August 25, 2023

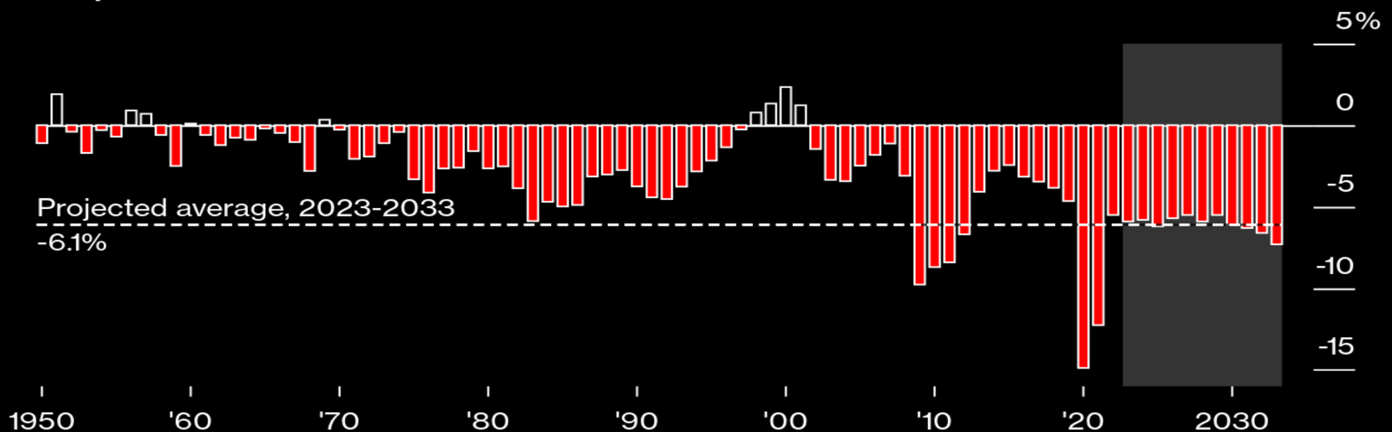
Market Memo

Research and Insights

Many of you know my research revolves around studying cause/effect relationships pertaining to how the economic machine works. I view the economic machine in the same manner a car mechanic studies an engine. An engine has many cause/effect relationships, and a good mechanic is one that understands these relationships. My dad taught me this principle at a young age when we worked on engines that weren't running, whether that was an old Ford tractor, four-wheeler, or car. He didn't use the term cause/effect, but it's exactly the same thing. I remember a conversation we had when I was in my mid-twenties. I was driving to work, and all of a sudden, my power steering went out. The car was running fine, but it was extremely difficult to turn, and then I noticed my temp. gauge was climbing. At the time, I had no idea what would cause these issues to happen simultaneously. I immediately pulled over and shut the car off, pulled out my cell phone, and called my dad at work. I described to him the effects: no power steering and overheating. Without a second to think about it, he gave me the cause…"Your belt broke." I checked, and sure enough, the engine's belt was gone. He understood the cause/effect relationship given the effect I described to him.

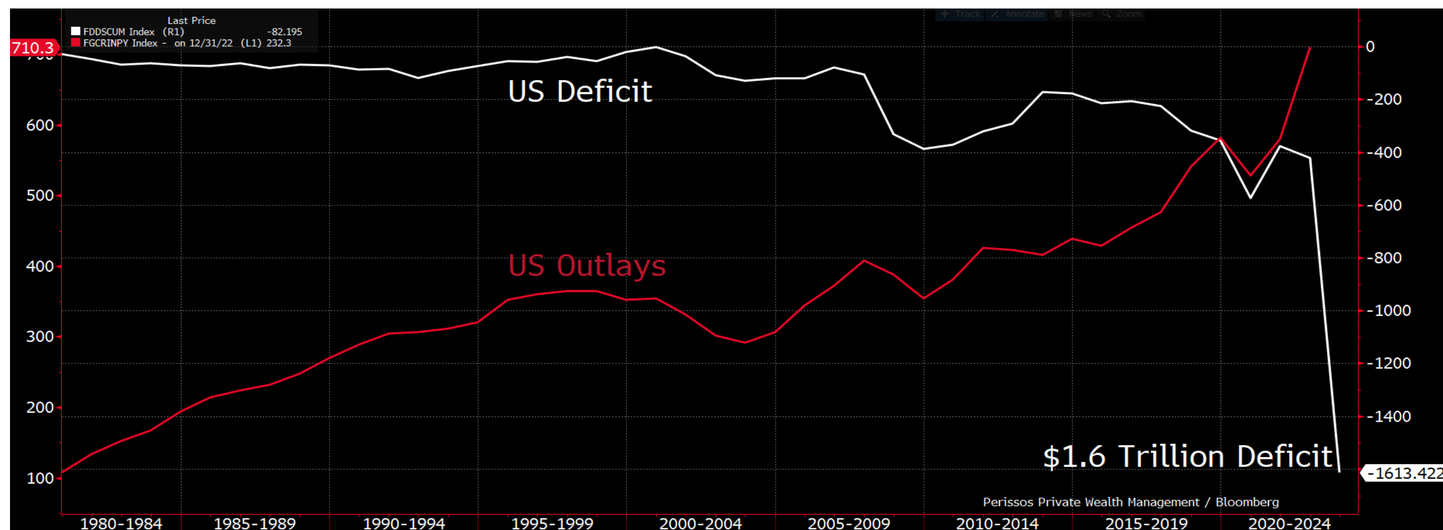
As with an engine, the economy has many moving parts with many cause/effect relationships. Studying these relationships helps us to understand what is happening now, its effects on the economy, and what will likely happen in the future if they continue, which brings us to the topic of this memo…Debt.

How much debt is too much? For as long as I have been in this industry, Wall Street has been hounding Washington's spending habits. We have seen debt downgrades (2011 and 2023), government shutdowns, and employee furloughs, all due to increased levels of debt.



The above chart shows the current budget deficit as a percent of GDP is right at 6%. This means the U.S. is spending 6% more than it earns. The dotted line is the projected deficit average for the next 10 years. It is hard to imagine the deficit maintaining this ratio over a decade when the Fed is intentionally trying to slow the economy.

In my last video commentary, I presented a chart that shows the deficit in dollar terms and have included it below. This year's explosion in the deficit, which more than doubled to $1.6 trillion in the ten months through July, looks like what happens when the government is fighting through a recession. However, right now, the economy is growing at a decent pace despite all the Fed's efforts to slow it.



Our current level of government spending is unprecedented outside times of war. But, when you have record-low unemployment, it is hard for politicians to want to change anything.

So, what can we expect the effect to be of an ever-increasing deficit? Higher interest rates. When the government runs a deficit, they have only a few ways to fund it. They can raise taxes, take on more debt by issuing bonds, or reduce government spending. Politicians tend to lean toward increasing debt since spending cuts and higher taxes are more painful in the short term, and we all know they only care about the next 4-6 years.

In order for the government to increase debt, they have to have people/countries/institutions willing to lend them money by buying government bonds. If the government sells more bonds than there is demand for purchasing the bonds, interest rates will rise. To illustrate, if I want to borrow $10,000 from you at the current market rate of, say, 5%, but you don't have $10,000 in cash to lend, you won't be able to loan me the money. But, if you have $10,000 invested in an asset that pays 5% already, you might say to me that you will lend me the $10,000 if I am willing to pay 6%. That is similar to how government bond auctions work.

This is just one of many cause/effect relationships associated with high levels of debt and a rising deficit that requires the government to issue increasing amounts of debt. If rates rise high enough, people will sell other assets to purchase higher-yielding debt assets, which means money flows out of one asset (i.e., stocks) into safer assets, thus causing the other asset values to fall toward equilibrium.

While I don't see a debt crisis in the near term, I will be watching the Federal Reserve balance sheet for clues as to when the debt issuance has outstripped demand. If interest rates continue to rise even after the Federal Reserve ends this tightening cycle, we can observe the Fed's balance sheet to see if they have to step in and purchase government debt to fund the government and keep interest rates from rising too high. If that occurs, the Fed will be sending more money out into the economy, likely causing a resurgence in inflation.

All my best,

Brandon VanLandingham CFA, CMT, CFP®

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