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Gleanings

Too Much Spending

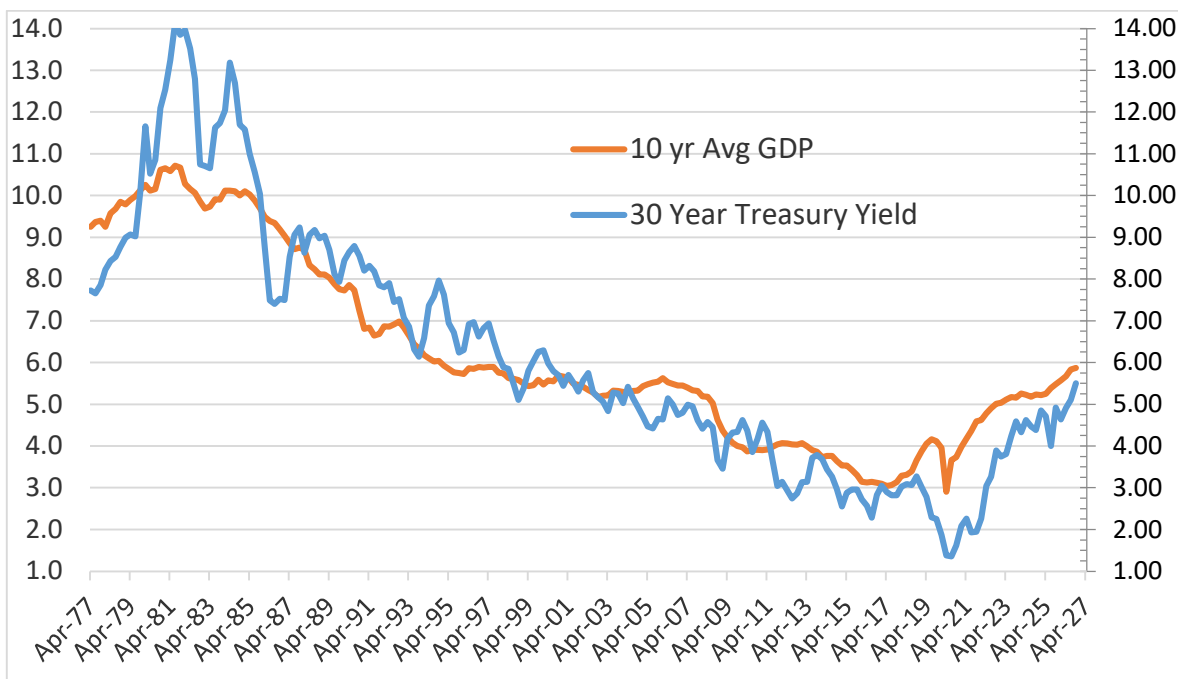
Historically, about 17% of the US national income has gone to the federal government, mainly from income taxes. Spending has

always been somewhat greater as the Treasury can issue bonds to pay for the difference. What has been happening in the period since 2008, however, is that the amount of spending has grown disproportionately. Before 2008, US government spending was about 11% greater per year than income. Now it's 34%. That is, for every dollar the federal government takes in, they spend \$1.34. All of that is financed by issuing debt. So, the government still has income of \$3.53 trillion, (mostly from income taxes), but it spends about \$1.2 trillion more per year, which again, they borrow. Add that to the short-term junk debt maturities that are about \$200 billion greater than normal as well as expected annual AI build-out related debt of \$500 billion and the amount of money that needs to be borrowed in the financial markets is about half-again greater the normal.

If we think about it from a supply and demand viewpoint, it shouldn't be a surprise then that thirty-year Treasury yields are heading to the top of the range at which you would normally expect them to be. In the graph below, I compare those yields to the average rate of growth of the US economy for the preceding ten years. When the government wants to slow the economy, typically to reduce inflation, it pushes rates higher so that the cost to borrow is greater than the expected growth rate of the economy. It gets just too expensive, on average, to pay that interest rate in the context of a slow-growing economy, or especially one in recession. When inflation comes under control, they can work to reduce rates and stimulate the economy to grow as borrowing becomes profitable again. With demand driving rates higher already, despite the government's efforts, it remains to be seen whether rates stay unrestrictive (under the 5.9% GDP growth average) or move higher and potentially push us towards recession.

Index Returns

	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>YTD</u>
S&P 500	26.3	24.9	17.9	12.8%
ML 1-5 yr Gov't/Corp	5.2	4.6	6.1	-.3%
EAFE (Dev Fgn Mkts)	18.2	3.8	27.9	8.1%
Emerging Markets	10.1	7.5	30.6	21.4%



How will high rates affect your portfolio? It will take time to tell. If they dampen the economy and growth comes down, so will rates. Currently though, it's business as usual and while mortgage rates at 7.3% have slowed housing price appreciation from 5% annually to 3%, we still appear to be solidly in an upcycle. One thing to watch is the Chicago Fed's Financial Conditions Index. Graphed below in blue, it is comprised of 105 financial indicators compiled by the Federal Reserve. Above-average inflation and growth in economic activity have been historically associated with the index below zero, and below-average inflation and slowing growth in economic activity have been associated with the opposite. While we might hear talk about controlling inflation, (by tamping down growth), the reality of monetary policy shows up here. High interest rates alone don't tell the whole story. When the Index rises and crosses zero, it indicates tightening conditions and typically is followed shortly thereafter by a lower stock market and lower interest rates.

The chart to the right shows that sequence which resulted in a 39% drop in the S&P. Short and long-term rates were high in 1997 and 1998, with both over 5.5%, and when Asian markets discovered that the enormous amounts of new debt issued by industries and ventures there were less profitable than projected, defaults ensued and credit markets seized up. Reflected by the Financial Conditions Index (in blue) crossing zero on the right scale in late 1999, the S&P peaked in March of 2000 as we entered a recession.

Similarly, in 2006, both short and long-term rates hovered around 5% but credit conditions were quite favorable with the Financial Conditions index solidly below zero. Perhaps too favorable however. Excessive amounts of debt issued by sub-prime mortgage lenders also turned out not to be economically viable and losses made lenders (and investors) question their risk assumptions. As a result, credit markets tightened in the extreme. With the blueline going vertical in late 2007, the S&P's top came in October with a subsequent drop of 57% over the next 17 months. (Rates dropped as well.)

There are some parallels now to the past two episodes. Long-term rates are high and short-term rates are coming up. Yet financial conditions are still very favorable with many trillions of dollars being targeted at a promising industry whose ultimate profitability is not yet proven. Our recent experience with Treasury rates hitting new highs, while a clear sign of excessive demand, has not yet been reflected at all in Financial Conditions. Markets are more than willing (currently) to continue to finance expansion. It will be interesting to see if the August high of 8317 on the S&P holds but for now, still all green lights.

