Market Commentary

‘G’ is for Government

October 2023

Summary

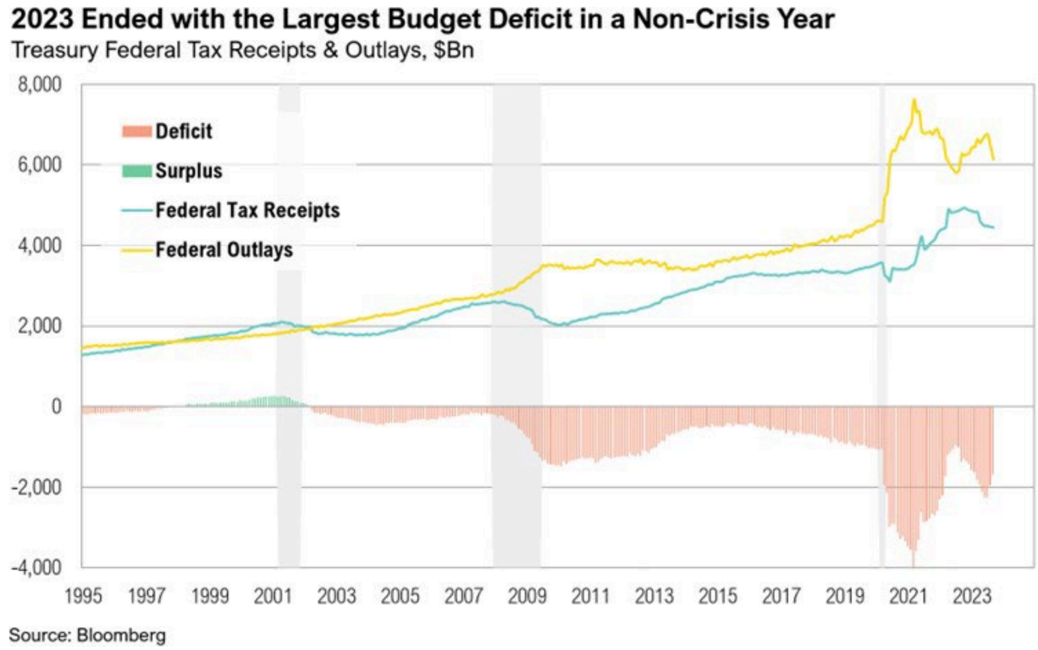
- Bond markets continued lower, and the Bloomberg Aggregate Bond Index ended October down 1.6%, marking the longest stretch of negative bond returns since the 18th century.
- Geopolitical tensions surged following Hamas’s attack on Israel on October 7, prompting Israel to declare war.
- The U.S. GDP grew by 4.9% on an annualized basis in the third quarter, primarily driven by robust consumer spending and likely enhanced by pandemic-related financial relief programs.
- The U.S. government added $532 billion in debt outstanding in October, while facing future budget strains due to a record (and growing) $659 billion in interest outlays, signaling additional challenges for government spending productivity and overall fiscal health.

Overview

In October, financial markets reached several key milestones. Notably, October marked the one-year anniversary of the 2022 bear market low on October 12. While the S&P 500 ended October down 2.1%, it is up 10.1% over the past twelve months. Bond markets continued their decline in October, and the Bloomberg Aggregate Bond Index ended October down 1.6%. 2023 marks the third consecutive year of negative bond returns, a trend not seen since the Declaration of Independence was signed, making it the most extended bond drawdown in history.[1] When adjusted for inflation, the return on the 10-year Treasury bond ended October down 36.2% since its peak in July 2020.

On the geopolitical front, tensions escalated sharply on Saturday, October 7, when Hamas launched a coordinated assault on Israel from Gaza. In response, Israel declared war on Hamas. Israel Prime Minister Benjamin Netanyahu emphasized the gravity of the situation and strongly suggested that the conflict would continue well past October, citing historical parallels to U.S. responses to homeland attacks: “Just as the United States would not agree to a ceasefire after the bombing of Pearl Harbor or after the terrorist attack of 9/11, Israel will not agree to a cessation of hostilities with Hamas after the horrific attacks of October 7”, he declared.[2]

October also ushered in the new fiscal year for the United States, which ended the 2023 fiscal year with a notable deficit of $1.7 trillion—by far the largest deficit in a year without a recession or global crisis.[3] On average, annual deficits since 2002 have hovered around $0.9 trillion. The Treasury's issuance announcements for the fourth quarter of 2023 and projections for the first quarter of 2024 suggest that the deficit may not be an anomaly but rather the continuation of the trend. Borrowing for the last quarter of 2023 is expected to reach $776 billion and an estimated $816 billion in the first quarter of 2024.[4] The forecast for the first quarter alone exceeds the annual borrowing average of $721 billion since the turn of the millennium. Moreover, the government's debt outstanding increased by $532 billion in October alone—the first month of the fiscal year—which is $256 billion more than the same period in the previous fiscal year.[5]



‘G’ is for Government

On October 26, preliminary estimates showed that U.S. real Gross Domestic Product (GDP) had grown at an annualized rate of 4.9% in the third quarter, propelled by vigorous consumer spending. Nominal GDP growth, which does not adjust for inflation, rose 8.5% (annualized quarterly rate).[6] Outside of the COVID-19 pandemic, this level of growth has only occurred three times since the Global Financial Crisis (GFC)—twice in 2014 and once in 2019.[7]

GDP is the sum of several parts: personal consumption (‘C’), business investment (‘I’), government spending (‘G’), and the balance of exports and imports (‘X-M’). ‘G’ represents the government’s role in an economy—as a consumer and investor. In times of conflict or crisis, such as the GFC and the more recent COVID-19 global pandemic, ‘G’ has historically taken a central role in stabilizing and boosting economic activity through spending, tax credits, and stimulus checks.

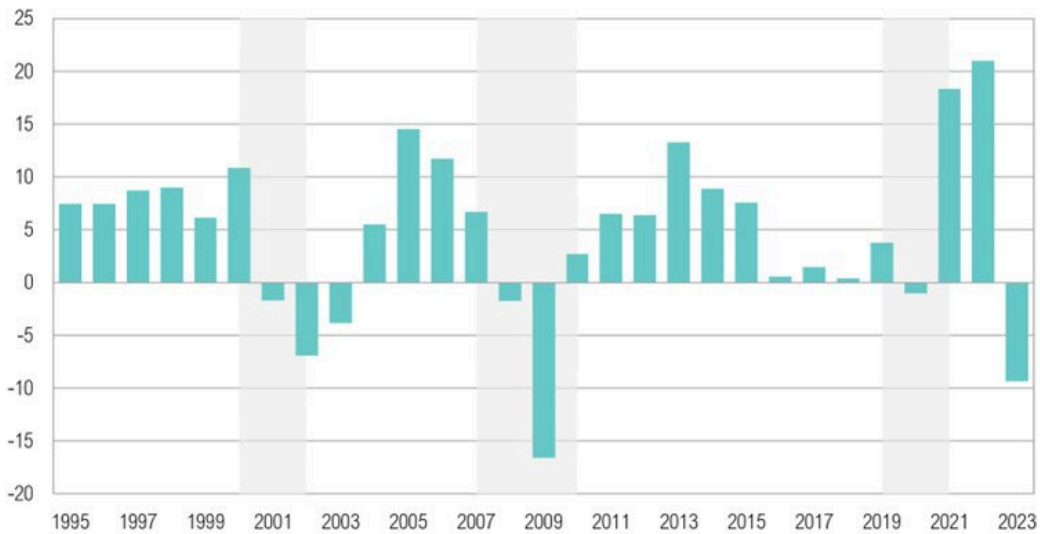
Personal consumption, or 'C,' continues to be a powerhouse for the U.S. economy, comprising 68% of the latest quarter's GDP—surpassing the usual 65%.[8] This uptick underscores consumers' resilience despite higher interest rates. The strength of consumer spending owes much to lingering pandemic-era programs, notably the federal student loan repayment moratorium, which has provided over $260 billion in payment suspensions, and the employee retention credit, which has delivered more than $230 billion through a refundable tax credit to businesses and employees in the past two years. These programs have played a dual role: keeping funds in consumers' wallets and actively replenishing them.[9,10,11] Although these efforts bolstered personal consumption, they did not show up as an increase in government spending.

'G' represented 17% of U.S. GDP in the third quarter, which, perhaps surprisingly, is below the historical average of 20%.[8] Arguably more important than the level of government spending relative to the total economy is how much of that is covered by tax receipts and how productive that spending is. To understand why the 2023 deficit ballooned to such an extent, we must examine various factors:

Federal tax receipts experienced a rare 9.3% year-over-year decline. Such a drop in tax revenue outside of a recession has not been observed since the Global Financial Crisis. Additionally, the Social Security Administration (SSA) delivered an 8.7% COLA for 2023, the largest cost-of-living adjustment in 40 years. As a result, SSA outlays increased to $1.4 trillion, an increase of more than $100 billion from the previous year. The COLA for 2024 will be 3.2%.[12,13]

Declining Tax Receipts Outside Of Recessions Are Unusual

Change in Federal Tax Receipts, Year-over-Year %



Source: Bloomberg, U.S. Treasury.

Due to the banking crisis earlier this year, outlays of the Federal Deposit Insurance Corporation (FDIC) were $94 billion more in 2023 than in 2022.[13,14] The FDIC, an agency responsible for the stability of the U.S. financial system, reported that recoveries associated with failed banks have been slower than projected and have added to the higher-than-expected outlays.[14]

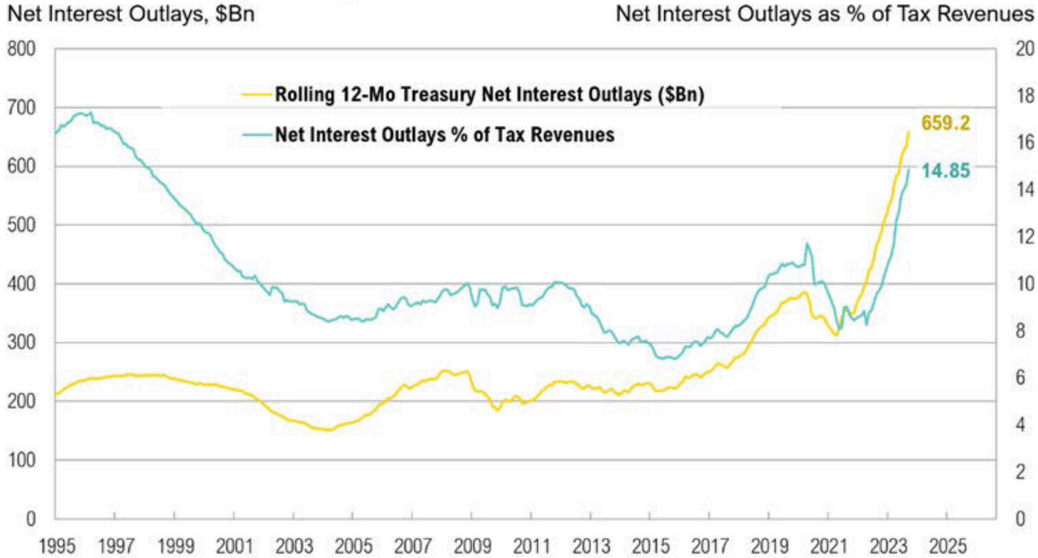
By law, the Federal Reserve returns its profits after covering operating expenses to the Treasury. The Fed's aggressive rate-hiking cycle and subsequent higher short-term interest rates have raised the Fed's interest expenses, which has cut into the amount of money it handed back to Treasury. The Fed returned $581 million to Treasury in the 2023 fiscal year, much less than the $76 billion handed back in 2022.[13,15]

The Department of Defense spent $54 billion more in the 2023 fiscal year than during the 2022 fiscal year.[13] Further, the Biden administration has recently asked Congress for $106 billion in military aid for Ukraine and Israel, as well as additional funding for the U.S. southern border and defense in the Pacific area to deter a third war breaking out in Taiwan.[16,17] As renowned U.S. investor Stanley Druckenmiller recently pointed out, it may be necessary for the U.S. to spend this money on defense now to prevent a Russia-China -Iran axis because:

> *"Do you know how much we're going to have to spend if Putin wins Ukraine?"*[18]

As government debt continues to mount, so do the government's debt payments. For the 2023 fiscal year, net interest outlays (the amount of interest the government pays on outstanding debt) reached a record high of $659 billion. Net interest outlays are already a major contributor to the growth of total deficits in the U.S., and the Congressional Budget Office estimates that the government will spend at least $10 trillion over the next 10 years on interest payments alone.[19] For context, the average net interest payments over the past 10 years have been $298 billion per fiscal year. Even if government spending as a percentage of GDP appears stable, the actual productivity of such spending is at risk of declining as debt service consumes a larger portion of the budget.

Net Interest Outlays are Expected to Accelerate Over the Next Decade



Source: Bloomberg

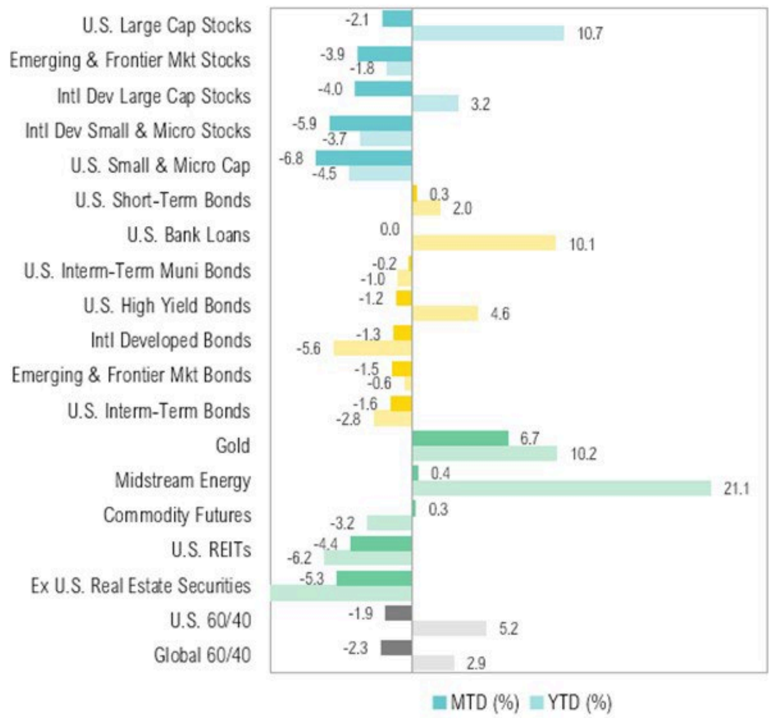
In essence, the critical issue with 'G' is not its current share of GDP, but the mounting deficit amidst rising interest rates—particularly in a non-recessionary period. Additionally, the uptick in consumer spending, in part a result of generous government support during the pandemic, raises questions about its sustainability as these programs wind down, inflation persists, and personal savings diminish.

Markets

Nearly all asset classes ended October with negative returns. Gold was the only standout performer, which ended the month up 6.7%, due to strong returns largely fueled by the war in Israel. U.S. small cap stocks, as proxied by the Russell 2000 Index, continued their decline throughout October, ending the month down 6.8%. In fact, U.S. small cap stocks dropped into negative territory for the year, ending October down 4.5% year-to-date. Non-U.S. equities continue to trail U.S. equities, and the MSCI EAFE ended the month down 4.0%. International bonds ended October down 1.3%.

Third-quarter earnings season kicked off in October. As of the end of October, 81% of S&P 500 companies had reported actual results, and earnings growth for the third quarter hit a lackluster 3.7%.[20] Third-quarter earnings growth estimates improved over the month, rising from -0.3% at the end of September to 3.7% at the end of October. Despite this modest improvement, full-year 2023 earnings growth is expected to be just 0.6% after fourth-quarter earnings estimates were cut by 3.9% in October, the largest such cut since the second quarter of 2020.[20]

October 2023 Key Market Total Returns



Source: Bloomberg

On November 2, the Japanese government approved an economic stimulus package worth approximately $113 billion in an effort by Japanese Prime Minister Fumio Kishida to lessen the impact of inflation on Japanese consumers, which reached a 40-year high earlier this year and remains near these levels.[21] Part of the package includes income and residential tax cuts, as well as subsidies for lower income households.[22] This would be the equivalent of a $680 billion economic stimulus package for the U.S. economy. Japanese equities are up 7.7% year-to-date, narrowly trailing the U.S. (up 10.7% year-to-date), and they continue to be one of the top-performing countries, ranking in seventh place.

In similar news, on October 25, China announced a fiscal stimulus plan to boost new areas of the Chinese economy, such as advanced manufacturing and renewable energy.[23] This follows an initial announcement on October 17 that the Chinese government would issue $137 billion in sovereign debt, as well as raise the budget-deficit ratio.[23] In contrast to Japan, Chinese equities are down 10% year to date, and the country ranks as one of the worst performers in 2023.

Looking Forward

The net result of the mix of lower tax receipts and unbridled spending over the past few years is plain to see. At the end of fiscal year 2019, the U.S. national debt was $22.7 trillion. Currently, the U.S. national debt is $33.7 trillion—an $11 trillion jump (nearly 50%) in approximately four years. Higher interest rates mean that an increasing proportion of government spending will be consumed with debt service payments, and we question whether the government can continue to take such a heavy-handed role in the economy directly, as well as through indirect support of the consumer.

For this and other reasons, we anticipate heightened market volatility in the quarters ahead. The delayed impact of the Federal Reserve's aggressive rate-hiking cycle, higher long-term interest rates, the unfolding of two wars, and the upcoming U.S. presidential election all have the potential to disrupt markets. As such, a diversified approach with higher-than-normal allocations to short-term bonds and other safe havens seems prudent. Further, given the rapidly increasing U.S. government debt and growing unease in the bond markets due to persistent inflation, poor fiscal management, and geopolitical factors, we believe a diversified approach to safe havens makes sense.

Disclosures

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Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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