Yardeni Research

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Morning Briefing

DOGE & The Deficit

Check out the accompanying chart collection.

Executive Summary: Federal spending needs to be cut to pre-pandemic levels relative to GDP, in our opinion, and we're confident that Trump 2.0 can do so. But DOGE may not be the way that is achieved. The new department's bold early initiatives seem misaligned with the administration's goals. ... However: A look at how Trump 2.0 may be able to ease pressure on the fiscal deficit by increasing domestic production and overhauling global trade to remedy imbalances. We're optimistic that these approaches will work, which supports both our Roaring 2020s economic outlook and Stay Home investment strategy.

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

Strategy I: The DOGE Days. We're optimistic that Trump 2.0 can cut federal spending. However, we doubt that will be accomplished via the Department of Government Efficiency (DOGE).

Our measuring stick for success is cutting outlays as a percentage of GDP, currently 23.9%, to 22.0% by 2028, where it stood in the months leading up to the pandemic. An even better scenario would be lowering it to 20%, its pre-Great Financial Crisis level (*Fig. 1*). Using Q4 US nominal GDP of $29.7 trillion and assuming it grows by around 5% each year, that would require roughly $650 billion of cuts annually. That's about half of total discretionary spending (*Fig. 2*). There appears to be little to no chance that this can be achieved via DOGE.

In the next section, we detail the strategies President Trump is using to rein in spending, and their likelihood of success.

We do applaud the virtues of what DOGE—and many of Trump's cabinet picks—are trying to accomplish. Politicians from both sides of the aisle and nearly all investors agree that the federal government spends profligately and often inefficiently. Trimming the fat and cutting out waste will help bring down the federal debt and boost productivity, as well as usher in an ethos of cost savings and spending scrutiny that may bring longer lasting benefits. Moreover, deregulation will free up the private sector from administrative and compliance expenses that cost much but produce negative returns.

Unfortunately, DOGE's early start suggests it may cause more collateral damage than any achieved savings justify. Consider why the DOGE Boys may have bitten off more than they can chew:

(1) *Savings don't add up*. Doge.gov states that the department's estimated savings amount to $55 billion, to be achieved through "a combination of fraud detection/deletion, contract/lease cancellations, contract/lease renegotiations, asset sales, grant cancellations, workforce reductions, programmatic changes, and regulatory savings."

DOGE says it's working to upload all of the data transparently and has started with contract and lease cancellations, which "account for approx. 20% of overall DOGE savings." The list, however, has been shrinking. A *WSJ* *analysis* found the canceled contracts totaled $16.5 billion on February 17, but are down to just $7 billion as of the 20th, or 13% of stated savings. The *WSJ*'s analysis found that the true savings were more like $2.6 billion. That is roughly what the US will spend to service its debt *each day* this year (*Fig. 3*). The *WSJ* also suggested that some of these cancelled contracts were already spent or represented budget allotments that may or may not have been used in full eventually.

Cutting spending won't help balance the federal budget deficit if it also reduces assets or prevents an investment from yielding a return, for instance. That seems to be lost on DOGE's "shoot first, ask questions later" approach to cuts. One canceled $230 million contract was to modernize the Social Security Administration's (SSA) technology. This arguably would have helped to address the SSA's organizational malaise and alleged fraud, problems that Musk has targeted.

(2) *Lower wage costs?* One benefit of the wave(s) of federal resignations and layoffs is that it lowers the government's wage expenditures. The federal government employs about 2.4 million civilian workers, or 1.4% percent of the U.S. workforce (*Fig. 4*). The federal government spent around $293 billion to compensate its employees last year, including benefits. That's less than 4.5% of federal outlays. And roughly 60% of total compensation goes to workers in the Department of Defense, the Department of Veterans Affairs, and the Department of Homeland Security. Feasibly, the government can't save much here.

(3) *But less income for workers!* Personal incomes may fall more than government savings

on compensation.

One reason: According to the *CBO*, around 13% of federal government employees have less than a high-school education. That's less than the private sector, where non-diploma workers comprise one-third of employees. However, strong federal benefits mean these workers earn 40% higher compensation working for the government than their private sector counterparts.

Rising unemployment was mostly concentrated in this part of the labor market last year (*Fig. 5*). While it has subsided in recent months, and less immigration may cap the unemployment rate for less educated workers, those vulnerable to federal layoffs are likely to see fewer job opportunities and less compensation as they exit.

(4) *Shadow government jobs*. The private sector is likely to lose more jobs than the public sector, too. Federal funding and grants, including via environmental and educational agencies, pay a lot of employees' wages. For instance, the Mercatus Center *found* that in some states (e.g., Maryland, New Mexico, and Virginia) between 7.7%-10.7% of nonfarm payroll jobs are funded by the federal government through contracts to private-sector firms.

Government data also show that federally funded research centers account for around *18% of total US R&D expenditures* as of 2022. So it's no surprise that some US research universities are *pausing doctoral admissions* in anticipation of funding cuts and that China is *advertising itself as a safe haven* for aspiring PhDs as a result. The prospective brain drain, if sustained, would be an unquantifiable loss in the precise fields in which the US is seeking to compete with China and lead the world. We hope that this pro-tech administration will find a way to correct course shortly.

(5) *Budget deadline & tax cuts*. The federal government is currently operating under a continuing resolution until March 14, so there's only three weeks for Congress to pass a new budget deal for fiscal 2025. Republicans in the House and Senate are working on tax cuts as part of a giant, all-encompassing, bill (or two). Extending the 2017 Tax Cut and Jobs Act, a core component of whatever deal the GOP constructs, is estimated by the Congressional Budget Office to reduce revenues by $4.6 trillion over the next decade. No tax on tips, Social Security benefits, or overtime pay are also Trump priorities. But reducing federal receipts to below the current 17.5% of GDP would complicate plans to rein in the budget deficit (*Fig. 6*).

That said, individual income taxes continued to rise during Trump 1.0 as the economy grew

(*Fig. 7*). Cuts to social programs are also likely, which would reduce "mandatory" outlays.

Strategy II: Putting the Budget on a Sustainable Path. The US federal budget deficit is driven by Americans consuming and investing more than we produce and save. The causes of this imbalance and who bears the ultimate responsibility for it are up for debate. Trump 2.0 believes that it can reduce the pressure on the fiscal deficit by producing more at home and therefore helping to balance the trade deficit.

As we wrote in our February 19 *Morning Briefing*, defense makes up $1.1 trillion of the federal government's annual spending, or 3.7% of GDP. The Eurozone spends less than €330 billion annually, less than 2% of its GDP (*Fig. 8*). Meanwhile, NATO wants to spend more than 3% of GDP on defense, which would roughly double Europe's defense expenditures and could allow for a lot of relief from our deficit funding.

But going line item by line item isn't a viable solution to getting the fiscal train back on the tracks. A rewiring of global trade may be necessary. Consider how that may be achievable:

(1) *Current account deficit*. The US current account balance, which comprises net trade but also earnings and payments on foreign investments, is around historical lows. At 4.2% of GDP as of Q3, the current account deficit has only been lower in the runup to the Great Financial Crisis (GFC) (*Fig. 9*). One reason is that the US primary income balance—what America earns on assets overseas versus what it pays to foreign creditors—has turned negative for the first time on record (outside of one brief blip in 2001).

It's no secret that the rest of the world (ROW) owns more US assets than the US owns foreign assets. And despite a net international investment position of nearly -$24 trillion, very low US interest rates have allowed America to pay little to creditors while earning much more on assets abroad. For instance, a few selected foreign countries own $3.34 trillion of Treasuries (*Fig. 10*). Most of these were acquired during the zero-interest era following the GFC and therefore have very low coupons relative to current rates (*Fig. 11*).

Notably, members of Trump's economic team have proposed debt-issuance strategies that would lessen the debt-servicing burden. However, action is already being taken on the secondary income balance, which is at a record low of -0.84% of GDP. This balance includes foreign aid, remittances, and contributions to multinational institutions. By pulling out of several of these organizations, limiting foreign aid, and reducing immigration right out of the gate, we believe half a percentage point of GDP can be saved here alone.

(2) *Latest executive orders.* President Trump issued two executive orders (EOs) regarding trade and investment on Friday. Both target unfair practices by China and protect the US private sector abroad.

The *[“America First Investment Policy”]* encourages foreign investment into the US while limiting US investment in China. An expedited process for allies to invest in the US will help restructure the grossly negative international investment position, help US companies like US Steel, and encourage domestic employment.

While the EO expands restrictions on investing in Chinese military-linked companies and instructs the Treasury Department to crack down on Chinese investments, it will also encourage allies to pivot away from China to receive favorable terms for investing in the US.

And domestically, the EO will expedite environmental and regulatory reviews for large investments of over $1 billion. Given the outsized burden that these reviews place on projects in the US, this could encourage a manufacturing boom that revitalizes the US industrial base.

The *“Defending American Companies and Innovators from Overseas Extortion and Unfair Fines and Penalties”* EO is meant to investigate foreign digital services taxes, regulations, and IP transfer requirements in the name of creating reciprocal tariffs to balance trade. We believe this is part of the “race-to-the-bottom” tariff measures that will lead to reduced trade barriers, not greater ones.

(3) *Upshot*. One of the most contrarian positions right now is to be bullish on global trade and domestic manufacturing. We believe Trump 2.0 will aid US companies and domestic investment without creating a Smoot-Hawley redux. The imbalances that have sidelined US goods producing and led to a huge wave of offshoring since China entered the World Trade Organization in 2001 are finally being remedied. The Roaring 2020s may very well lead to the Roaring 2030s in this outlook. While markets in Europe and other countries are likely to benefit from finally investing in their own economies, we remain bullish on the US and continue to favor our long-standing “Stay Home” investment stance—overweighting US equities in global portfolios—over a “Going Global” one.

Calendars

US: Tues: Consumer Confidence 102.1; Richmond Fed Manufacturing Index -2; Logan;

Barr; Barkin. **Wed:** New Home Sales 680,000 units; MBA Mortgage Applications; Barkin; Bostic. (FXStreet estimates)

Global: **Tues:** Eurozone GDP -0.2%q/q, -0.2%y/y; Bundesbank Annual Report 2024; Schnabel; Nagel; Pill. **Wed:** Germany Gfk Consumer Sentiment -21; Dhingra. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the February 21 week, forward earnings rose for two of these three indexes, after falling for all three simultaneously for two straight weeks for the first time in 14 months. LargeCap's forward earnings rose 0.2% w/w to less than 0.2% below its January 31 record high. MidCap's rose 0.1% w/w to 0.6% below its record high in early June 2022. SmallCap's posted its fourth straight weekly decline, dropping 0.5% w/w to 12.2% below its June 2022 record. LargeCap's forward earnings has soared 22.4% from its 54-week low during the week of February 1, 2023; MidCap's is 8.2% above its 55-week low during the week of March 10, 2023; and SmallCap's is just 1.6% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2025: LargeCap (11.1%, 10.1%, 14.0%), MidCap (-0.4, 10.9, 16.4), and SmallCap (-12.8, 13.9, 18.5).

S&P 500/400/600 Valuation (*link*): Valuations were lower w/w for these three indexes as the SMidCaps test their 17-week lows during the January 10 week. LargeCap's forward P/E dropped 0.4ppt w/w to 21.8 from a 10-week high of 22.2, and is now 0.5pt below its 43-month high of 22.3 during the December 6 week. It's up 4.8pts from a seven-month low of 17.0 during the October 27, 2023 week and 7.1pts 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 fell 0.5pt w/w to match its four-month low of 15.6 during the January 10 week, and is now 1.4pts below its 40-month high of 17.1 during the November 29 week. It's up 3.3pts from a 12-month low of 12.3 at the end of October last year and compares 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 also fell 0.5pt w/w to 15.3, which is just 0.1pt above its four-month low during the January 10 week and 1.8pts below its 41-month high of 17.1, also during the November 29 week. It's up 4.7pts 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 is now at a seven-month low 28% discount to LargeCap's P/E, which compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. It's now just 1.0ppt above its 25-year-low 29% discount during the July 5, 2024 week. SmallCap's P/E is now at a 17-week low 29% discount to LargeCap's P/E, which compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 3.0ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's 2% discount to MidCap's is narrowing again and remains among the smallest since July 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above Midcap's, and both were above LargeCap's.

Global Economic Indicators

Eurozone CPI (*link*): The *Eurozone CPI* was confirmed at a six-month high of 2.5% in January, ahead of next week's ECB policy meeting. The CPI accelerated for a fourth successive month, from a three-year low of 1.7% in September to 2.5% in January. Meanwhile, the *core CPI* is at 2.7% for the fifth successive month. The headline and core CPIs are down sharply from their recent peaks of 10.6% in October 2022 and 5.7% in March 2023. Looking at the components, the *services* rate ticked down from 4.0% in December to 3.9% in January—fluctuating around those rates for the fifth consecutive month. The rate for *food, alcohol & tobacco* slowed from 2.9% in October to five-month low of 2.3% in January. The rate for *non-energy industrial goods* has bounced in a flat trend from 0.4% to 0.6% for six successive months. Among the four *largest Eurozone countries*, Germany's yearly rate remained at 2.8% in January, while France's held at 1.8%. Meanwhile, Spain's climbed from 1.7% in September to 2.9% by January, while Italy's accelerated from 0.7% in September to 1.7% in January.

Germany Ifo Business Climate Index (*link*): "Sentiment among companies in Germany continues to be skeptical," notes Clement Fuest, Ifo's president. "While companies were slightly less satisfied with current business, expectations brightened somewhat. The German economy is waiting to see how things develop." Ifo's *business climate index* was unchanged at 85.2 in February, down from a recent peak of 89.0 in May 2024. The *current situation component* dipped to 85.0 from 86.0 in January, bouncing around recent lows, while *expectations* climbed to 85.4 in February, after falling from 87.4 in October to 84.3 in January—which was the lowest reading since January 2024. Activity in the *service sector* deteriorated in February, with companies pessimistic about both the current situation and expectations. Meanwhile, the *manufacturing sector* saw a slight improvement in February, with companies noticeably less pessimistic about the future, though assessed the current situation as somewhat worse. The *trade sector* also saw improvement in its business climate index—boosted by a more optimistic outlook—while traders in both wholesale and retail also assessed their current situation as somewhat better. *Construction*'s business climate improved as well, but only because of slightly less skeptical expectations; the current assessment was somewhat worse due to a lack of orders.

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