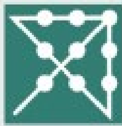
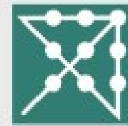
 Yardeni Research 

MORNING BRIEFING
October 4, 2023

The Debt Crisis Scenario

Check out the accompanying chart collection.

Executive Summary: Are we headed for a debt crisis? Demand for Treasury bonds has fallen in the wake of Fitch's federal debt downgrade at a time when supply has been escalating. Rising yields in response may clear the Treasury market but also reduce both demand for and supply of the private sector's credit. A credit crunch and recession could ensue, possibly setting off a deflationary debt default spiral. … But that worst-case scenario isn't inevitable. The Treasury bond yield may not soar above 5.00%, as increasingly feared, given our expectations for "immaculate disinflation" (i.e., without an economy-wide recession) and slowing real GDP growth. … Also: Joe's analysis suggests the S&P 500's Q3 earnings may hit a record high.

Debt Crisis I: A Plausible Scenario? "We're going to have a debt crisis in this country," Ray Dalio, the founder of hedge fund Bridgewater Associates, warned in an *interview* with CNBC's Sara Eisen that aired last Thursday. The two were speaking at a fireside chat at the Managed Funds Association. "How fast it transpires, I think, is going to be a function of that supply-demand issue, so I'm watching that very closely."

Melissa and I referenced Dalio's debt crisis scenario yesterday. It's a simple plot that makes sense. We've been covering the story but haven't concluded that it must end as badly as Dalio expects. Consider the following:

(1) Fiscal policy is out of control, as evidenced by the rapidly widening federal government budget deficit. Over the past 12 months through August, the deficit totaled $2.0 trillion, up from a recent low of $1.0 trillion through July 2022 (*Fig. 1*). It's simple arithmetic: The trend in outlays is steeper than the trend in revenues (*Fig. 2*).

In the past, the federal budget deficit was counter-cyclical. As a percent of nominal GDP, it widened when the economy fell into recessions and narrowed during expansions (*Fig. 3*). As a percent of nominal GDP, outlays rose during recessions and fell during expansions (*Fig. 4*). Receipts tended to do the opposite of outlays.

So it is disturbing to see that outlays are rising, while receipts are falling during the current economic expansion.

(2) It is widely assumed that the recent widening of the federal deficit is mainly attributable to the spending programs enacted by the Biden administration during 2022. In fact, the recent widening is mainly attributable to inflation, which has boosted federal government outlays on Social Security and net interest (*Fig. 5*).

Net interest totaled $634 billion over the past 12 months through August (*Fig. 6*). It has doubled since April 2021. It is the fastest growing of the federal government outlays categories (*Fig. 7*). We calculate that the federal government is currently paying about 2.50% on its outstanding debt held by the public (*Fig. 8*). The 2-year Treasury note is currently above 5.00%.

The biggest contributor to the bulging deficit in recent months has been a decline in individual income tax revenues during the current fiscal year after they were boosted last year when investors sold lots of their stocks that had capital gains during the 2022 bear market. They paid lots of capital gains taxes.

(3) Outlays will get boosted even more in coming years by all the spending Congress approved last year. In addition, the net interest expense of the federal government will continue to soar, as it has been doing ever since the Fed started raising interest rates aggressively in 2022.

(4) The Treasury supply issue came to the fore during the past summer, when the Treasury securities outstanding held by the public jumped by a whopping $1.4 trillion from June through August (*Fig. 9*). Fitch Ratings downgraded the federal debt from AAA to AA+ on August 1 on concerns about the mounting federal debt and the lack of political will in Washington to do anything to rein in the deficit. That announcement really marked the start of the Treasury bond market's concern about too much supply relative to demand. The 10-year bond yield was 4.05% on August 1. Now it is almost 4.80%.

(5) So the bond market is adjusting yields upward to clear the market, i.e., to boost demand to meet the increased supply. The risk is that the market yield will crowd out the credit demands of the private sector. That would amount to a credit crunch, which would cause a recession.

In the debt crisis scenario, a recession attributable to excessive fiscal deficits would require the federal government to reduce spending and increase taxes, which would exacerbate the credit crunch and the recession. In a worst-case scenario, it could unleash a deflationary debt default spiral. In this scenario, the Fed might be forced to lower interest rates and to

terminate its quantitative tightening.

Debt Crisis II: It Doesn't Have To End Badly. Okay, now let's come up for some air from these lower depths. So far, the Treasury bond yield has essentially normalized to the yield levels of 4.00% to 5.00% that prevailed from 2003 to 2007, before the "New Abnormal" (*Fig. 10*). That was the period from the Great Financial Crisis through the Great Virus Crisis, when the major central banks worried about deflation and obsessed about raising the inflation rate up to their 2.0% targets. During that period, interest rates were abnormally low and quantitative ease proliferated.

So far, the economy has proven remarkably resilient in the face of the three-year jump in the bond yield from a record low of 0.52% on August 4, 2020 to almost 4.80% currently. This raises the possibility that the economy can live with the bond yield back to its old normal level.

Then again, the velocity of the rate backup has been head-spinning, as it took only three years to fully reverse the decline in the bond yield during the 12 years of the New Abnormal. Depressing lagged effects on the economy are likely still to emerge. However, they might continue to play out as a rolling recession rather than an economy-wide recession. The rolling recession is currently rolling into the commercial real estate market.

What would it take to stop the Treasury bond yield from climbing well above 5.00% other than a deflationary debt debacle? Possibly the "immaculate disinflation" we expect. That is, we think inflation can continue to fall without an economy-wide recession. We also expect to see a slowdown from Q3's consumer-led boomlet, with real GDP rising to between 4.0% and 5.0%. We think that Q4 real GDP growth will be back down to 2.0%. In this scenario, demand for Treasuries should absorb the supply with the yield south of 5.00%.

Be warned: If we see the yield soaring over 5.00%, we (along with everyone else) will have to conclude that Dalio's debt crisis might have started.

Earnings I: Eyes Back on the Earnings Ball. There are plenty of questions about the outlooks for the economy and stock market floating around nowadays and few solid answers. One thing's for sure: The stock market follows earnings and profitability over the longer term, both of which have been improving so far this year (*Fig. 11*).

In Monday's QuickTakes titled *The Wild Bunch*, we wrote: "[W]e believe that the Q3 earnings season during October and early November will be much better than widely

expected. After all, Q3's real GDP is turning out to be well above consensus forecasts. Looking ahead to Q4, analysts are predicting that S&P 500 operating earnings per share (EPS) will be at a record high during the final quarter of this year. That's barring a long auto strike, a government shutdown, and surprising credit losses at the banks."

However, Joe's analysis of the consensus EPS estimate data for S&P 500 companies in the context of historical trends suggests a very real possibility that record-high operating earnings could come sooner, i.e., during Q3. Here's what he says:

(1) *The case for record-high quarterly S&P 500 EPS as soon as Q3.* As of the September 27 week, analysts polled by I/B/E/S are estimating that Q3 earnings will be $55.92. That represents only a 3.7% upside earnings surprise hook, which is historically low so could well turn out to be greater. Also, the latest Q3 consensus is below the record-high actual EPS of $57.62 recorded by I/B/E/S for Q2-2022. A surprise surpassing that prior record high appears easily attainable given the historical surprise patterns of the past (*Fig. 12*).

By the way, we have been forecasting that the S&P 500 would report record-high EPS of $58.00 for the quarter since last November, when we first initiated our forecast.

(2) *More sectors could see record-high quarterly earnings in Q3 than in Q2.* Let's take a look at what analysts are expecting for the 11 S&P 500 sectors' Q3 earnings as of September 29 to see which look bound for hitting record highs in quarterly earnings (using data from Q1-2009 to Q2-2023).

During Q2-2023, quarterly earnings hit record highs for two sectors, Consumer Discretionary and Industrials. That was an improvement from Q1-2023, when no sectors hit that mark; but it fell well short of the seven sectors several years earlier, in Q2-2021 (*Fig. 13*).

The current Q3-2023 consensus estimate for Utilities, if realized, would be a record high. While the estimates for Communication Services, Consumer Discretionary, and Consumer Staples are still 3%-4% below their past record actuals, even a modest earnings hook would propel them to new highs too in Q3-2023. So we think four sectors' Q3 EPS will be at record highs. For Communication Services, Q3 would mark its first record high in quarterly EPS since Q4-2021.

Looking further ahead to Q4, the consensus currently expects record-high quarterly earnings for the S&P 500 and two sectors: Communication Services and Information

Technology.

Despite the recent improvement in its earnings estimates, Energy still has a long way to go before surpassing its record level in Q2-2022. However, Energy's recovery is now having a negative impact on the profit forecasts for the Airlines industry and the sector where it's housed, Industrials.

While the remaining seven sectors currently don't have record quarterly earnings forecast for Q4-2023, a continuation of this year's upward estimate revision trend in response to the Q3-2023 earnings releases could propel many of them higher, possibly into the record-high realm (*Fig. 14* and *Fig. 15*).

(3) *Revisiting the S&P 500 sectors Q3 earnings growth outlook*. S&P 500 companies' collective earnings growth is expected to be positive y/y in Q3-2023 following declines in the prior three quarters. These are the S&P 500 sectors' expected earnings growth rates for Q3-2023, on a proforma basis, versus their final earnings growth rates for Q2-2023: Communication Services (34.0% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (23.0, 57.0), Utilities (12.4, 0.6), Financials (11.9, 9.3), Industrials (8.6, 15.7), S&P 500 ex-Energy (6.7, 3.6), Information Technology (5.9, 5.0), S&P 500 (1.6, -2.8), Consumer Staples (1.3, 8.5), Real Estate (-7.1, -2.1), Health Care (-9.7, -26.7), Materials (-20.5, -26.4), and Energy (-35.0, -47.5).

Earnings II: Revisiting S&P 500 Growth Prospects Ex Energy & MegaCap-8. In the September 27 *Morning Briefing*, we presented the Q2 actual results for S&P 500 companies' collective revenues and earnings growth along with the Q3 outlook. We included the outlooks on an ex-Energy-sector basis as well as an ex-MegaCap-8 basis (i.e., excluding the stocks of Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Nvidia, and Tesla). We've been asked by accounts to update the S&P 500's growth rates excluding both groups. Here's what Joe found:

(1) *Revenues growth.* During Q2, the S&P 500 revenues growth rate was 1.2% y/y with both groups included; that improves to 4.6% without them. Energy's revenues tumbled 28.9% y/y in Q2, while the MegaCap-8's revenues rose 10.2%.

Looking ahead to Q3, S&P 500 revenues are expected to rise 0.8% with both groups included, which improves to 2.8% without them. Analysts expect Energy's revenues to fall 22.5% y/y in Q3 and the Megacap-8's revenue growth to accelerate to 11.1% y/y.

(2) *Earnings growth.* S&P 500 earnings fell 2.8% y/y in Q2 with both groups but rose 4.6% without them. Energy's earnings tumbled 47.5% y/y in Q2, while the MegaCap-8's earnings rose 29.7%.

A 1.6% gain is expected for the S&P 500 in Q3, but that improves to 2.8% without both groups. Analysts think Energy's earnings will fall 35.0% y/y in Q3, but they expect the MegaCap-8's earnings to soar 39.1% y/y.

Calendars

US: Wed: ADP Employment 160k; Factory Orders 0.3%; ISM NM-PMI 53.6; S&P Global C-PMI & NM-PMI 50.1/50.2; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; OPEC Meeting; Goolsbee; Bowman. **Thurs:** Trade Balance -$64.6b; Initial & Continuous Jobless Claims 210k/1.678m; Fed's Balance Sheet; Barr; Daly; Barkin; Mester. (FXStreet estimates)

Global: Wed: Eurozone Retail Sales -0.3%; Eurozone PPI 0.6%m/m/-11.6%y/y; Eurozone, Germany, and France C-PMIs 47.1/46,2/43.5; Eurozone, Germany, and France NM-PMIs 48.4/49.8/43.9; UK C-PMI & NM-PMI 46.8/47.2; Lagarde; DE Guindos; Panetta. **Thurs:** Germany Trade Balance €15.8b; France Industrial Production -0.4%; Japan Household Spending 0.9%/m/-4.3%y/y; De Guindos; Lane; Nagel; Broadbent. (FXStreet estimates)

US Economic Indicators

JOLTS (***link***): There are signs in August's JOLTS report of a tighter jobs market, as job openings unexpectedly jumped after falling six of the prior seven months. *Job openings* rebounded 690,000 in August to 9.6 million, after sliding 2.3 million the first seven months of this year, to 8.9 million in July, which was the first level below 9.0 million since March 2021. The series peaked at a record-high 12.0 million last March. Prior to the pandemic, in early 2020, the highest level of job openings recorded was 7.6 million. Openings reached 10 million in June 2021 for the first time in the history of the series going back to 2000. There were 6.4 million people unemployed in August, so there were 1.51 available jobs for each unemployed person that month—which was the lowest since September 2021 though still a strong number. It was a recent high of 2.01 during March 2022. By industry, the *biggest increases* by far occurred in professional & business services (+509,000), followed by

finance & insurance (+96,000), state & local government education (+76,000), nondurable goods manufacturing (+59,000), health care & social assistance (+40,000), and the federal government (+31,000). The biggest decline occurred in accommodation & food services (-55,000), retail trade (-48,000), transportation, warehousing & utilities (-47,000), and information services (-20,000). Total separations rose 38,000 in August to 5.7 million, after a two-month decline. Separations include quits, which are generally voluntary separations initiated by employees—serving as a measure of workers' willingness or ability to leave jobs. Total quits increased 19,000 in August to 3.6 million (matching its pre-pandemic level), after declining five of the prior seven months by 472,000. Quits have been in a downtrend since peaking at 4.5 million during April 2022. Hirings increased 35,000 in August to 5.9 million versus a recent peak of 6.8 million during February 2022.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

Copyright (c) Yardeni Research, Inc. Please read complete copyright and hedge clause.