** for several years in the mid-1940s.



The core issue is interest expense, which is now officially the second largest expenditure of the US government, second only to social security. Over the past two years, interest payments have surpassed spending on both defense and healthcare. This situation stands to only get worse if lower interest debts continue to be refinanced at higher rates.



## Impact of DOGE

The Department of Government Efficiency (DOGE) is hard at work identifying areas for potential savings. The team recently announced that they believe they can save the US government approx. \$1 billion per day. If this is true, this amounts to approx. \$365 billion, or approximately 20% of last year's deficit. These savings, while impactful, are not enough on their own to fully resolve the nation's fiscal challenges.

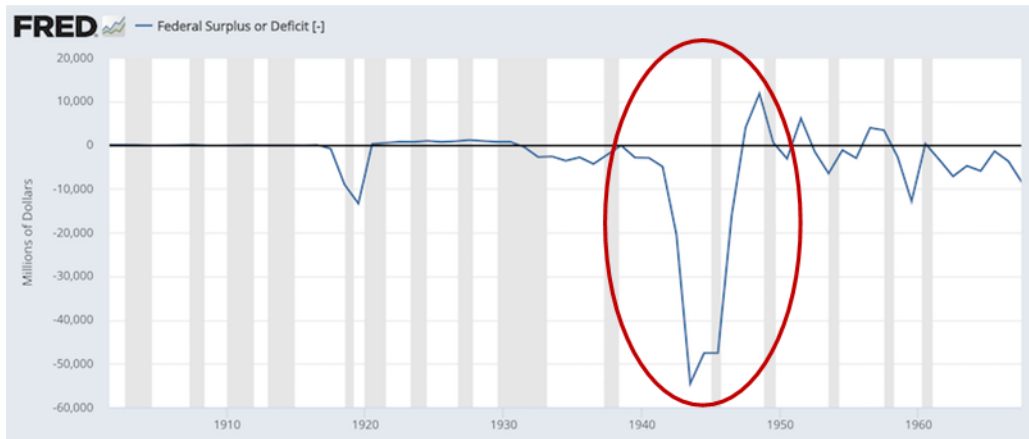
## Historical Lessons From The 1940s: Yield Curve Control

Yield curve control occurs when a government overrides market forces and caps yields on its debt. Typically implemented as a last resort, this policy implies that an economy requires accommodative financial conditions, particularly in the face of large fiscal deficits. While this strategy has been adopted by other countries in recent years, most notably Japan and Australia, it has not been employed in the US since World War II.

How long a central bank maintains these policies depends on how successfully their economies return to full employment and inflation targets and how tolerant central banks will be if inflation rises materially above targets. In the 1940s, short-term interest rates were fixed at 0.375 percent for approximately 5 years, from May 1942 to June 1947. See chart below.



Intermediate yields ranged from 0.875% on 1-year bills to 2.5% on long term issues. This approach allowed the government to finance deficits at lower (and fixed) interest rates. Combined with robust GDP growth, this facilitated the US economy's recovery after World War II, as it effectively "grew its way" out of debt. The huge deficits of the early 1940s turned into surpluses by the late 1940s (see below). Once this was achieved, rates were permitted to fluctuate and treasury bill yields gradually climbed to 4% within the decade.

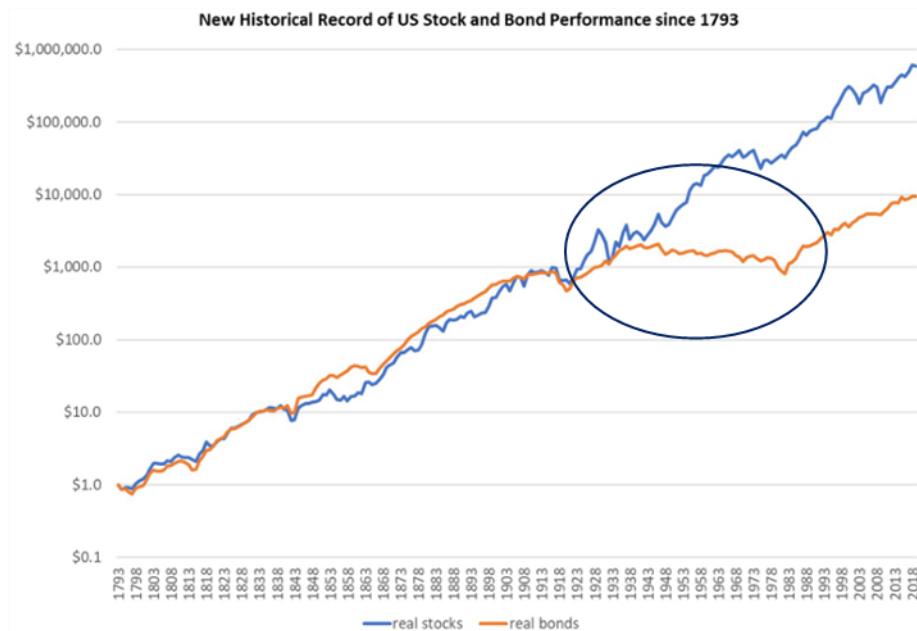


Source: U.S. Office of Management and Budget

The intended outcome of yield curve control is to improve growth conditions in the economy. The risk is driving inflation above sustainable levels. Indeed, inflation rose above 10% several times during the 1940s. But in the end, the government achieved its goal of returning to surpluses.

### One Significant Side Effect

When interest rates are capped, central banks become less responsive to economic fluctuations. Bond yields stay steady. This can be good news for stocks, which often rise along with other asset prices. But bonds typically struggle. Consider the chart below, which compares real (inflation adjusted) bond performance to that of real stock performance. Bonds underperformed radically during the 1940s. And the 1950s. And the 1960s & 1970s. See below. The suppression of both short **and** long rates contributed to prolonged underperformance in bonds.



Source: Study by Edward F. McQuarrie, Professor Emeritus, Santa Clara University, July 2021

The intricacies and clarity surrounding yield curve control policies are crucial. The relative steepness of the yield curve plays a pivotal role. A steep yield curve can keep longer duration bonds relatively attractive, provided inflation is contained. But if inflation emerges, like it did in the 1940s, the spread (long yield vs short yield) is not sufficient and real bond returns suffer.

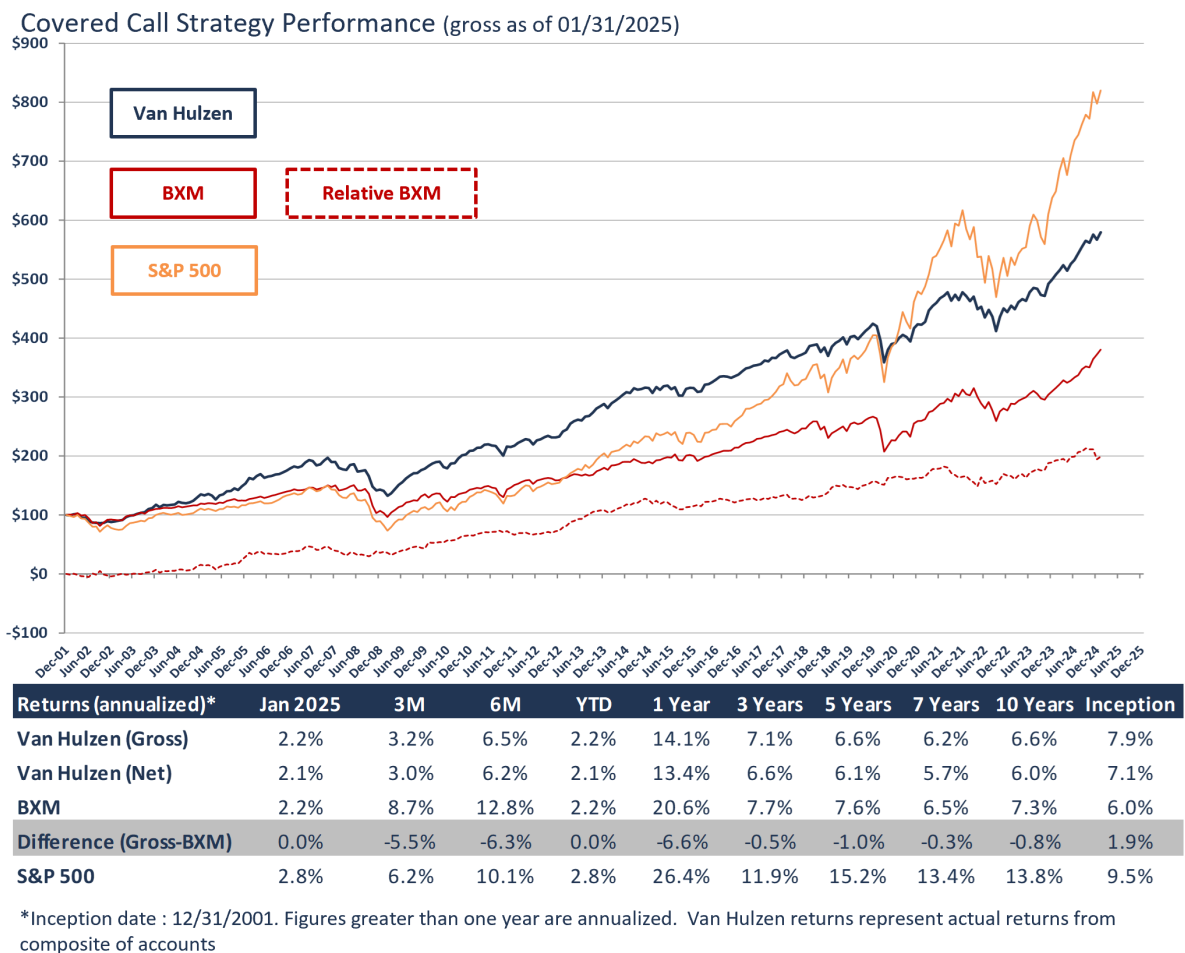
### **Implications For Your Investment Portfolio**

To be clear, yield curve control is not our base case. But we want our clients to be aware of all possibilities. If even a mild version of yield curve control emerges, bonds could experience elevated volatility, leading to prolonged periods of poor returns for bonds, potentially even negative returns in real terms. This scenario could undermine the traditional benefits of a 60/40 portfolio, as bonds may no longer act as a cushion when stocks decline. This would significantly affect retirees' portfolios. Will investors flock to stocks? Commodities? Bitcoin? These are all volatile markets.

If you read our commentaries, you already know our recommendation. We manage a hedged equity strategy that has the same standard deviation as high yield bonds but 2%+ higher returns. The strategy targets a yield of 6% and has a 23-year track record of delivering 83% of the upside of the S&P 500, at 65% of the risk (volatility). That's a strong upside/downside ratio (1.3x) and an annualized alpha of 2.1%.

## Van Hulzen Covered Call Strategy

The Van Hulzen Covered Call strategy invests in US companies that we consider to have high shareholder yield (dividends and share repurchases) and uses call options with the goal of reducing portfolio volatility and creating incremental income. The goal is a portfolio that has equity exposure while seeking higher than average annual income (target of 6-8% annual), although there is no guarantee that the strategy will achieve its objective, generate profits or avoid losses. Below you will find the graph of the Van Hulzen Covered Call Strategy and the Covered Call Index BXM.



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