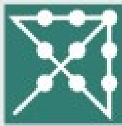

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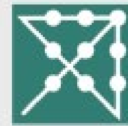

July 16, 2024

Morning Briefing

Fiscal Excesses & Bond Volatility

Check out the accompanying chart collection.

Executive Summary: Would a Republican sweep in November boost the federal deficit? The Republicans would certainly extend Trump's 2017 tax cuts beyond 2025. But they might also rein in federal government outlays. In any case, the initial reaction of the bond market to Trump's dodging the bullet on Saturday was a slight disinversion of the yield curve, perhaps in anticipation of wider deficits. … Eric reviews the 60/40 portfolio rule and how unrestrained government spending and deficits can impact financial markets. … While the federal budget deficit shrank during the first nine months of this fiscal year, the Treasury still has plenty of securities to sell investors. … Eric also reviews the Sahm Rule.

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

Bond Market I: Dodging the Fiscal Bullet? The current path of US deficit spending is clearly unsustainable. But after the attempted assassination of former President Donald Trump on Saturday, a Republican sweep in November seems more likely—which could narrow deficits over the long run. In this scenario, the Republicans undoubtedly would extend Trump's 2017 tax cuts beyond 2025, but they might also rein in federal government spending.

The initial response of the bond market on Monday morning was to signal its concern about wider deficits under a Republican-controlled government. The difference between 2-year and 10-year Treasury yields disinverted to -23bps on Monday, which is the slimmest inversion since January, reflecting concerns for wider federal deficits to raise long-term yields (*Fig. 1*).

Until the assassination attempt, we thought that only a debt crisis could force Congress to finally rein in the budget. A debt crisis still might occur if Washington remains politically gridlocked after the November election. Of course, dumping risky assets in advance of an event that's far from certain could invite severe underperformance. Investors must consider

the potential implications for their portfolios.

With this in mind, Eric reviews how unconstrained government spending can impact financial markets:

(1) *Interminable deficits.* The Congressional Budget Office (CBO) expects the federal budget deficit to exceed 6.7% of GDP in 2024. Excluding the Great Financial Crisis and Great Virus Crisis periods, that's the largest annual deficit since 1946. The CBO forecasts that the deficit will run at 5.5% or more of GDP each year over the coming decade under current law, well above the average of 3.3% since 1965 (*Fig. 2*). These forecasts will certainly be raised if the 2017 individual and estate tax cuts—which are set to expire at the end of 2025—are extended in part or in full, as is expected under a Republican-controlled government. That's if nothing is done to slow federal government outlays.

(2) *Asset allocation & bond volatility.* The crux of the classic 60/40 stock/bond portfolio is that bonds are meant to hedge against stocks' losses during economic downturns. From the 1980s until 2020, there were few complaints with the 60/40 allocation, as both bond and stock prices generally rose.

In September 2021, the correlation between stocks and bond prices flipped to a positive one as the Fed raised interest rates and stocks and bond prices fell together (*Fig. 3*). In September 2022, the correlation between stocks and bonds became the most positive since 1998—and it has remained at such highs since. Without bond prices moving inversely to stocks, they lose much of their value as a hedge within portfolios.

Bond portfolio returns and bond volatility tend to be very negatively correlated (*Fig. 4*). Higher bond volatility would be facilitated by varying interest-rate and inflation expectations as well as profligate federal deficits.

Higher bond volatility attributable to widening deficits would reduce the demand for Treasuries from risk-parity portfolios, volatility targeting funds, pension funds, and others that allocate more to less volatile assets. The upshot is even lower prices and higher yields.

(3) *Deficit difficulties.* Government spending can boost growth in certain sectors of the economy, but broadly it tends to decrease productivity growth and crowd out private investment. Spending to service debt also crowds out government investment in more productive outlays. Indeed, net interest costs are set to surpass defense as the government's second largest outlay this year (*Fig. 5*). Treasury securities rose to 96.8% of

US GDP in Q1, having surpassed the comparable ratios for both household and business debt for the first time during the pandemic (*Fig. 6*).

(4) *Growing out of it*. Our Roaring 2020s scenario sees higher productivity boosting corporate margins, keeping nominal labor costs subdued, and increasing real GDP. Rising productivity therefore helps prevent the debt load from growing out of hand relative to the size of the economy; and as a corollary, it prevents bond yields from rising drastically (*Fig. 7*).

The CBO currently sees annual real GDP growth of 1.7%-1.8% from 2026-34, but this is highly sensitive to how productive the labor force is. Higher productivity growth reduces the government debt-to-GDP ratio.

On upcoming Q2 earnings calls, we expect to hear much about how companies are investing in automation, robotics, and artificial intelligence to augment their workers' productivity and mitigate the shortage of skilled labor.

Bond Market II: Federal Budget Update. The federal budget deficit shrank in this fiscal year's first nine months (i.e., October 2023-June 2024) from the same period a year earlier. Government revenues jumped 10%, or $342 billion, while outlays rose 5%, or $225 billion, in the period.

A sizable chunk of 2024's rise in revenues is due to timing shifts that boosted the deficit the prior year. Outlays (23.3% of GDP) were 5.5ppts higher than receipts (17.8%) as of Q1, and the deficit is still a whopping $1.3 trillion over the past 12 months through June (*Fig. 8* and *Fig. 9*). Let's dive deeper into the current fiscal situation:

(1) *Quarterly refunding*. Last month, the 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, a 27% increase. That's up from $1.7 trillion (6.3%) last fiscal year. The government will need to come up with roughly an additional $400 billion of funding. That complicates the Treasury Department's next Quarterly Refunding Announcement (QRA), scheduled for July 29.

An extra $400 billion in borrowing needs contradicts the Treasury Department's last QRA in May, having commented that they do not anticipate increasing the auction sizes of longer-term securities for at least several quarters. Ostensibly, they didn't want to test demand at the long end of the yield curve until after the November presidential election. Now, they'll be disrupting their stated goal of "regular and predictable" debt management for the second

time in the course of a year.

(2) *Trouble with the curve.* Last August, the Treasury Department increased its quarterly borrowing needs by roughly a third. Investors dumped Treasuries, and the 10-year yield rose from 3.75% to 5.00% in a matter of three months. Then, Treasury Secretary Janet Yellen decided she would flood the market with lower-duration Treasury bills to satisfy the government's borrowing needs—10-year Treasury yields quickly fell (*Fig. 10* and *Fig. 11*). We're not so sure the same maneuver will work this time around, as investors will likely question whether demand is strong enough to absorb the oncoming supply glut of Treasuries.

(3) *Finding buyers*. US debt is backed by the federal government. But the interest rate on those securities is determined by what buyers are willing to pay. Demand for US debt is backed by the reserve status of the dollar, but the interest rate that buyers are willing to pay is not. The latest auction of 30-year Treasuries saw the weakest demand since December, with a bid-to-cover ratio of 2.3 times (*Fig. 12*). The auction yield also tailed 2.2bps, meaning that the coupon paid on those bonds was 2.2bps higher than preliminary trading among big banks suggested it would be.

(4) *Banking on banks.* The Treasury Department may have found new marginal buyers among their oldest cohort of financiers. Large domestic banks bought $235 billion of government bonds (includes Treasuries and agency mortgage-backed securities) over the past eight months, taking its total holdings to $3.2 trillion (*Fig. 13*). Big banks represent roughly three-fourths of total domestic bank holdings—but small banks are still a meaningful source of demand. They've been paring holdings since July 2022, from a peak of $1.1 trillion to $868 billion as of July 3.

A new regulation relaxation could boost bank bond holdings further. We discussed in our July 10 *QuickTakes* that the GSIB surcharge—essentially a size tax on big banks that restricts lending by forcing them to hold more capital—could be eased. Some of that cash will be lent out, but some likely will end up back on big banks' balance sheets as Treasuries.

Labor Market: Some Thoughts on Sahm Rule. One reason that many say the Fed must cut the federal funds rate to prevent a recession is the Sahm Rule. It is a relatively new indicator that has gained prominence as other tried-and-true recession signals (e.g., the inverted yield curve and the declining Index of Leading Indicators) sounded false alarms this business cycle. The Sahm Rule has yet to flash red but is nearing that point. We're not fans

of using the Sahm Rule to predict recessions, and we do not see one on the horizon as of now. Let's review why we aren't concerned:

(1) *Mathematical mechanics.* The Sahm Rule says that if the three-month moving average of unemployment rises 0.500ppts above its low of the past year, a recession is nigh (or already begun). That's a mouthful of math, all of which tells you that unemployment spiked during past recessions. It's unhelpful in the current employment environment that includes a flood of immigrants and normalization of the labor market from the pandemic shock.

The Sahm Rule neared its trigger point in June as the three-month moving average of the unemployment rate rose to 0.433ppts above its low of the past year (*Fig. 14*). Our alternative version of the Sahm Rule uses the insured unemployment rate available in the weekly jobless claims data. It shows little cause for concern at just 0.029ppts above its low of the past year (*Fig. 15*).

(2) *Employment rising?* The current rise in unemployment is unique in that it's occurring at a time when employment is also increasing! The labor force grew by 3.9 million workers from June 2022-24, while household employment rose by 3.1 million (*Fig. 16*). Unemployment has increased by 826,000 even as very few employed workers have lost their jobs. We suspect that the survey of households undercounts illegal immigrants, which affects the rate of unemployment, skewing it higher. Illegal immigrant workers are likely better reflected by the payrolls data reported by employers. Payroll employment has surged by 6.3 million in the last two years.

(3) *New workers for hire*. Breaking out the household employment data into the reasons for unemployment shows that new entrants and reentrants to the labor force accounted for 41.1% of total unemployment in June, up from 25.3% in January 2021 (*Fig. 17*). Permanent job losers and those who completed temporary jobs, meanwhile, accounted for 36.1% of unemployed workers, down from 61.5% three and a half years ago.

In other words, workers reentering the labor force are looking for jobs, while permanent job losses are falling. And employment among prime-age (ages 25-54) workers is at 80.8%, highs not seen since 2001, while the labor force participation rate of that cohort is similarly at multi-decade highs of 83.7% (*Fig. 18*). The unemployment rate may have risen to 4.1% in June from 3.4% last April; but looking under the hood, the labor market still looks solid.

Calendars

US: Tues: Retail Sales Total & Core -0.2%/0.1%; Business Inventories 0.4%; NAHB Housing Market Index 44; Atlanta GDPNow 2.0%; Import Prices 0.2%; API Weekly Crude Oil Inventories. **Wed:** Industrial Production 0.4%; Capacity Utilization 78.6%; Housing Starts & Building Permits 1.310mu/1.390mu; MBA Mortgagee Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Barkin; Waller. (FXStreet estimates)

Global: Tues: Eurozone ZEW Economic Sentiment 48.1; Germany ZEW Economic Sentiment 41.2; Italy CPI 0.2%m/m/0.9%y/y; ECB Bank Lending Survey; German Buba Monthly Report; ECOFIN Meetings; Eurogroup Meetings. **Wed:** Eurozone Headline & Core CPI 0.2%m/m/2.5%y/y & 0.3%m/m/2.9%y/y; UK Headline & Core CPI 1.9%/3.5%y/y; UK PPI Input & Output Prices 0.1%/0.1%; Germany Buba Monthly Report. (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 11 of the past 13 weeks. LargeCap's forward earnings rose 0.2% w/w to a new record high. It has achieved new record highs for 29 straight weeks and in 40 of the 44 weeks since mid-September; last week now matches the lengthiest string of record-high forward earnings for LargeCap in six years (since the March 16 week of 2018, when it hit record highs for 34 straight weeks). MidCap's rose 0.2% w/w and is just 2.2% below its record high in early June 2022. SmallCap's rose 0.1% w/w to a 35-week high, but is still 10.0% below its mid-June 2022 record. Through the week ending July 12, LargeCap's forward earnings has soared 16.1% from its 54-week low during the week of February 1, 2023; MidCap's is 6.4% 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 (9.9%, 14.5%), MidCap (1.9, 17.4), and SmallCap (-5.4, 19.8).

S&P 500/400/600 Valuation (*link*): Valuations were mostly lower during the July 5 week for these three indexes, but remain near their recent two-year highs. LargeCap's forward P/E fell 0.5pt w/w to 20.4 from a 30-month high of 20.9. That's up from a seven-month low of

17.0 during the October 27 week and is now up 5.3pts 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 0.7pt w/w to an eight-week high of 15.5. That's just 0.5pts below its 27-month high of 16.0 at the end of March and up 3.2pts from a 12-month low of 12.3 at the end of October. It's now up 4.4pts 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 rose 0.7pts w/w to an eight-week high of 14.6, and is now just 0.1pt below its 28-month high of 14.7 during the May 17 week. It's up 4.0pts 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 28% discount to LargeCap's P/E has improved slightly from its 29% discount in recent weeks, which matched 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 32% discount is up from a 34% discount in recent weeks which also matched its 23-year-low 34% discount during the October 19, 2023 week. That 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 New York Fed released its first glimpse of manufacturing activity for July and showed manufacturing activity contracted for the eighth straight month. The *general activity* measure (to -6.6 from -6.0) declined at a steady pace this month. The new orders (-0.6 from -1.0) gauge remained fairly steady, while the shipments (3.9 from 3.3) measure moved slightly higher; unfilled orders (-11.2 from 1.0) declined. Meanwhile, *inventories* (-6.1 from 1.0) showed a liquidation this month. *Delivery times* (-9.2 from -4.1) remained below zero, suggesting delivery times shortened, while supply availability (0.0 from -1.0)—a new monthly indicator recently included in the report—showed supply availability was unchanged. Labor market indicators show *employment* (-7.9 from -8.7) continued to contract, while the *average workweek* (-0.1 from -9.9) moved back toward positive territory. Turning to prices, the *prices-paid* (to 26.5 from 24.5) gauge showed input prices continued to rise, while the *prices-received* (6.1 from 7.1) measure showed selling price gains remained minor. Looking ahead, the index for *future business conditions* (to 25.8 from 30.1) continued to expand at a healthy clip, with 40.8% of respondents expecting conditions to improve in the next six months and only 15.1% of respondents expect

conditions to be worse. The *new orders* (20.8 from 30.0) and *shipments* (25.3 from 28.7) measures both expanded at a healthy, though slower pace. Meanwhile, the outlook for *employment* (5.8 from 9.4) remained weak, with only 19.8% expecting employment to be better in six months.

Global Economic Indicators

Eurozone Industrial Production (*link*): Eurozone industrial production fell more than expected in May, posting only one gain so far this year. *Headline* production, which excludes construction, fell 0.6% (vs -1.0% expected) in May, with only March (+0.5%) in the plus column. Production was flat in both February and April; the year began with a 2.2% shortfall. Among the *main industrial groups*, intermediate goods production fell for the third straight month, by 1.0% in May and 1.6% over the period, while consumer durable goods output contracted 1.8% in May following a 0.4% gain and a 0.6% loss the prior two months. Capital goods output sank 1.2% after a three-month increase of 3.5%, while energy output rose 0.8% after a three-month decline of 3.5%. Consumer nondurable goods production soared 5.2% during the two months ending May after falling the first three months of the year. *Compared to a year ago*, total production fell 2.9%, led by shortfalls in capital goods (-6.5%), consumer durable goods (-4.2), and intermediate goods (-3.5), while consumer nondurable goods (2.8) and energy (0.7) output were above year-ago levels. Looking at the *largest Eurozone economies*, output was diverse in May with production falling on both a monthly and yearly basis in France (-2.1% m/m & -3.2% y/y) and Germany (-2.4 & -6.6), while Italy (+0.5 & -3.3) was a mixed bag. Spain (-0.2 & 0.2) showed little change over both time periods.

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