June 25, 2024

Morning Briefing

Fiscal Follies

Check out the accompanying chart collection.

Executive Summary: The federal budget deficit is far higher than typical during economic expansions—and current estimates are likely too low. The deficit is unlikely to shrink anytime soon absent a debt crisis, and it's increasing the supply of US Treasuries to the point of rivaling demand. The Treasury Department's newly adopted debt issuance strategy is tenuous and could lead to more market volatility. … It's not all doom and gloom: Treasuries are buoyed by the US dollar's reserve currency status. Strong productivity in our Roaring 2020s scenario can keep the debt load manageable as well. No crisis looms.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Fiscal Policy I: Mind the Gap. The US federal government is running its largest budget deficit on record during a peacetime economic expansion. With the US economy heading for the eighth consecutive quarter of real economic growth, the best time to clean up the budget would be now (*Fig. 1*). Instead, the difference between government outlays and receipts is a widening gap and a problem that won't be fixed anytime soon.

In the past, federal budget deficits tended to rise and fall with the unemployment rate. That's because during recessions, fiscal policy turned stimulative as tax revenues fell while income support programs expanded. During economic expansions, fiscal policy turned restrictive as tax revenues rose along with incomes and the government reduced outlays on stimulating the economy. Some say there's little relationship between large federal deficits or ballooning Treasury supply and nominal growth—but that's because deficits historically rose only when the economy was sagging. This time is clearly different: Running a big deficit with a robust economy changes the calculus.

Interestingly, the federal deficit as a percentage of GDP historically has tended to be below the unemployment rate. Since the pandemic, that no longer holds true, and it isn't projected to return to normalcy anytime soon (*Fig. 2*).

It is widely believed that only a debt crisis will force Congress to clean up the government's finances. Few agree on whether that crisis point will be sooner or later. Let's try to assess the magnitude of the problem and consider how it might be resolved by looking at the federal government's fiscal path:

(1) *CBO forecasts.* Last week, the nonpartisan Congressional Budget Office (CBO) revised its federal budget deficit estimate for fiscal 2024 to $1.9 trillion (6.7% of GDP) from $1.5 trillion (5.4%) in February. That's up from $1.7 trillion (6.3%) last fiscal year.

Longer-term projections depict the course that the economy is on. They point to unprecedented profligacy.

The CBO expects the federal government's outlays to widen from 22.7% of GDP in 2023 to 24.9% by 2034 while revenues edge higher over those years, from 16.5% of GDP to 18.0% (*Fig. 3*). Debt held by the public is expected to grow from 97.3% of GDP last year to 122.4% by 2034, well above the previous record of 106% in 1946 (WWII) (*Fig. 4*).

(2) *Forgiving folly.* The CBO raised its forecast for outlays in large part due to revisions to four major factors: 1) student debt relief (+$145 billion); 2) FDIC bank resolutions (+$70 billion); 3) aid to Ukraine, Israel, and America's Indo-Pacific allies (+$60 billion); and 4) Medicaid (+$50 billion). So, much of the increase represents debt forgiveness—with the burden of the debt shifted to taxpayers.

(3) *Demographics.* The CBO points to "growth in spending on programs that benefit older people [i.e., Medicare and Social Security] and rising net interest costs" as the primary drivers of the deficit over the coming decade.

A record 48 million Americans aged 65 and up are not in the labor force, as of May (*Fig. 5*). Births (3.64 million in the past 12 months) now barely outpace deaths (3.15 million).

The US now relies on immigration to fill the worker shortage—and the CBO expects it to be a budgetary boon. Assuming that net immigration totals 200,000 people per year (which it has exceeded in recent years), the CBO sees the deficit shrinking by about $900 billion.

But the CBO's assumptions don't account for the likelihood of stricter immigration policies. Even President Biden recently signed an Executive Order to prevent those who illegally cross the border from receiving asylum. The upshot: The CBO's baked-in deficit benefit could be revised away.

(4) *Compound interest.* Net interest costs will continue to rise as long as the Fed maintains its higher-for-longer interest-rate policy. The US has spent $836 billion over the past 12 months on net interest outlays, shelling out an average of 3.1% to service its debt (*Fig. 6*). Net interest paid is set to surpass annual defense spending before the end of the current fiscal year and will soon become the second largest category of outlays, after Social Security. The CBO expects net interest costs to rise from 3.1% of GDP this year to 4.1% by 2034, while the primary deficit will be around 2.7% of GDP. In other words, the government will be issuing new debt mostly just to service its old debt.

(5) *Won't cut it.* The US has spent more than it has earned since 2002; but for the first time in modern history, the US will be spending more on entitlement programs than it takes in via taxes. Defense, which represents about half of the $1.86 trillion in discretionary outlays, can be trimmed but not axed. Barring a debt crisis or radical legislative change, the options to slim the deficit are limited, which could crowd out private investment.

Even in 2009 during the Great Financial Crisis (GFC), mandatory outlays ($2.09 trillion) didn't surpass revenues ($2.11 trillion). That barrier was broken in 2020, when mandatory outlays soared to $4.58 trillion and revenues only reached $3.42 trillion.

(6) *Tax man.* The 2017 individual and estate tax cuts are set to expire at the end of 2025. The CBO has estimated that extending them would reduce revenues by $4 trillion to $5 trillion over the coming decade. President Biden has said he would extend some expiring cuts, financed via taxing households that earn more than $400,000 per year and corporations. Notably, the CBO is projecting that all of these cuts will expire, which will inevitably need to be revised and thus widen the estimated deficit.

Fiscal Policy II: Debt Deluge. The most direct impact the federal government budget deficit has on the financial markets is that it increases the supply of US Treasuries. Most of the $27 trillion of debt held by the public is in Treasury notes ($14 trillion) with maturities between two and ten years (*Fig. 7*). But short-term bills outstanding is rising quickly, with the current $4.6 trillion up from $2.5 trillion in 2019.

Last year, the US Treasury Department learned very quickly that supply can outstrip demand. After it surprised the Street last summer by upping its borrowing estimate by more than a quarter-trillion dollars to about $1 trillion in Q3, the 10-year Treasury yield climbed from 3.75% to 5.00% from July to October. Treasury Secretary Janet Yellen dramatically changed the government's debt issuance strategy to soothe financial markets.

Here's our take on the Treasury market upheaval:

(1) *Banking on bills.* Treasury bill issuance started surging after the debt limit deal was passed in June 2023. The Treasury Department had to refill its coffers—the Treasury General Account (TGA)—after running them down while taking "extraordinary measures" to finance federal spending during the debt-limit impasse. From May 2022 to May 2023, the US issued $1.02 trillion of Treasuries. In the following year, it issued $2.72 trillion (*Fig. 8*). Most of these securities, 70% in fact, were Treasury bills (*Fig. 9*).

Bill issuance continues to track higher because Secretary Yellen is responding to tepid demand for longer-term bonds and notes by relying on bills, the constant refinancing of which continues to boost overall issuance to levels far above pre-pandemic norms.

(2) *Irregular and unpredictable.* Bills rising as a percentage of the overall debt load is in direct opposition to the Treasury's stated mission of minimizing the cost to taxpayers by issuing debt in a "regular and predictable" manner. The larger portion that is in short-term bills, the higher the government's sensitivity to short-term interest rates.

The Treasury Department should have taken advantage of ultralow rates and termed out its debt during the pandemic, as most households and corporations did. It has now subjected financial markets to the least regular or predictable policy by blurring the lines on the T-bill range (15%-20% of total debt) set by the Treasury Advisory Borrowing Committee (TBAC).

Treasury bills are now 21.7% of the overall debt, having remained above the 20% upper limit since September 2023 (*Fig. 10*).

We suspect Washington recognizes using bills is the only way to continue issuing so much debt without instigating a violent reaction from the Bond Vigilantes. The TBAC now recommends remaining above the 20% band over the short term to avoid increasing the issuance of notes and bonds. It even suggested that it may scrap the range down the road.

(3) *Why bills?* There's insatiable demand for T-bills. Wall Street has preferred to lend cash secured against high-quality assets (e.g., Treasuries) since the GFC.

Eventually, bond investors may question America's fiscal sustainability if the Treasury is unable to increase coupon issuance at a reasonable rate. And there's a higher cost to taxpayers—the government is financing itself at 5.4% in short-term bills rather than 4.3% on longer-term Treasuries since the yield curve is inverted (*Fig. 11*).

Fiscal Policy III: Exorbitant Privilege. The US benefits from less elastic demand than other countries because the dollar is the global reserve currency. Commodities are priced in dollars, and Americans pay for imports in dollars, many of which are recycled into US assets by exporting nations. The main risk is that buyers will require higher interest rates to finance the US budget deficit.

In any event, there's no balance-of-payments crisis looming. Let's look at why:

(1) *Treasury auctions*. US debt auctions are always oversubscribed. Sales of 10-year and 30-year Treasuries have averaged bid-to-cover ratios of 2.5 and 2.4, respectively, since 2009 (*Fig. 12* and *Fig. 13*).

(2) *Global greenback.* The Bank of International Settlements *estimates* that the US dollar is involved in nearly 90% of foreign exchange transactions. Half of global trade is denominated in US dollars. More than 58% of foreign exchange reserves held globally is in dollars (*Fig. 14*). That's down from 71% at the turn of the century, but no major currency has arrived as a competitor. The euro represents just 20% of global reserves, down from a peak of 28% in 2009.

(3) *Capital flows.* Foreign private and official institutions are funneling cash into US assets at a rate similar to pre-pandemic highs, including $613 billion in the past 12 months (*Fig. 15*). Private investors abroad bought $840 billion of US bonds (including Treasuries, corporate debt, and mortgage-backed securities) in the 12 months ended April, and tacked on another $195 billion of US stocks (*Fig. 16*).

(4) *Roaring 2020s*. In our base-case Roaring 2020s scenario, US growth would be propelled by strong productivity (which simultaneously puts downward pressure on inflation). That would keep the debt level in check relative to the size of the economy and postpone the day of reckoning for a debt crisis.

Calendars

US: Tues: Consumer Confidence 100.2; Richmond Fed Manufacturing Index 2; API Weely Crude Oil Inventories; Cook; Bowman. **Wed:** New Home Sales 650k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Bank Stress Test Results. (FXStreet estimates)

Global: Tues: Spain GDP 0.7%q/q/2.4%y/y; Spain PPI; Japan Leading & Coincident Indicators -0.1%/1.0%. **Wed:** Germany Gfk Consumer Climate Index -19.9; France Consumer Confidence; Spain Consumer Confidence; Lane. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week simultaneously for all three of these indexes, and has done so in nine of the past 10 weeks. LargeCap's forward earnings rose 0.3% w/w to a new record high. It has achieved new record highs for 25 straight weeks and in 36 of the 41 weeks since mid-September; last week is now the lengthiest string of record-high forward earnings for LargeCap in six years (since the September 21 week of 2018, when it hit record highs for 26 straight weeks). MidCap's rose 0.2% w/w to a 21-month high and is just 2.0% below its record high in early June 2022. SmallCap's rose 0.4% w/w to a seven-month high, but is still 10.0% below its mid-June 2022 record. Through the week ending June 20, LargeCap's forward earnings has soared 15.7% from its 54-week low during the week of February 1, 2023; MidCap's is 6.6% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.1% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows ago a year, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.6%, 14.1%), MidCap (3.3, 16.8), and SmallCap (-4.0, 18.8).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower again during the June 14 week for these three indexes and remain slightly below their recent two-year highs. LargeCap's forward P/E rose 0.1pt w/w to 20.9, matching its 27-month high at the end of March and up from a seven-month low of 17.0 during the October 27 week. It's now up 5.8pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.2pt w/w to 15.0. That's down 1.0pts from a 27-month high of 16.0 at the end of March and up 2.7pts from a 12-month low of 12.3 at the end of October. It's now up 3.9pts from its 30-month low of 11.1 at the end of September 2022; these compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was steady w/w at 13.9, and is now 0.8pt below its 28-month high of 14.7 during the May 17 week. It's up 3.3pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November

2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 29% discount to LargeCap's P/E is now testing its 24-year-low 29% discount during the June 1, 2023 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 34% discount is also now testing its 23-year-low 34% discount during the October 19, 2023 week, which compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Regional M-PMIs (*link*): The *Dallas Fed* has released manufacturing data for June, showing basically flat activity. This report follows the *New York Fed*'s survey of manufacturing activity for June, which showed continued contraction, though at a slower pace, and the *Philadelphia* survey showing mostly steady activity overall. Turning to the *Dallas* survey, *production* (to 0.7 from -2.8), a key measure of state manufacturing conditions, rose just above zero in June, the breakeven point between expansion and contraction. The *new orders* (-1.3 from -2.2) measure continued to move back toward zero, improving the past few months from -11.8 in March, while the shipments (2.8 from -3.0) gauge moved back above zero. Meanwhile, the perceptions of broader conditions continued deteriorate in June, though at a slower pace, with the both general business activity (-15.1 from -19.4) and company outlook (-6.9 from -13.4) measures showing some modest improvement during the month. Labor conditions showed employment (-2.9 from -5.3) declines were smaller, while the workweek was shorter, holding fairly steady at -5.0. Meanwhile, there was upward pressure on both wages and prices in June, with the wage and benefits measure slightly higher than average, while finished goods prices shot up 10 points to 14.4; the raw materials price index was slightly below its historical average. Looking forward, both the future production (to 27.1 from 17.3) and future general activity (12.9 from -3.3) indexes surged in June, though expectations for employment (11.7 from 13.4) and capital expenditures (12.6 from 14.9) were slightly less positive.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "The German economy is having difficulty overcoming stagnation," according to Ifo's June report. German business confidence came in below expectations again in June. The *business climate index* fell to 88.6 this month from 89.3 in May; the *expectations* component dropped to 89.0 from 90.3 in May, while the *current situation* component was unchanged at 88.3. *Trade's* business sentiment deteriorated significantly this month, falling to -23.5 from -17.0 in May, with expectations leading declines. Both wholesalers and retailers were equally impacted by the negative development. In *manufacturing*, the business climate index declined in June after improving the prior three months, as companies were more pessimistic about the months ahead, with companies particularly concerned about declining backlogs. Meanwhile, companies were more satisfied with current business. The *service sector* index improved in June, with companies assessing both current situation and expectations more favorably. Sentiment in the hotel sector improved, while the hospitality sector suffered a setback. *Construction's* business climate increased slightly, as expectations were less pessimistic, though the current situation deteriorated—with a lack of orders a core problem.

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