MORNING BRIEFING
April 26, 2023

Fiscal Dystopia

Check out the accompanying chart collection.

Executive Summary: If Congress doesn't increase the federal debt ceiling soon, the government will no longer be able to pay its bills. Jim Lucier of Capital Alpha Partners reports on the progress of the Limit, Save and Grow Act, which may well pass the House this week. … The government has been in such pickles before, and the debt limit usually got raised before the 11th hour and a couple of times at the 12th hour. Of course, the recent consequences of the government's unprecedented fiscal excesses have been massive federal deficits and inflation boosted by helicopter money. But doomsday has never arrived. We examine why. … Also: Joe looks at the profit margins that analysts expect for S&P 500 sectors and industries.

US Fiscal Policy I: X-Date Is Coming. Axios' Matt Phillips *reported* on Tuesday that the federal government's day of reckoning is approaching sooner than expected: "Analysts have been watching recent tax receipts especially closely, hoping that a bumper crop of tax payments could push out the day of reckoning—also known as the 'X-date,' when the government runs out of money and could default on payments. But no dice." April is the best month for federal tax receipts because taxes are due on April 15. But last year was an awful year for stock investors. So capital-gains tax receipts are coming up short.

The US government hit its statutory debt limit of $31.4 trillion in January, putting a lid on the Treasury's ability to borrow (*Fig. 1*). Treasury has been taking "extraordinary measures" to pay its bills. That includes deferring payments to some government pension plans. Nevertheless, the Treasury's funds are low, and its cash balance at the Fed was down to $166.5 billion on April 19, and falling rapidly toward zero (*Fig. 2*).

US Fiscal Policy II: The X-Games. Our good friend James Lucier bravely sorts out Washington's political intrigues on fiscal policy matters for *Capital Alpha Partners*. He believes House Speaker Kevin McCarthy (R-CA) is within striking distance of passing a debt-limit bill, the *Limit, Save, and Grow Act*, through the House this week. Jim writes:

"McCarthy may surprise to the upside this week with a quick win on the debt limit. This will bring the first round of House proceedings to a successful close in April rather than the possible alternative of extending them through May and June, which seemed likely only weeks ago. A number of factors are working in McCarthy's favor on the House floor this week. We still see the X-date as trending for late July, but we expect improved forecasts soon.”

The following are highlights from Jim’s recent analysis of the debt-ceiling impasse and what it will take to pass a deal:

(1) McCarthy has only four votes to spare, and a single high-profile defection could doom his chances of passing the bill on the first try.

(2) However, McCarthy’s conference appears to be coming together despite some trepidations from moderates and demands for more content from conservatives.

(3) Should McCarthy succeed in passing the bill this week, we think investors would receive the news that he has concluded the first stage of House proceedings with a win in April, rather than stretching the drama through May and June, as a positive surprise.

(4) McCarthy then would close the week with his political capital enhanced, not depleted. The sooner things go to the cooling-off stage on the Senate side, the better.

(5) The real challenge, of course, will be whether the House can pass a Senate-drafted bill in the end.

(6) The timing of the vote has yet to be announced, but we would not be surprised to see it on Wednesday rather than Thursday or Friday, when such votes typically take place.

(7) The House’s full agenda this week works in McCarthy’s favor, improving his chances of passing the bill through the House during this last week of April. A week-long break is coming up after Friday, South Korean President Yoon Suk Yeol will address a joint session of Congress on Thursday evening, and there will be several other votes this week that should be popular among Republicans. These include a Congressional Review Act vote to repeal President Biden’s tariff safe harbor for photovoltaics imported from South East Asia that would otherwise be subject to antidumping penalties.

(8) On the whole, moderate Republicans seem ready to support McCarthy because they see his debt-ceiling proposal as an opening offer that will jumpstart talks in the Senate and perhaps completely obviate the need for any direct talks with the Biden administration.

(9) There has never been any chance that the Senate would pass a clean debt-limit

extension, in our view, a view widely shared by other observers.

(10) The Senate also has a 60-vote threshold for passing its own debt-limit package, which means that at least nine Republicans plus Democrat Joe Manchin (WV) must support it. Some features of the Senate product could be hard for House Republicans to swallow. But for now, Republicans appear to be united by the desire to beat conventional wisdom and stick one to the Biden administration.

To put Jim's analysis of the current debt-ceiling impasse into historical context, we'd add one more important point: Such impasses have happened many times before and been resolved. The last major cliffhanger occurred at the end of 2012. It was resolved on New Year's Eve with an agreement between Vice President Joe Biden and Senate Minority Leader Mitch McConnell! They are both still in positions to resolve the latest debt-ceiling crisis.

Fiscal Policy III: A Trillion Here, a Trillion There. Debbie and I have been on Wall Street as economists and strategists for more than 40 years. Over that entire period, doomsters have been scribbling away, producing lots of articles and books about the US federal deficits and debt. The only pause in their doom and gloom was during the late 1990s and early 2000s, when the federal government ran a surplus for a brief time. Nevertheless, while the annual federal deficits are now measured in trillions rather than billions, doomsday has yet to occur (*Fig. 3*).

Of course, as a result of the pandemic, the US budget deficit ballooned to record levels as government outlays soared, while receipts were depressed (*Fig. 4*). On a 12-month basis, the deficit hit a record $4.1 trillion during March 2021. It briefly fell just below $1.0 trillion during July 2022. In March of this year, it was back at $1.8 trillion, as outlays have been outpacing receipts.

There's been one obvious adverse consequence of running such large deficits. The rebound in inflation since late 2021 undoubtedly was attributable to the three rounds of billions of dollars in pandemic relief checks sent by the government to millions of Americans in 2020 and 2021. All that fiscal stimulus combined with ultra-easy monetary policies amounted to "helicopter money," a concept discussed by economist Milton Friedman and former Fed Chair Ben Bernanke. That money drop triggered a buying binge, mostly for goods since many services providers were hampered by social-distancing restrictions. The resulting demand shock overwhelmed global supply chains and sent inflation soaring.

But so far, the consequences of massive deficits haven't been doomsday in nature. Nevertheless, it is hard to see how this doesn't end badly eventually. There is a doomsday mechanism built into the government's ever rising debt. The net interest paid by the government continues to grow rapidly, especially now that short-term interest rates have soared by 500bps over the past year. This outlay rose to a record $564.9 billion over the 12 months through March (*Fig. 5*). Just before the pandemic, it was $383.7 billion.

As Treasury issues mature and must be refinanced at higher interest rates, the government's outlays on net interest paid will continue to rise. We estimate that the average interest rate paid by the Treasury on its publicly held debt is currently around 2.20% (*Fig. 6*). At 3.00%, the annual net interest expense would be $740 billion currently.

So why isn't the deficit causing interest rates to soar? Consider the following:

(1) The Fed's holdings of Treasury, agency, and mortgage-backed securities peaked at a record high of $8.5 trillion during May 18, 2022. As a result of the Fed's quantitative tightening program, the Fed's holdings of these securities are down $633.8 billion to $7.9 trillion as of April 19 (*Fig. 7*).

The comparable securities held by commercial banks peaked at a record $4.7 trillion on February 23, 2022. They are down $570.7 billion since then through April 12.

(2) On the other hand, bank depositors have been moving their money into money market mutual funds (MMMF), which have been buying lots of Treasury bills. The assets of MMMF increased $739.7 billion y/y through April 19 (*Fig. 8*).

(3) The major buyers of US bonds over the past year have been foreigners. Over the past 12 months through January, they purchased a record $1.1 trillion in the US bond markets, led by $878.1 billion in Treasury notes and bonds (*Fig. 9* and *Fig. 10*).

(4) Finally, we have long believed that actual and expected inflation and the Fed's reaction to inflation are more important in driving interest rates and the yield curve than supply and demand fundamentals. The latter two suggest that investors expect that inflation will moderate and the Fed will soon stop tightening.

Fiscal Policy IV: The Baby Boomers' Bequest. The main reason that mounting government deficits and debt haven't had major adverse consequences so far is that they represent intergenerational theft. The Baby Boomers are stealing from our children. We are leaving them a huge bequest of debt.

Strategy: Profit Margins. The consensus of analysts polled by Refinitiv expects the S&P 500 companies' collective quarterly profit margin to improve to 11.8% in Q1-2023 from the 11.5% reported in Q4-2022 (*Fig. 11*). Since companies typically beat analysts' forecasts, we think the actual profit margin could turn out to be 12.1% once all the Q1 results are in. That still would be below the 12.6% recorded for Q3-2022 and the record high of 13.7% hit in Q2-2021. But what's more important for investors than how the level compares to past quarters' margins is how much it prompts analysts to adjust their future expectations.

With the Q1 earnings season just getting underway, the initial response has been a lower-than-expected reduction to forecasts for Q2 and the rest of the year. For Q2, analysts currently think the profit margin will improve to 12.2%, above their current projection of 11.8% for Q1. Keep in mind that neither estimate yet reflects the typical bump that comes after companies report earnings beats, so the final profit margins should be slightly higher.

We calculate the S&P 500's forward profit margin from analysts' consensus forecasts for revenues and earnings. It's down from peak levels last June for all 11 of the S&P 500's sectors. But most sectors' margins have held up extremely well. Energy, Financials, and Industrials have fallen the least, while just three sectors have trailed the S&P 500's decline: Communication Services, Health Care, and Materials.

For a more in-depth look, see our S&P 500 *Sectors & Industries Forward Profit Margins* report, from which we highlight the notable changes below:

(1) *S&P 500.* The effects of the pandemic and ensuing shortages allowed companies to raise their prices, which caused the S&P 500's forward profit margin to rise from 12.3% in April 2021 to a record high of 13.4% during the June 9 week last year. As of the April 20, 2023 week, it has round-tripped all the way back to 12.3%.

(2) *Energy, Financials, and Industrials.* Within the Energy sector—where margins now are rolling over from their record highs during 2022—only the Oil & Gas Refining & Marketing industry's forward margin is still at a record high. Oil & Gas Equipment & Services' margin is holding on at a post-pandemic high.

Within Financials, all of the banking industries' forward margins have been drifting downward. Those of most insurance-related industries are stable, but the Insurance Brokers and Reinsurance industries' margins have continued to move higher. These two Industrials sector industries' margins remain near their record highs: Construction Machinery & Heavy Transportation Equipment and Electrical Components & Equipment. The Passenger Airlines industry is still rebounding from its losses during the pandemic, but its margin remains below its pre-pandemic highs.

(3) *Communication Services, Health Care, and Materials.* Two industries in the Communication Services sector, Broadcasting and Publishing, have been among the worst-performing S&P 500 industries in terms of profit margins. Advertising's forward margin remains near a record high though. Health Care's forward profit margin has dropped to a record low, paced by margin weakness in the Biotechnology, Health Care Facilities, and Pharmaceutical industries.

(4) *Materials and Utilities.* Most of the forward margins in the Materials sector's industries have continued to drift downward except for that of Industrial Gases, which remains near a record high. Both the Copper and Gold industries' margins seem to have bottomed following their steep declines in 2022, as they've trended higher so far in 2023. Within Utilities, only Water Utilities' margin is trending higher; it was at a record high during the April 20 week.

Calendars

US: **Wed:** Durable Goods Orders Total, Ex Defense, and Core 0.8%/0.3%/-0.2%; Goods Trade Balance -$89.0b; Wholesale & Retail Inventories; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. **Thurs:** GDP & GDP Price Index (q/q) 2.0%/3.7%; PCE Prices Headline & Core 3.7%/4.7%; Kansas City Manufacturing Index 3.0; Initial & Continuous Jobless Claims 248k/1.878m; Pending Home Sales 0.5%. (Bloomberg estimates)

Global: **Wed:** Germany Gfk Consumer Climate -27.5; France Consumer Confidence 82; UK Labor Productivity 0.3%; Canada Manufacturing Sales -0.3%; China Industrial Production -12.0%ytd; De Guindos; Tuominen; Jochnick; Enria. **Thurs:** Eurozone Economic Sentiment Indicator 99.9; Italy Consumer & Business Confidence 105.5/104.0; Spain Retail Sales 5.5%y/y; Spain Business Confidence -2.2; Spain Unemployment Rate 12.9%; Japan Industrial Production 0.5%; Japan Retail Sales 5.8%y/y; Japan Unemployment Rate 2.5%; Japan Leading Index 97.7; BOJ Monetary Policy Statement; Panetta. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q1 Earnings Season Monitor (*link*): With the Q1-2023 earnings season now 26% complete, the early indications are that this season is an improvement from Q4-2022's relatively weak showing. Then, the earnings surprise was the lowest since Q4-2008 and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 130 of the S&P 500 companies finished reporting for Q1-2023, revenues are ahead of the consensus forecast by 2.3%, and earnings have exceeded estimates by 8.5%. At the same point during the Q4 season, revenues were 0.6% above forecast and earnings had beaten estimates by 1.6%. Just 69% of the 130 Q1 reporters that have reported so far through mid-day Tuesday has reported a positive revenues surprise, while 79% has reported an earnings beat. That's close to the weakest reading for revenues since the Great Virus Crisis, but the percentage with positive earnings surprises may have bottomed in Q4-2022. Their aggregate y/y revenue and earnings growth rates are little changed from their Q4-2022 readings. The collective y/y revenue gain for the 130 reporters so far has remained steady at 5.7%, and earnings are up 0.8% y/y from a 1.9% y/y decline in Q4-2022. During the past 56 quarterly reporting seasons over the last 14 years, y/y earnings growth has trailed revenue growth in only 14 of the quarters, and it's likely to do so again in Q1-2023. Significantly fewer companies are reporting positive y/y earnings growth in Q1 (57%) than positive y/y revenue growth (72%). These figures will continue to change as more Q1-2023 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q1, earnings are likely to decline for a second straight quarter.

US Economic Indicators

Consumer Confidence (*link*): Consumer confidence fell in April for the third time in four months on a sharp drop in expectations, while the present situation component remains around recent highs. *Headline* consumer confidence fell by 2.7 points this month and 7.7 points over the period to a six-month low of 101.3, as the *expectations* measure tumbled 5.9 points and 15.3 points over the comparable periods to a nine-month low of 68.1. The report noted that in every month but one since February 2022, the expectations index has remained below 80—a level associated with a recession within the next year. Meanwhile, the *present situation* component has increased in four of the past five months, by 2.2 points m/m and 12.8 points over the period to 151.1, matching its Q1 average, which was the strongest quarter since Q1-2020 and above last year's average of 145.7. *Current business conditions* improved a bit in April, with the percentage saying conditions were bad falling to 18.1% from 19.3% in March, while the percentage of consumers saying business conditions were good held at March's 18.8%. The *current labor market* also improved slightly, with 48.4% of consumers saying jobs are plentiful, up from 47.9% in March, and 11.1% saying jobs are hard to get, down slightly from 11.4% in March. *Short-term business conditions* (six-month outlook) this month were more pessimistic than March: 13.5% expected business conditions to improve this month, down from 16.4% in March, while the percentage expecting conditions to worsen rose from 19.2% last month to 21.5% this month. Consumers' assessment of the *short-term labor market* was less positive, with the percentage of consumers expecting more jobs to be available six months from now moving down to 12.5% from 15.5% last month, while 21.0% anticipated fewer jobs, up a bit from March's 20.5%. Their *short-term financial prospects* was, on balance, slightly more favorable, with 15.7% of consumers expecting their incomes to increase, little changed from last month's 16.2%, while 11.6% expect incomes to decrease, down from 13.8% in March.

Regional M-PMIs (*link*): Four Fed districts (New York, Philadelphia, Dallas, and Richmond) have reported on *manufacturing activity* for April, and they show growth declined for the 12th successive month, though more slowly, as the New York region showed a big swing in growth from negative to positive. Overall manufacturing activity declined at a slightly slower pace in April, climbing to -13.5 this month after deteriorating from -14.9 in February to -17.1 in March, fluctuating between -13.5 and -17.1 the past four months. New York's (to +10.8 from -24.6) measure expanded for the first time since last November and at the fastest pace since last July (recording a 35.4-point swing), while both the Philadelphia (-31.3 from -23.2), Dallas (-23.4 from -15.7), and Richmond (-10.0 from -5.0) regions showed steeper declines. *New orders* (-6.8 from -18.8) moved back toward expansionary territory, as billings in the New York (+25.1 from -21.7) region rebounded sharply, while Dallas' (-9.6 from -14.3) contracted at the slowest pace in three months, and Philadelphia (-22.7 from -28.2) and Richmond (-20.0 from -11.0) billings continued to contract at a fast pace. *Employment* (0.0 from -3.8) was flat this month, as hirings in the Philadelphia (-0.2 from -10.3) and Richmond (0.0 from -5.0) areas moved back up to the break-even point of zero. Factories in the Dallas (+8.0 from +10.4) region hired at a slower pace, while New York's (-8.0 from -10.1) declined at a slower pace. Looking at *prices-paid* indexes, the Philadelphia (8.2 from 23.5) measure slowed dramatically to its lowest percentage since mid-2020, while Dallas' (19.5 from 20.3) eased to a 33-month low, and New York's (33.0 from 41.9) saw price pressures ease back to January's 26-month low of 33.0 after a slight tightening in February. Meanwhile, Richmond's (75.7 from 62.4) accelerated after slowing to a two-year low last month. They were at record highs of 83.6 (November 2021), 84.1 (November 2021), 86.4 (April 2022), and 150.1 (May 2022), respectively. *Prices-received* indexes were mixed: New York's ticked up to 23.7 after easing to 22.9 in March, remaining above January's two-year low of 18.8, while Dallas' inched up to 8.4 this month after easing to a 28-month low of 7.0 in March. The Philadelphia measure moved down for the third month to -3.3 this month from 29.9 at the start of the year. Richmond's barely budged for the second month, averaging 55.9 the past three months. They were at record highs of 56.1 (March 2022), 51.3 (October 2021), 65.8 (November 2021), and 103.1 (June 2022), respectively. (Note: The New York, Philadelphia, and Dallas measures are diffusion indexes, while Richmond's measures are average annualized inflation rates—which we multiply by 10 for easier comparison to the other regional measures.)

New Home Sales (*link*): New home sales (counted at the signing of a contract) continued to climb in March, jumping to its highest level in a year, as sales shot up 170.8% in the Northeast and 29.8% out West last month. Overall sales climbed for the third time in four months, soaring 9.6% in March and 17.4% over the period to 683,000 units (saar); that's only 3.4% below a year ago—a sharp narrowing from the 25.9% y/y drop at the end of last year. Of the 683,000 homes sold in March, 269,000 units were under construction, while 246,000 were completed and 168,000 not yet started—the highest since February 2022. Meanwhile, there were 432,000 units for sale last month, with only 71,000 units completed and 94,000 not yet started; 267,000 were under construction. At the current sales pace, it would take 7.6 months to run through the supply of new homes, a 12-month low and down from 10.1 months last September and June—which was the highest since April 2009.

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