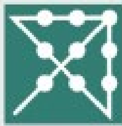

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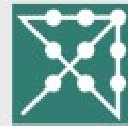

MORNING BRIEFING
September 11, 2023

‘Talk To An Economist’

Check out the accompanying chart collection.

Executive Summary: It’s worrying investors big time, but the escalating federal budget deficit doesn’t even merit an explanation from the administration driving it out of historically normal proportions. A federal deficit that’s rising as a percentage of nominal GDP at a time when GDP is rising is highly unusual. At risk is the bond market’s ability to finance the deficit at current interest rates. ... This concern could make bond yields less sensitive to inflation (and the Fed’s reaction to it) and more sensitive to bond supply and demand. For now, we’re sticking with our back-to-the-old-normal bond yield forecast, based on our moderating inflation forecast, but we are increasingly concerned about the flood of Treasuries.

YRI Weekly Webcast. Dr. Ed is on vacation and has prerecorded his Monday webcast, which is available *here* along with replays of his past weekly webcasts. He will see you next week live on Monday at 11:00 a.m. for his next weekly webcast.

US Federal Deficit I: The Two-Trillion-Pound Gorilla. The September 5 issue of *The New York Post* *reported*:

“White House Press Secretary Karine Jean-Pierre on Tuesday called President Biden ‘fiscally responsible’—but couldn’t explain away the latest dismal deficit figures, saying dismissively, ‘Talk to an economist.’

“The Biden rep brushed off statistics indicating the federal deficit is on track to double this year, blaming the tenuous situation on ‘volatile’ factors—but then refusing to be more specific. ‘Deficits from year to year can be volatile, and so that’s kind of how we have tracked that, but the reality is the president has a real plan, as we have laid out multiple times, to reduce the deficit,’ Jean-Pierre claimed at her regular briefing in response to a question from a Time reporter.

“The scribe followed up, ‘What is the reason it’s going up, though? Why is the deficit increasing?’ Jean-Pierre responded, ‘I just said, it can be year to year—it can be very volatile.’ When challenged again for a reason, Jean-Pierre repeated, ‘I just laid out, it can be very volatile. … That’s the way it is, from year to year, it can be variable.’ A reporter from The Post interjected, ‘Why?’ She shot back, ‘Talk to an economist, and they’ll tell you

specifically.'"

The nonpartisan Committee for a Responsible Federal Budget recently projected that the federal deficit for fiscal 2023, which ends September 30, will hit $2 trillion. That's the highest ever excluding during the Covid-19 pandemic, despite Biden's claim that his administration has implemented measures to slash the deficit.

If Jean-Pierre were to talk about the deficit with Debbie and me, we would make the following points:

(1) *Deficit cycle.* The federal deficit always widens during economic recessions as tax receipts fall and outlays increase owing to automatic federal income support programs and spending (and/or tax cuts) aimed at boosting the economy. As a result, the ratio of the deficit to nominal GDP is inversely correlated with the unemployment rate and the growth rate of real GDP (*Fig. 1* and *Fig. 2*). So it is extremely unusual to see the ratio rising—as it is now—at times like now, when the economy is growing and the unemployment rate is near record lows, around 3.5% recently.

(2) *Ballooning deficit.* The federal deficit, on a 12-month sum basis, narrowed from a record $4.1 trillion through March 2021 to a recent low of $1.0 trillion through July 2022 (*Fig. 3*). Since then, it has ballooned to $2.3 trillion through July.

(3) *Revenues.* The recent widening of the federal deficit is partly attributable to a significant drop in federal individual income tax receipts so far this year (*Fig. 4*). Meanwhile, payroll tax receipts rose to a record high of $1.6 trillion over the 12 months through July, reflecting record employment. Corporate tax receipts totaled $430.7 billion, near their recent record high. But individual income tax receipts fell from a record high of $2.7 trillion over the 12 months through last April to $2.2 trillion over the 12 months through this July.

Last year's individual income tax revenues were boosted by capital gains tax revenues, as individual investors bailed out of their stocks during the 2022 bear market. So this year's decline reflects a more normal pace of income tax receipts. Unfortunately, without such one-time windfalls boosting revenues, the underlying trend in the federal deficit is to widen.

(4) *Outlays.* While revenues are falling (on a 12-month sum basis), outlays are rising at a more rapid pace led by net interest income, Social Security, and Medicare (*Fig. 5* and *Fig. 6*). The former (on a 12-month sum basis) is up $628 billion y/y, while the sum of the latter two is up $2,151 billion.

US Federal Deficit II: Bond Drivers. How much higher might record federal deficits drive up the 10-year Treasury bond yield? In the past, we've often observed that supply and demand for bonds aren't usually as important to the determination of the bond yield as are actual and expected inflation and the expectations of how the Fed will respond to them. So given that we expect inflation to continue to moderate toward 2%-3% by late next year, we currently predict that the bond yield should range between 4.25% and 4.50%.

That's not so high in a historical context, as we've previously shown; it simply represents a return to the "old normal" yields of 2003-07, i.e., before interest rates were slashed to the "new abnormal" levels from the Great Financial Crisis through the Great Virus Crisis. From 2003-07, the 10-year TIPS yield averaged about 2.00%, and the expected inflation spread between the 10-year nominal Treasury and comparable TIPS yield ranged around 2.25%-2.50% (*Fig. 7* and *Fig. 8*). They add up to a normal nominal bond yield of 4.25%-4.50%.

On August 1, Fitch Ratings downgraded US government debt from AAA to AA+ for all the reasons that have been concerning the investors for years. None of this is news. However, the Fitch downgrade serves as a reminder to financial markets broadly that fiscal policy continues to get more and more abnormally profligate.

As noted above, in the past, federal deficits tended to narrow during economic expansions and to widen during recessions. Now the federal deficit is widening even though the economy is expanding. This raises the possibility that the bond market might have trouble financing the government's huge deficits at current market interest rates.

Let's assess the outlook for the bond market based on a supply-and-demand analysis:

(1) *The Fed and banks are sellers.* The US Treasury will be selling lots of notes and bonds over the rest of this year and next year, while the Fed's quantitative tightening (QT) program will continue to reduce the Fed's holdings of Treasuries by about $60 billion per month (*Fig. 9*). Additionally, commercial banks are allowing their portfolios of securities to mature and using the proceeds to offset net deposit outflows (*Fig. 10*).

(2) *Other investors are buyers.* The Treasury, therefore, must increasingly rely on US households, US institutional investors, and foreign investors to purchase the rapidly increasing supply of US debt. They will undoubtedly do so. The only question is whether interest rates are high enough already to attract these buyers or whether rates would have to go higher to do so.

We have monthly data on net inflows into all bond mutual funds and ETFs in the US. On a 12-month-sum basis, they show net outflows from September 2022 through April 2023 (*Fig. 11*). Through July, there have been net inflows of $189 billion. That's not much. Weekly data on money market mutual funds (MMMF) show significant net inflows of $1,060 billion over the past year through the September 6 week, with $599 billion in retail and $461 billion in institutional MMMF (*Fig. 12* and *Fig. 13*).

Monthly data compiled by the US Treasury on net capital inflows show private foreign purchases of US Treasury notes and bonds at a record $989.5 billion over the 12-month period through October 2022 (*Fig. 14*). This pace slowed to $761.3 billion through June. That is still a very large number.

(3) *Fed still buying Treasury bonds.* By the way, the Fed has been trying to moderate the impact of its QT program on the bond market by continuing to purchase Treasury bonds with maturities of 10 years or longer (*Fig. 15*). The Fed's holdings of these securities rose $74 billion since the start of QT through the September 6 week. The Fed's total holdings of Treasuries fell $857 billion over this period.

(4) *Bottom line.* So: How much higher might record federal deficits drive up the 10-year Treasury bond yield? We are sticking with our back-to-the-old-normal bond yield forecast of 4.25%-4.50%. The yield has been trading in that range since early August. Staying in that range when the federal deficit is abnormally large requires that inflation continues to moderate as we expect.

We acknowledge that there could be temporary setbacks in the disinflationary trend since last summer. Those could send the yield temporarily above our range, but we would view them as temporary buying opportunities in the bond market.

Of course, we could be wrong about inflation. In a rebounding inflation scenario, the federal deficit obviously would exacerbate the rise in the bond yield. That would be a very ugly scenario for stock and bond investors as well as for the economy. That's not our outlook. But that scenario is the risk to our outlook.

Calendars

US: Mon: None. **Tues:** NFIB Small Business Optimism 91.6; Federal Budget Balance; API Weekly Crude Oil Inventories; EIA Short-Term Energy Outlook; OPEC Monthly Report.

(FXStreet estimates)

Global: **Mon:** Italy Industrial Production -0.3%m/m/-1.7%y/y; China New Loans & Total Social Financing 1.15t/2.46t; Japan Machine Tool Orders; Westpac Consumer Sentiment; Pill; Mann. **Tues:** Eurozone Headline & Core CPI; Eurozone Economic Sentiment -6.2; Germany Economic Sentiment & Current Conditions -15.0/-75.0; Germany ZEW UK Unemployment Rate 4.3%; UK Average Earnings Index Including & Excluding Bonus 7.8%/8.2%;UK NIESR GDP Estimate; Japan PPI 0.1%m/m/3.2%y/y. (FXStreet estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index fell 1.3% last week for its first drop in three weeks. That decline caused the index to weaken to 8.2% below its record high on December 27, 2021. The US MSCI ranked 17th of the 48 global stock markets that we follow in a week when nine of the 48 countries rose in US dollar terms. The AC World ex-US index underperformed with decline of 1.5%, and remains in a deep 17.9% correction from its June 15, 2021 record high. All regions fell w/w, but these regions outperformed the AC World ex-US: BIC (-0.4%), EM Asia (-0.8), and EAFE (-1.4). EM Eastern Europe was the worst performing region last week with a 6.6% decline, followed by EM Latin America (-3.4), EMU (-2.1), and EMEA (-2.0). Egypt was the best-performing country last week, with a gain of 4.7%, followed by Turkey (3.3), Sri Lanka (2.9), Pakistan (2.2), and India (1.9). Among the 27 countries that underperformed the AC World ex-US MSCI last week, the 9.6% decline for Argentina was the biggest, followed by those of Poland (-9.3), Chile (-7.0), Peru (-4.7), and Ireland (-4.4). Looking at 2023's performance so far, the US MSCI is up 16.6%, as its ytd ranking remained improved two places w/w to 9/48. The AC World ex-US's ytd gain of 5.1% is trailing the US's, with 30/48 countries in positive territory. EM Eastern Europe is the best regional performer ytd with a gain of 13.8%, followed by EMU (10.2), EM Latin America (8.1), and EAFE (6.7). The regional laggards so far in 2023: BIC (-1.6), EMEA (1.4), and EM Asia (1.7). This year's best ytd country performers: Greece (36.3), Sri Lanka (33.3), Hungary (32.7), Argentina (28.0), and Ireland (22.6). Here are the worst-performing countries of the year so far: Pakistan (-31.4), Hong Kong (-16.9), Colombia (-13.9), Finland (-12.9), and New Zealand (-10.2).

S&P 500/400/600 Performance (*link*): All three of the these indexes fell for the first time in three weeks. LargeCap's 1.3% decline was smaller than the 3.6% and 4.3% drops for MidCap and SmallCap. At Friday's close, LargeCap finished the week at 7.1% below its record high on January 3, 2022, MidCap moved back into a correction to end at 11.5%

below its record high on November 16, 2021, and SmallCap neared bear market territory again at 19.1% from its November 8, 2021 record high. Just three of the 33 LargeCap and SMidCap sectors moved higher for the week, compared to 29 rising a week earlier. LargeCap Energy was the best performer with a gain of 1.4%, ahead of SmallCap Energy (0.9), LargeCap Utilities (0.9), and LargeCap Communication Services (0.0). Among the biggest underperformers for the week were SmallCap Tech (-6.6), SmallCap Materials (-5.9), SmallCap Consumer Discretionary (-5.4), SmallCap Health Care (-5.0), and MidCap Materials (-4.8). Looking at performances so far in 2023, LargeCap, with a gain of 16.1%, remains well ahead of MidCap (5.9) and SmallCap (2.4); 19 of the 33 sectors are higher ytd. The top sector performers in 2023: LargeCap Communication Services (43.3), LargeCap Tech (40.6), LargeCap Consumer Discretionary (32.3), MidCap Industrials (19.6), and MidCap Tech (17.8). Here are 2023's biggest laggards: MidCap Utilities (-19.3), MidCap Communication Services (-14.0), SmallCap Utilities (-13.5), SmallCap Financials (-12.6), and LargeCap Utilities (-11.1).

S&P 500 Sectors and Industries Performance (*link*): Two of the 11 S&P 500 sectors rose last week, but eight outperformed the composite index's 1.3% decline. That compares to a 2.5% rise for the S&P 500 a week earlier, when nine sectors rose and five outperformed the index. Energy was the best performer with a gain of 1.4%, followed by Utilities (0.9%), Communication Services (0.0), Consumer Discretionary (-0.5), Consumer Staples (-0.5), Financials (-1.1), Real Estate (-1.1), and Health Care (-1.1). Industrials was the worst performer, with a drop of 2.9%, followed by Materials (-2.4) and Tech (-2.3). Looking at 2023's performance so far, the S&P 500 is up 16.1% ytd, with just three sectors still outperforming the index and six higher for the year. The best ytd performers: Communication Services (43.3), Tech (40.6), and Consumer Discretionary (32.3). These are 2023's worst performers: Utilities (-11.1), Consumer Staples (-3.3), Health Care (-3.2), Real Estate (-1.3), Financials (-0.1), Energy (4.3), Materials (4.8), and Industrials (7.1).

S&P 500 Technical Indicators (*link*): The S&P 500 fell 1.3% last week and weakened relative to its 50-day moving average (50-dma) and its 200-day moving average (200-dma). The index moved back below its 50-dma after spending just one week above that level, but has been above in 21 of the past 24 weeks. It remained above its 200-dma for a 25th week. As for what the dmas themselves have been doing, the 50-dma rose for a second week after falling for one week for the first time in 22 weeks, and the 200-dma rose for a 15th week in its longest positive streak since March 2022. The S&P 500 dropped to 0.5% below its rising 50-dma from 1.0% above its rising 50-dma a week earlier, but is up from 2.0% below (a 22-week low) its rising 50-dma in mid-August. For perspective, the latest reading is also down from a 20-week high of 5.4% above its (rising) 50-dma in mid-June and up from a

20-week low of 3.6% below its (falling) 50-dma at the beginning of March. Other comparison points include: a four-month low of 10.6% below its (falling) 50-dma at the end of September 2022, a 23-month high of 8.7% above its (rising) 50-dma in August 2022, 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. Turning to the 200-dma, the price index closed Friday at 6.7% above its (rising) 200-dma, down from 8.4% above a week earlier and an 11-week low of 5.5% in mid-August. That 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.

S&P 500 Sectors Technical Indicators (*link*): Just two of the 11 S&P 500 sectors are trading above their 50-dmas, a marked deterioration from eight above a week earlier. That's also down from all 11 S&P 500 sectors above in the three weeks before the end of July. Communication Services and Energy are the only sectors trading above their 50-dma. Just three sectors now have a rising 50-dma, down from nine a week earlier. These are the three sectors with a rising 50-dma: Communication Services, Energy, and Financials. Looking at the more stable longer-term 200-dmas, the positive club dropped w/w to seven members from eight as Health Care fell below in the latest week. The other three sectors still trading below their 200-dmas are Consumer Staples, Real Estate, and Utilities. The rising 200-dma club remained steady w/w at five sectors, but Energy turned up and Materials turned down. Energy joins these four sectors with a still-rising 200-dma: Communication Services, Consumer Discretionary, Industrials, and Information Technology.

Global Economic Indicators

Eurozone GDP (*link*): Real GDP increased 0.1% during Q2, revised down from the preliminary estimate of 0.3%. That follows a 0.1% gain and a 0.1% loss the prior two quarters. Exports contracted 0.7% last quarter, not showing a positive quarter since Q3-2022. Meanwhile, household consumption was flat for the second straight quarter, after falling 0.7% during the final quarter of last year, as high interest rates and inflation

continued to depress consumer spending. Real gross fixed capital formation—which tracks investment—increased 0.3% during both Q1 and Q2, after declining 0.2% during the Q4-2022. Germany, the largest of the Eurozone economies, hasn't posted an increase in real GDP since Q3-2022, showing no growth during the second quarter following declines of 0.1% and 0.4% the prior two quarters. Italy, the third largest economy in the Eurozone, contracted 0.4%, following a 0.6% gain and a 0.2% loss the previous two quarters. Meanwhile, real GDP in France and Spain continued to expand.

Germany Industrial Production (*link*): German industrial production declined for the third successive month in July, after climbing three of the first four months of the year. Germany's *headline production*, which includes construction, fell 0.8% m/m and 2.4% during the three months through July, after climbing 2.5% over the four months through April. Meanwhile, *production excluding construction* (which the overall Eurozone uses) also declined the past three months, by 2.8%, following a four-month climb of 1.4%. Looking at the main industrial groupings, *capital goods* production declined 2.9% in July, building on June's 3.3% drop, after increasing 17.1% from its recent bottom during March 2022 through May 2023. *Consumer durable goods* have slumped 6.4% during the four months through July, while *consumer nondurable goods* production fell 1.0% after climbing two of the prior three months by 4.1%. Meanwhile, *intermediate goods* output fell during four of the past five months, by 0.7% m/m and 3.6% over the period. On a *y/y basis*, headline production dropped 1.4%, with construction output basically flat. Looking at the *main industrial groupings*, capital (3.7% y/y) and consumer nondurable (1.8) goods production posted gains. Meanwhile energy (-21.6% y/y) output led declines, followed by intermediate (-5.8) and consumer durable goods (-3.8) production.

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