MORNING BRIEFING
August 21, 2023

No Hard Feelings

Check out the accompanying chart collection.

Executive Summary: Is the strength of the economy a double-edged sword that means higher-for-longer inflation, further monetary tightening, and a recession? Or will the tightening that's already occurred fell the economy still? Or is the mounting federal budget deficit the economy's Achilles' Heel? While we remain in the light-side camp, we do share the deficit concerns of dark-side prognosticators: Profligate government spending combined with falling revenues as a percent of GDP points to nowhere good. The bond market is concerned too. Fed Chairman Powell will have a chance to calm the bond market at Jackson Hole on Friday. Much depends on whether he does. … And: Dr. Ed reviews "Breaking" (+ +).

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

US Economy I: The Great Debate Continues. To our pessimistic friends on the dark side of the Great Debate over the economic outlook, we say: "Keep up your thought-provoking work! We are constantly challenged by your insights as we continue to be your sparring partners on the lighter side of the debate."

Let's review the honorable opposition's latest debating points before we focus on the federal budget deficit issue, which does concern us:

(1) *Jeremy Grantham*. In an August 18 *interview* on Bloomberg Wealth with David Rubenstein, Jeremy Grantham of GMO doubled down on his grim outlook for the economy. He is betting with near certitude that the Fed will fail to avoid a recession: "They have never called a recession, and particularly not the ones following the great bubbles." As higher rates continue to depress other corners of the market, particularly real estate, the US economy will see "a recession running perhaps deep into next year and an accompanying decline in stock prices." Grantham thinks that inflation will "never be as [low as] its average for the last 10 years." So interest rates will remain higher, which will "push asset prices down."

(2) *David Rosenberg.* In an August 17 *post* on X (a.k.a. Twitter), David Rosenberg of

Rosenberg Research predicted that equites are "heading into a new bear phase." He noted that "rule number eight" by Wall Street veteran Bob Farrell states that bear markets have three stages, namely, sharp down, reflexive rebound, and drawn-out fundamental downtrend. The same day that he posted his tweet, he *told* BNN Bloomberg in a TV interview: "The recession has been delayed; it's not derailed." Rosenberg said that on average recessions start two years after the first Fed rate hike. He warned that a "huge default cycle" is coming. He added, "We're not getting out of this without a recession."

(3) *Mike Wilson*. In an *interview* posted on August 8 by *Fortune*, Mike Wilson of Morgan Stanley warned that "excessive" government spending could be fueling a "boom-bust" scenario in the stock market.

(4) *Marko Kolanovic*. On August 2, *Yahoo! Finance* reported that Marko Kolanovic of JPMorgan wrote the following in a note to investors: "While the economy's recent resilience may delay the onset of a recession, we believe that most of the lagged effects of the past year's monetary tightening have yet to be felt, and ultimately a recession will likely be necessary to return inflation to target."

(5) *Ray Dalio*. At a June 7 *Bloomberg conference*, Ray Dalio of Bridgewater Associates warned that the US is facing a debt crisis and a looming balance-sheet recession. One of his concerns is that there may not be enough buyers for the deluge of securities that the Treasury must issue to finance the rapidly widening deficit. "In my opinion, we are at the beginning of a very classic late, big-cycle debt crisis when you are producing too much debt and have also a shortage of buyers," Dalio said. He argued that interest rates are likely to stay high for some time, which will weigh down the economy.

(6) *Bottom line.* At the beginning of the year, the bears warned that a recession was imminent. Instead, real GDP rose 2.0% (saar) during Q1 and 2.4% during Q2. The Atlanta Fed's *GDPNow* model is tracking real GDP growth at 5.8% during Q3. The estimate has consistently been rising since July 27, when it was 2.0%.

Now some of the economy's naysayers are saying that the strength of the economy means that inflation will stay higher for longer, forcing the Fed to continue hiking the federal funds rate until a recession occurs, maybe early next year. Others in the bearish camp are saying that the Fed's tightening of monetary policy since early last year will cause a recession even if the Fed doesn't raise rates because the long and variable lags of monetary policy will soon hit the economy hard.

The gloomiest pessimists expect that the mounting federal deficits can be financed only at higher interest rates, which will cause a debt crisis and a recession. The doomsday version of this scenario is that the net interest outlays of the federal government will compound at a pace that is simply unsustainable, with lots of dire consequences.

We are counting on continued moderation in the inflation rate and lower interest rates next year to prevent these dire predictions from playing out. Nevertheless, let's have a closer look at the federal deficit issue, which is the one that troubles us the most.

US Economy II: Federal Budget Deficit Matters. The hard-landers are highly regarded strategists with some great calls behind them. They've been wrong so far about a recession arriving in 2022 and 2023, but they could still be right about one coming before year-end 2024. In particular, Debbie and I share their concerns about the mounting federal budget deficit, which has been exacerbated by mounting federal outlays led by soaring net interest outlays.

In the past, we didn't care as much about the federal budget deficit because it tended to widen during recessions and narrow during economic expansions relative to nominal GDP (*Fig. 1*). That's because during recessions (expansions), outlays rose (fell) relative to GDP, while tax receipts declined (increased) relative to GDP (*Fig. 2*). This time, the government's outlays are increasing while its revenues are decreasing relative to rising GDP as the economy expands.

In the past, bond investors were much more focused on inflation and the Fed's policy response to it rather than on the supply of Treasuries. That's because inflation tended to moderate during recessions and economic recoveries (as productivity rebounded) (*Fig. 3*). So a widening deficit didn't matter much. That's why in the past, we didn't care that much about the federal budget deficit—because the bond market didn't care that much.

The Fitch Ratings downgrade of US federal government debt from AAA to AA+ on August 1 reminded us all that fiscal policy has turned increasingly profligate since the pandemic. As Clinton administration adviser Rahm Emanuel famously said: "You never let a serious crisis go to waste. And what I mean by that it's an opportunity to do things you think you could not do before." That's always been Washington's *modus operandi*, but never more so than since the pandemic.

Arguably, the first round of pandemic relief checks distributed by the Treasury during the spring of 2020 worked remarkably well to stabilize the economy that year. But the second round in late 2020 and the third round during the spring of 2021 set the stage for a significant surge in inflation. Here is a summary of the *three rounds of checks* and subsequent fiscal extravaganzas:

Round 1 (March 2020): $401.5 billion sent in 167.6 million payments.

Round 2 (December 2020): $141.5 billion sent in 146.5 million payments.

Round 3 (March 2021): $271.4 billion sent in 161.9 million payments.

American Rescue Plan (March 2021): This act authorized the third round of relief checks, with a total price tag of $1.9 trillion.

Infrastructure Investment and Jobs Act (November 2021): The Biden administration's second legislative victory came in November. This act provided $1.2 trillion to fund physical infrastructure projects such as roads, bridges, water pipes, and broadband internet.

CHIPS and Science Act (July 2022): This act included more than $50 billion for incentivizing the expansion of the semiconductor manufacturing industry in the US. It also increased funding for the Advanced Manufacturing Investment Tax Credit by nearly $25 billion and provided nearly $5 billion for research and innovation.

Inflation Reduction Act (August 2022): This act included nearly $370 billion for clean energy and climate programs.

The Congressional Budget office (CBO) issued a July 20 *report* that assessed the long-term budget outlook and included the following grim summary: "If current laws governing taxes and spending generally remained unchanged, the federal budget deficit would nearly double in relation to gross domestic product (GDP) over the next 30 years, driving up federal debt, the Congressional Budget Office projects. In CBO's extended baseline projections, debt held by the public rises from 98 percent of GDP in 2023 to 181 percent of GDP in 2053—exceeding any previously recorded level and on track to increase further. Those projections are not predictions of budgetary outcomes; rather, they give lawmakers a point of comparison from which to measure the effects of policy options or proposed legislation."

In other words, the Fitch downgrade was justified by the CBO's projections.

The Fed: Will Powell Calm the Bond Vigilantes? It's hard to put lipstick on this pig. Our relatively sanguine outlook since last year has been predicated on inflation coming down this year, which it has. As a result, we concluded that the 10-year Treasury yield probably peaked at 4.25% on October 24 and that the Fed would soon stop raising the federal funds rate.

The bond yield bottomed this year at 3.30% on April 6. But here it is, back to 4.25% on Friday, led higher by the 10-year TIPS yield's rise to 1.94%, little changed from Thursday's 1.97%, which was the highest since July 6, 2009 (*Fig. 4*). The yield rebounded from its low as the hard-landers were forced to concede that the economy was more resilient than they expected. The yield rose above 4.00% following the Fitch downgrade on August 1. The July FOMC minutes released on August 16 showed that the committee might continue to raise the federal funds rate if inflation doesn't continue to moderate.

Melissa and I expect that Fed Chair Jerome Powell will try to calm the bond market with his speech on Friday at the Fed's annual Jackson Hole conference. We think he will agree with the views *expressed* by New York Federal Reserve Bank President John Williams earlier this month—basically that monetary policy is restrictive enough as it is to bring down inflation. Powell will likely acknowledge that inflation has been moderating and say that if it continues to do so, the Fed may have to lower the federal funds rate next year to stop real interest rates from tightening credit conditions further.

If he doesn't do so (or succeed in doing so), the yield curve will continue to disinvert, with the 10-year yield rising toward the 2-year yield (*Fig. 5* and *Fig. 6*). In that scenario, the rating agencies, anticipating more loan defaults, would subject the banking sector to another round of credit-rating downgrades, especially in the commercial real estate sector.

The odds of a recession occurring before the end of next year would increase in that scenario. That would be unfortunate indeed since inflation is likely to continue to moderate without requiring a recession to do so. We currently are still assigning 85% odds to a no-landing scenario through the end of next year and 15% to a hard-landing one. However, we are leaning toward lowering the former and raising the latter.

Powell's speech will matter a great deal to what happens next.

Movie. "Breaking" (+ +) (*link*) is based on the 2017 real-life story of the late Brian Brown-Easley, a decorated Marine Corps veteran who walked into a Wells Fargo bank and claimed to have a bomb in his backpack. He didn't want to rob the bank. Rather, he wanted the regional office of the Department of Veterans Affairs (VA) to give him his benefits check for $892. The VA used the money to reduce the balance on his outstanding student loan instead. It's a very sad story, suggesting that we need to do much more to help our veterans after they've bravely served our country.

Calendars

US: Mon: None. **Tues:** Existing Home Sales 4.15mu; Richmond Fed Manufacturing Index -7; API Weekly Crude Oil Inventories; Bowman; Goolsbee; Barkin. (Bloomberg estimates)

Global: Mon: Germany PPI -0.4%m/m/7.6%y/y; Spain Consumer Confidence 85.7; Buba Monthly Report**. Tues:** Eurozone Current Account -€6.9b; UK Industrial Trend Orders. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index fell last week for a third straight week, the first time that's happened since late February. Its 2.1% decline caused the index to drop back into a correction at 10.1% below its record high on December 27, 2021. The US MSCI ranked 15th of the 48 global stock markets that we follow in a week when only one of the 48 countries rose in US dollar terms. The AC World ex-US index underperformed with a 3.4% decline, and dropped deeper into a correction at 18.6% from its June 15, 2021 record high. All regions fell for a third straight week, but EMEA was the best performing region with a 1.4% decline, ahead of EM Latin America (-3.0%), EMU (-3.2), and EAFE (-3.4). EM Eastern Europe was the worst performing region last week with a decline of 4.4%, followed by BIC (-4.1) and EM Asia (-3.5). Egypt was the best-performing country last week, with a gain of 2.5%, followed by Mexico (-0.4), India (-0.9), and Hungary (-1.2). Among the 20 countries that underperformed the AC World ex-US MSCI last week, the 7.2% decline for Pakistan was the biggest, followed by those of Singapore (-6.8), Peru (-6.5), Poland (-5.9), and South Africa (-5.9). Looking at 2023's performance so far, the US MSCI is up 14.1%, as its ytd ranking rose two places w/w to 13/48. The AC World ex-US's ytd gain of 4.2% is trailing the US's, with 31/48 countries in positive territory. EM Eastern Europe is the best regional performer ytd with a gain of 21.5%, followed by EMU (11.1), EM Latin America (10.6), and EAFE (5.8). The regional laggards so far in 2023: BIC (-3.6), EM Asia (0.0), and EMEA (3.3). This year's best ytd country performers: Greece (38.3), Argentina (37.8), Sri Lanka (35.5), Hungary (33.7), and Ireland (24.4). Here are the worst-performing countries of the year so far: Pakistan (-27.5), Hong Kong (-16.7), Finland (-14.5), South Africa (-10.0), and Thailand (-9.5).

S&P 500/400/600 Performance (*link*): All three of these indexes fell for a third straight week in their longest simultaneous losing streak in 11 months. LargeCap dropped 2.1% w/w, less than the 3.1% and 3.4% declines for MidCap and SmallCap, respectively. At Friday's close, LargeCap finished the week at 8.9% below its record high on January 3, 2022, MidCap dropped back into a correction at 11.4% below its record high on November 16, 2021, and SmallCap slipped into a deeper correction at 18.1% below its November 8, 2021 record high. All 33 LargeCap and SMidCap sectors moved lower for the week, the first time that has happened since September 2020; that compares to 14 sectors rising a week earlier. MidCap Consumer Staples was the best performer, albeit with a decline of 0.2%, followed by LargeCap Tech (-0.8), MidCap Energy (-0.8), MidCap Materials (-1.4), and SmallCap Energy (-1.4). Among the biggest underperformers for the week were MidCap Utilities (-5.6), MidCap Communication Services (-5.1), SmallCap Communication Services (-5.1), SmallCap Real Estate (-5.0), and SmallCap Financials (-4.6). Looking at performances so far in 2023, LargeCap, with a gain of 13.8%, remains well ahead of MidCap (6.1) and SmallCap (3.8); 19 of the 33 sectors are higher ytd. The top sector performers in 2023: LargeCap Communication Services (37.2), LargeCap Tech (34.5), LargeCap Consumer Discretionary (27.7), MidCap Industrials (19.2), and MidCap Tech (14.9). Here are 2023's biggest laggards: MidCap Utilities (-18.3), LargeCap Utilities (-10.5), SmallCap Financials (-10.1), MidCap Communication Services (-10.1), and SmallCap Utilities (-8.7).

S&P 500 Sectors and Industries Performance (*link*): All 11 S&P 500 sectors fell last week, and only four outperformed the composite index's 2.1% decline. That compares to a 0.3% decline for the S&P 500 a week earlier, when seven sectors rose and seven outperformed the index. Tech was the best performer, albeit with a decline of 0.8%, followed by Health Care (-1.6%), Energy (-1.7), and Utilities (-2.0). Consumer Discretionary was the worst performer, with a drop of 4.1%, followed by Real Estate (-3.2), Financials (-2.8), Communication Services (-2.7), Industrials (-2.5), Consumer Staples (-2.4), and Materials (-2.4). Looking at 2023's performance so far, the S&P 500 is up 13.8% ytd, with just three sectors still outperforming the index but six higher for the year. The best ytd performers: Communication Services (37.2), Tech (34.5), and Consumer Discretionary (27.7). These are 2023's worst performers: Utilities (-10.5), Real Estate (-2.4), Health Care (-2.0), Consumer Staples (-1.7), Financials (-1.1), Energy (-0.5), Materials (3.8), and Industrials (7.9).

S&P 500 Technical Indicators (*link*): The S&P 500 fell 2.1% last week and weakened considerably relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index was below its 50-dma for the first time in 21 weeks, but remained above its 200-dma for a 22nd week. The S&P 500 dropped to a 22-week low of 2.0% below its rising 50-dma from 0.4% above a week earlier, and is down from a 20-week high of 5.4% above its rising 50-dma in mid-June. That compares to a 20-week low of 3.6% below at the beginning of March, a four-month low of 10.6% below at the end of September, a 23-month high of 8.7% above the index's rising 50-dma last August, and a 27-month low of 11.1% below its falling 50-dma in June 2022. The index had been trading above its 50-dma from most of late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at an 11-week low of 5.5% above its rising 200-dma, down from 8.1% a week earlier, which compares to a 24-month high of 12.4% above its rising 200-dma in mid-July. The S&P 500 is well above its 26-month low of 17.1% below its falling 200-dma in June 2022 and compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst level of the Great Financial Crisis following the failure of Lehman Brothers, the S&P 500 index was 39.6% below its 200-dma on November 11, 2008. As for what the dmas themselves have been doing, the 50-dma moved higher last week for a 21st week in its longest positive streak since September 2021, while the 200-dma rose for a 12th week in its longest positive streak since March 2022.

S&P 500 Sectors Technical Indicators (*link*): Two of the 11 S&P 500 sectors are trading above their 50-dmas, down from eight in the prior two weeks and down from all 11 S&P 500 sectors above in the three weeks before that. Energy and Health Care are the only sectors still trading above their 50-dmas. Eight sectors have a rising 50-dma, down from nine a week earlier as Real Estate turned down in the latest week and joined Tech and Utilities. Looking at the more stable longer-term 200-dmas, the positive club shrank last week to six members w/w from nine. Consumer Staples, Financials, and Materials moved below their 200-dmas and joined Real Estate and Utilities as the only sectors trading below. The rising 200-dma club also shrank to six sectors w/w from nine as the 200-dma turned lower w/w for Financials, Materials, and Real Estate. Energy and Utilities are the other two sectors with a falling 200-dma.

US Economic Indicators

Leading Indicators (*link*): Leading indicators continued to plunge in July, while coincident indicators set yet another record high. The Leading Economic Indicators (LEI) fell in June for the 16th straight month, sinking 0.4% m/m and 10.0% over the period—the longest losing streak since 2007-08—to the lowest level since mid-2020. Over the six months through July, the LEI dropped 4.0%, slightly steeper than the 3.7% drop over the previous six-month period through January. Leading indicators is biased toward the goods economy. In July, five of the 10 components contributed negatively, three positively, and two—real consumer goods orders and building permits—were unchanged. The biggest negative contributors to July's LEI once again were the new orders diffusion index (-0.18ppts), the interest rate spread (-0.15), and consumer expectations (-0.12ppt), followed by the average workweek (-0.06) and the leading credit index (-0.03). The biggest positive contributions came from stock prices (+0.15) and jobless claims (+0.14); real capital goods orders (+0.01) contributed a small amount.

Coincident Indicators (*link*): The Coincident Economic Indicators (CEI) index hasn't posted a decline this year, though there have been a few flat readings. The CEI rose for the third time in four months in July, up 0.4% m/m and 0.7% over the period to a new record high; it's up 1.1% ytd and 1.7% y/y. It exceeds its previous record high, just before the pandemic, by 3.0%. All four CEI components rose in July: 1) Industrial production (+0.19ppts) moved from the bottom of the pile to the top in July. Industrial production rose in July for the first time in three months, driven by a jump in motor vehicle production and a surge in utilities output, due to a heat wave. Headline production rebounded 1.0% in July, after falling 0.8% and 0.4% the prior two months. Utilities output soared 5.4% in July, while manufacturing production got a boost from a 5.2% jump in motor vehicle production, climbing 0.5% in July. 2) Real personal income less transfer payments (+0.07ppt) rose for the fifth time this year, by 0.2% in July and 1.3% ytd, to a new record high and is up 11.7% from its April 2020 bottom. 3) Payroll employment (+0.04) in July was weaker than expected, and there were downward revisions to the prior two months' data, for a net loss of 49,000. July payrolls rose 187,000 (vs 200,000 expected), the second straight month that gains came in under 200,000. July's increase was little changed from June's 185,000 gain—which was the weakest since December 2020. Nonfarm payrolls averaged monthly gains of 287,000 the first five months of the year. 4) Real manufacturing & trade sales (+0.03) rose for the third month, by 0.2%, slowing steadily from May's 1.1% increase. It remains in a volatile flat trend and is within 0.4% of its record high posted during January 2022.

Regional M-PMIs (*link*): Two Fed districts have reported on manufacturing activity for August—New York and Philadelphia—and show it's a tale of two regions. Manufacturing activity (to -3.5 from -6.2) continued to contract, though at a slower pace, easing from March's -23.9, as the Philadelphia (to 12.0 from -13.5) region moved from contraction to expansion, while New York's (-19.0 from 1.1) fell back into contractionary territory. New orders (-2.0 from -6.3) moved back near the breakeven point between expansion and contraction this month, as billings in the Philadelphia (16.0 from -15.9) area experienced a wide 31.9-point swing back into expansionary territory, while New York's (-19.9 from 3.3) fell deep into negative territory. Employment (-3.7 from 1.9) showed factories are slow to hire, bouncing around zero the past few months, with both the New York (-1.4 from 4.7) and Philadelphia (-6.0 from -1.0) showing slight contractions. Looking at prices-paid indexes, the Philadelphia (20.8 from 9.5) measure showed an acceleration from April's 8.2 reading—which was its lowest since mid-2020—while New York's (25.2 from 16.2) accelerated from July's pace, which was the slowest since August 2020. The former was at a recent high of 83.6 in November 2021, while the latter was at a record high of 86.4 in April 2022. Prices-received indexes were mixed: New York's (12.6 from 3.9) picked up a bit from July's three-year low; it was at a record high of 56.1 in March 2022. Philadelphia's measure moved down to 14.1 after climbing from -7.0 in May to 23.0 during July. It was at a record high of 65.8 in November 2021.

Global Economic Indicators

Eurozone CPI (*link*): The CPI rate for July moved down again, to 5.3%—its lowest since January 2022—from 5.5% in June; it peaked last October at a record-high 10.7%. Looking at the main components, energy fell 6.1% y/y, its fourth negative reading in five months and the weakest since December 2020, following double-digit yearly gains from April 2021 through February of this year. It peaked at a record high of 44.3% last March. The rate for food, alcohol & tobacco eased for the fourth month to 10.8% y/y after accelerating steadily from June 2021's 0.5% to a record high of 15.5% this March. The rate for non-energy industrial goods slowed for the sixth month to 5.0% y/y from February's record-high 6.8%. Meanwhile, the services rate accelerated to 5.6% y/y in July, the highest since fall 1992. Of the top four Eurozone economies, only Germany (6.5% y/y) and Italy (6.3) showed rates above the Eurozone's 5.3% rate, while France's (5.1) was a couple of ticks below. Meanwhile, Spain's (2.1) rate was one of the lowest of the overall Eurozone economies, though did accelerate from June's 1.6%. Here are the record-high inflation rates and dates they were achieved for the four countries: Germany (11.6%, October 2022), Italy (12.6%, October & November 2022), France (7.3%, February 2023), and Spain (10.7%, July 2022).

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