January 27, 2024

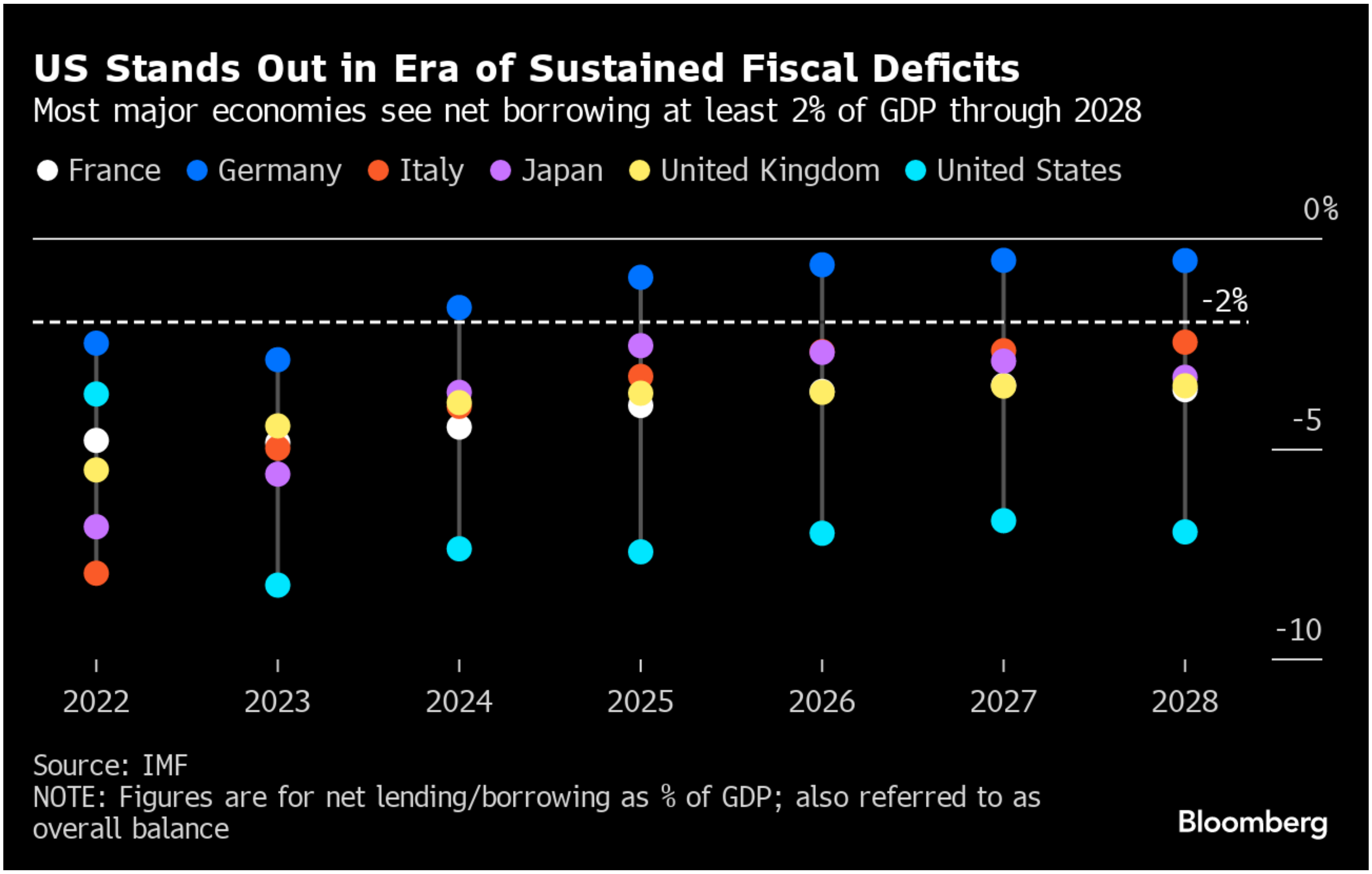
Market Memo

Research and Insights

PRIVATE WEALTH MANAGEMENT

I wrote about the Government's budget deficit in August of last year. (You Can Read It Here) I believe the deficit issues facing many countries will determine the direction of global asset prices, particularly bonds. I don't foresee the ballooning of debt and deficits being an issue this year, but it will be a major issue in the near future.

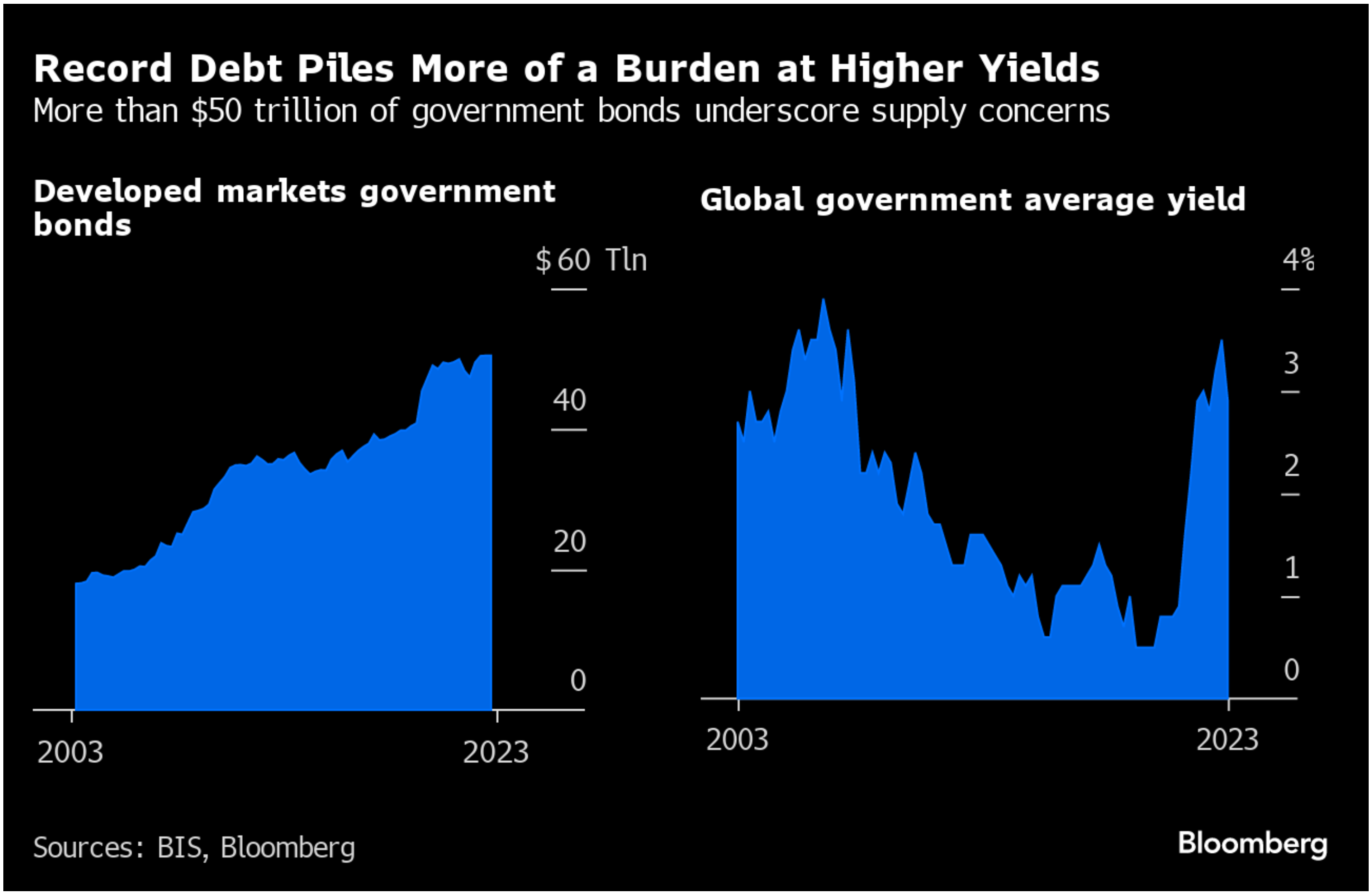
We know that a government deficit must be funded with debt. It's not much different than a typical household budget. If you spend more than you make in a given year, you financed the difference with debt. When comparing the U.S. to other major countries, the deficit as a percent of GDP is not surprisingly among the worst, as the chart below dictates.



The U.S. deficit as a percent of GDP doubled from 2022 to 2023 while most major economies improved, and it is projected that the U.S. will have a sustained deficit over the next five-plus years. The Government funds the deficit by selling bonds. Global governments have started flooding the market with newly issued debt amounting to $2.1 trillion to fund global deficits. This is important because of the supply/demand dynamics and their impact on interest rates. We will discuss that topic later in the Memo.

As global governments continue to set records for the amount of debt outstanding, today's higher yields will increase their cost to service the debt, likely leading to larger deficits and the need for more debt issuance. The era of falling interest rates to fund larger and larger deficits has likely run its course. From the early 1980s through 2021, we saw a period where interest rates were decreasing to the point of hitting zero on the Federal Funds rate in 2008 and staying low through 2021.

Now that the developed market's debt is over $50 trillion and interest rates on average across developed governments' debt are around three percent, it will be increasingly difficult not to increase the deficit as debt service costs increase. (Chart below) One caveat would be that GDP growth increases, helping to reduce the overall impact of increased debt service costs. As the high-interest rate environment continues to feed its way through the economy, it would be hard to imagine GDP doubling this year or next.



Earlier, I mentioned that the demand/supply for government debt will likely impact interest rates. To understand the demand/supply relationship as it pertains to interest rates, you need to understand the relationship between interest rates and bond prices. If interest rates go up, bond prices go down. There's a logical reason for this. Suppose you buy a bond today, the current interest rate is 4%, and you pay par value of $1000. Then, interest rates increase to 5%. Would someone be willing to buy your bond that only pays 4% for $1000? They wouldn't. They could easily buy a bond paying 5% for the same $1000. You would have to sell your bond at a discount so that the buyer could earn the going market rate of 5%. To calculate what your bond would be worth when current market rates are 5%, you would take the par value of $1000 and divide it by 1+(interest rate today- your bond interest rate), which would be $1000/1+(5%-4%) = $1000/1.01= ~$990.

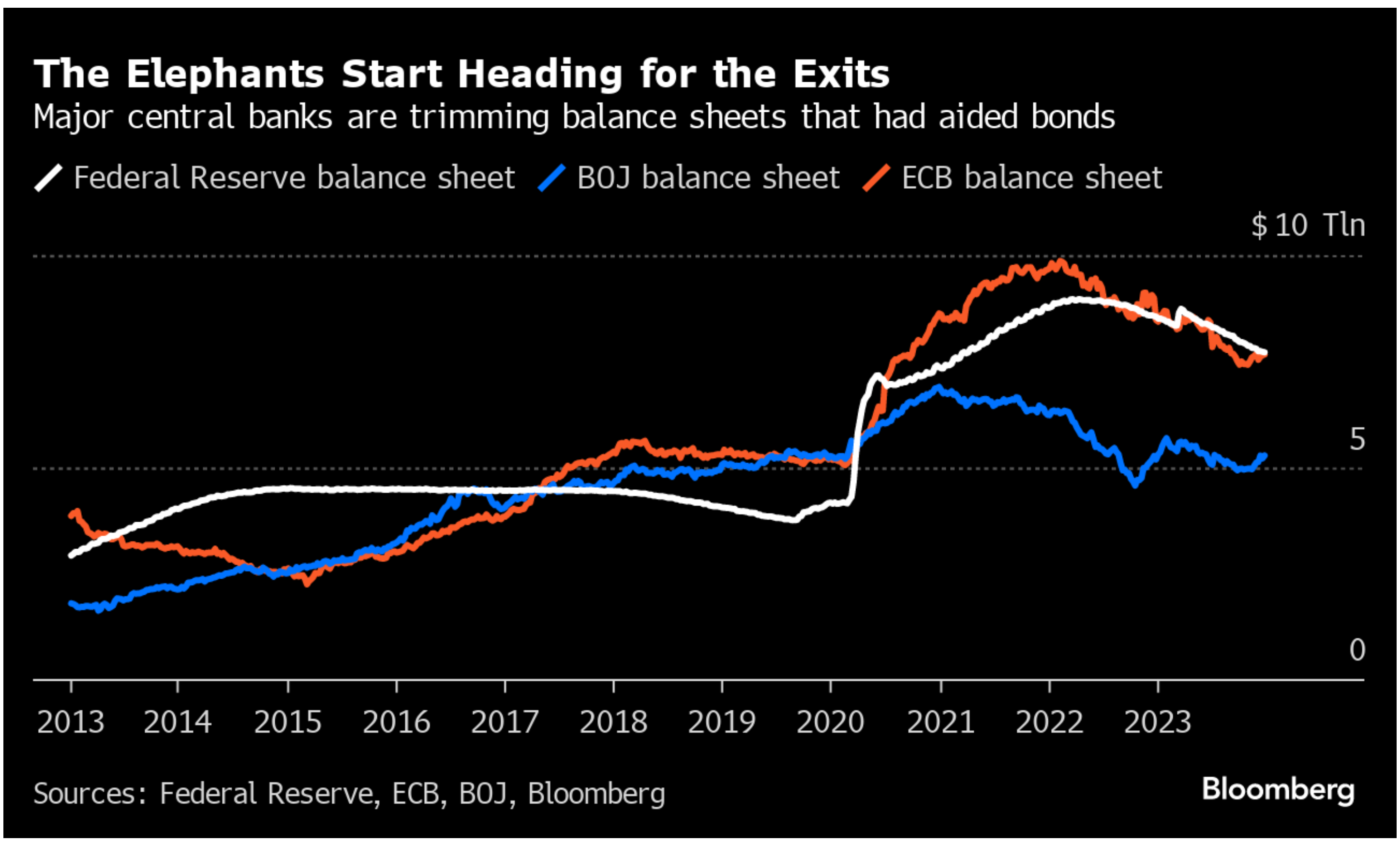
What does this mean for the demand/supply relationship? If the Government issues (supply) more debt than there is demand for the debt, bond prices will fall. As we just learned, if bond prices fall, interest rates will increase. If supply exceeds demand and interest rates begin to rise, this creates a situation where higher interest rates will further squeeze corporate profits and slow the economy. A slowing economy means increased deficit growth, more debt issuance, and higher interest rates.

How will we know if supply exceeds demand? We can monitor the Treasury market's bond auctions. Having written about this last August, most debt auctions have had robust demand since then. The auction for five-year Treasuries this Wednesday sparked me to revisit this topic. Here are the results of the five-year Treasury auction as reported on Bloomberg.

(Bloomberg) -- The bond market had been fairly well-behaved this morning given the equity rally...perhaps too well-behaved. **Today's 5-year auction tailed by 2 bps amid absolutely putrid demand.** Bid/cover of 2.31 was more than 2 sigma below the one-year average and the lowest for the tenor since September 2022. Indirects bidders bought just 60.9% of the print, also the lowest since September 2022 and 1.8 SDs below average.

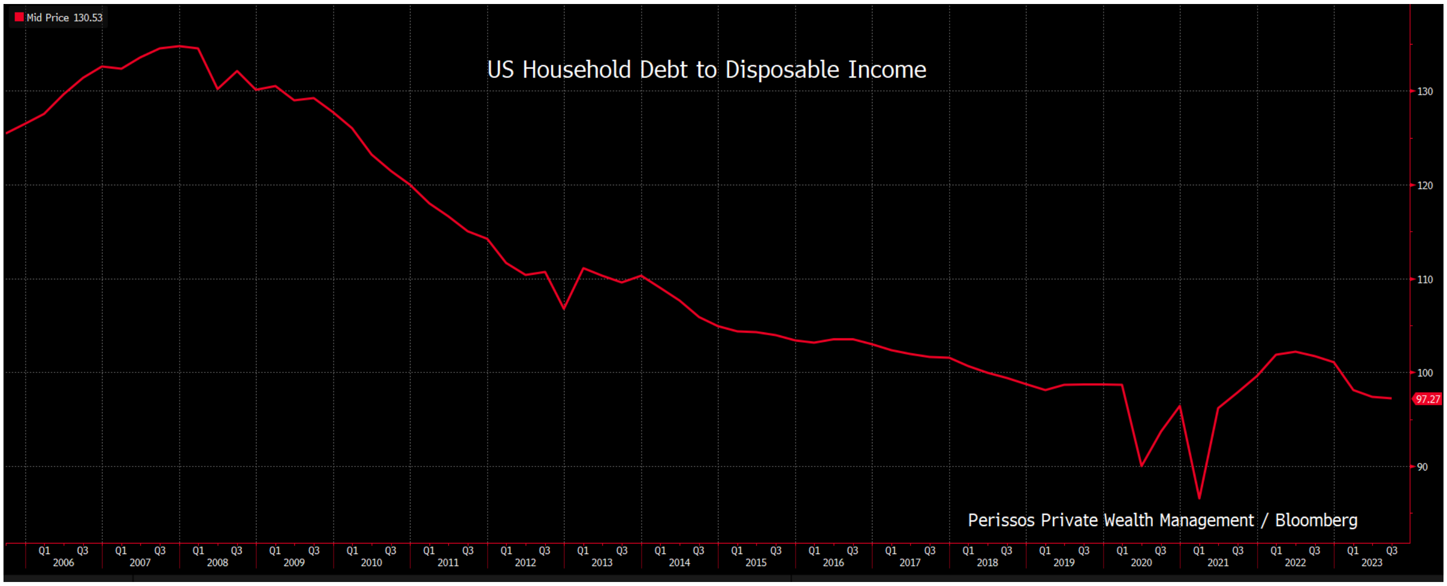
Dealers were left holding the bag, as they bought 20.4% of the print, yet again the highest since Sep 2022 and 2 sigma above average. That's not what you want at the biggest auction since October 2021, and it wouldn't be a surprise to see bonds sell off a bit more and the curve to flatten, insofar as 5s represent the long leg of the popular 5s-30s spread.

Just as the Government is issuing massive amounts of debt, the Federal Reserve is also adding to the debt supply by allowing its bond holdings to roll off its balance sheet. The chart below shows major central banks are all reducing the size of their holdings of government debt.



A possible scenario I am monitoring now is one where interest rates on longer-term bonds begin to increase because of a lack of demand, and the Federal Reserve is forced to buy bonds on the open market to hold down longer-term interest rates. If that were to occur, there are a couple of possible outcomes. If the economy is not heading into a recession and the Fed has to step in and buy bonds to keep longer-term interest rates from moving up too much, we could see the economy pick up steam, which would feed into higher inflation in the future. This would cause a second round of interest rate increases to keep inflation in check at some point in the future.

Based on my study of history and economic cycles, it is hard to imagine economic growth taking off to help relieve the deficit while interest rates are at a 15-year high and leading economic indicators point to slower growth. One way we could see an increase in economic growth even as interest rates are elevated is through consumer spending. Since 2008, households have deleveraged nicely as the chart below shows. If consumers increase their use of credit to fund spending, we could see the economy pick up in the face of higher interest rates. This might help in the short term but would be harmful to the consumers in the long run and only be a temporary boost to GDP growth.



My baseline for last year was that we would have seen a recession in 2023. We didn't, and one of the main reasons was consumers increased spending using credit through much of 2022 and 2023, keeping consumption elevated despite higher interest rates. As banks have tightened lending standards and consumer debt growth has recently slowed, I believe we will see a recession (however mild) in the next 12-18 months. That is unless the Fed does indeed cut interest rates by over one percentage point as the markets have currently priced in. This past week, fourth-quarter GDP came in at 1.3% higher than expected at 3.3%, and Personal Consumption came in at 2.8%, higher than expectations of 2.5%. I find it hard to imagine the Fed cutting rates in March with such robust economic data. We will know what the Fed thinks this coming Wednesday when the Federal Open Market Committee meets to decide on the Fed Funds rate.

All my best,

Brandon VanLandingham CFA, CMT, CFP®