Weekly Market Commentary

April 24, 2023

Weekly Commentary

As the banking crisis recedes further into the background, another crisis is gaining traction, as the debt ceiling imbroglio is heating up in Congress. House Speaker McCarthy's opening salvo, presenting the Republican quid pro quo for a one-year suspension, is likely to land on deaf ears with most Democrats, meaning that tensions surrounding negotiations will only get hotter in coming weeks. It's still unclear what the drop-dead date to avoid default will turn out to be; a lot depends on how strongly the Treasury's depleting coffers are refilled by incoming tax revenues. Bloomberg reported on Thursday that net inflows totaled $108 billion on the April 18 tax-filing date, boosting the Treasury's total cash on hand to $252.5 billion. We expect the Treasury to run out of cash sometime this summer with a non-trivial risk that the debt limit would need to be lifted as early as June.

Given the deep polarization in Congress, the financial markets are expecting another nail-biter, as Treasury bill auctions are already generating higher yields and credit default swaps are becoming more expensive. Unsurprisingly, Republicans and Democrats are hewing to traditional arguments, with the former highlighting the need for fiscal austerity and the latter striving to protect social programs. Significantly, the centerpiece of negotiations – federal debt – might seem to be an unlikely candidate for fiscal hawks to base their argument on. Although budget deficits have certainly risen to eye-popping levels, with the annual red ink totaling in the trillions of dollars, outstanding Federal debt has been shrinking at a historically rapid rate relative to the size of the economy.

Since the spring of 2020, federal debt outstanding as a percent of GDP plunged by 15 percentage points, the steepest decline in this ratio in at least 60 years. As noted, the downtrend received little help from deficits, which averaged $2.4 trillion a year over the past three fiscal years compared to $983 billion in fiscal year 2019, the last year before pandemic spending blew up the total. Instead, the shrinking ratio stems in good part from the same influence that ignited stress in the banking system, spiking interest rates that reduced the market value of outstanding bonds. Meanwhile, the denominator in the debt burden equation, nominal GDP, received a big lift from higher inflation and a robust post-pandemic recovery in real output. On the surface, this suggests taxpayers are reaping the rewards of a high inflation/tight Fed policy regime, likening the trend to a household or business that has more income to carry debt obligations.

Fred Eisel
Chief Investment Officer
Email: feisel@vfccu.org
Phone: 800-622-7494 ext. 1610

Scott Wood
Portfolio Strategist
Email: swood@vfccu.org
Phone: 800-622-7494 ext. 1631

Market Commentary provided by Oxford Economics. Content not written by Vizo Financial.

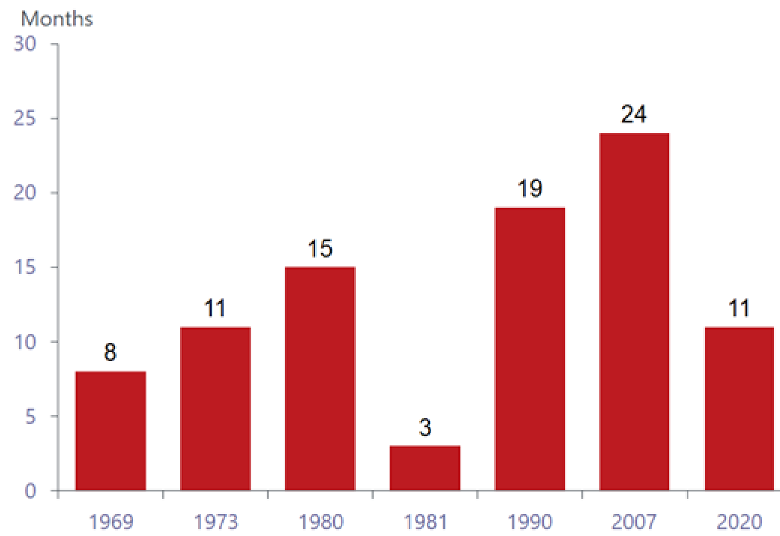
But such rewards are ephemeral at best. Unlike borrowers in the private sector, the government is constantly refinancing big portions of its $31.4 trillion in outstanding debt, and as rates increase, so, too, do its debt-servicing costs. Indeed, federal interest payments leaped 40 percent over the past year and are almost as large as military spending. As any homeowner with a mortgage will tell you, it is the monthly debt servicing charges that matter more than the outstanding debt. The higher those charges relative to income, the greater the squeeze on other expenditures. Given the limitations imposed by the debt ceiling, the government, too, has to choose what programs to cut back on as interest payments gobble up more of revenues. Keep in mind, also, that while higher inflation reduces debt/income ratios, it also undercuts the purchasing power of savers, which is the painful counterpoint to the notion that you can inflate away debt.

That notion is further undercut when interest rates rise faster than inflation, which has been the case over the past year and is starting to drive up loan delinquencies and defaults. For the most part, household balance sheets are still in good shape, thanks to a savings cushion built up during the pandemic and the income gains linked to the still sturdy growth in jobs and wages. But the savings buffer is shrinking, particularly among low and middle-income households, and job growth is slowing, albeit from a lofty pace. Importantly, the strain on bank balance sheets linked to the falling value of government bond holdings is contributing to tighter lending standards and reduced credit availability that will pose an increasing drag on economic activity.

Although the White House insists on an unconditional lifting of the debt ceiling, there is a good chance a compromise will be negotiated that results in some fiscal austerity. That prospective drag, in turn, would reinforce the lagged effects from the Fed's aggressive rate-hiking campaign and supports the widespread expectation the economy is heading for a recession later this year. To be sure, the hope for a soft landing is still very much alive, as many believe that healthy job growth and low unemployment will enable the economy to withstand the headwinds coming its way. But the job market is usually the last shoe to fall when the economy transitions from expansion to contraction; the lag may well be longer this time as companies hoard workers in the wake of acute labor shortages over the past year. But the longer the job market takes to capitulate, the greater the odds the Fed will keep its finger on the rate-hiking trigger, heightening recession prospects and the likelihood that the downturn would be more severe than otherwise.

The financial markets are betting on a recession and expect the Fed to start cutting interest rates later this year. Although a lagging indicator, it would be a mistake to underestimate the resilience that a healthy job market could impart to the broader economy. But leading indicators, including new orders, building permits, delivery times and some time-honored financial data, are pointing decisively towards a recession. The Conference Board Leading Economic Index, which consists of these and other forward-looking indicators, fell by 1.2 percent in March, the largest decline since the depth of the pandemic-induced recession in April 2020. This was the twelfth consecutive decline in the index, the longest string since the months leading up the Great Recession in 2008. The historical linkage between the index and the business cycle strongly indicates that a recession will set in over the second half of this year.

All components of the index had been released earlier, so the decrease in the overall index came as no surprise. But one key component depicting labor market conditions, claims for jobless benefits, is available through the second week of April, and it confirms that the trend is continuing. Initial filings edged up 5,000 to 245,000 in the week ending April 15, the highest since January 2022. That's still a historically low level and far below the 400,000 first-time applicants usually seen during recessions. But that's consistent with our view that the looming recession will be relatively mild with a lower unemployment rate than in past downturns. Importantly, initial claims for jobless benefits hit a low for this cycle last September at 182,000. The average lag between the low for claims and the onset of a recession spanning the last seven cycles has been 13 months. That timing would peg the start of the next recession sometime in the fall.



Months from jobless claims low to recession
Months
30
25
20
15
10
5
0
8
11
15
3
19
24
11
1969
1973
1980
1981
1990
2007
2020