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JUNE MARKET AND ECONOMIC INSIGHTS

July 2023

Introduction and Overview

Welcome to the June installment of our monthly report, where we aim to highlight topical matters and assess their potential impact on financial markets.

In this report, we will review/reaffirm our thesis about the fragility of the US economic recovery and our skepticism *vis-a-vis* the Fed's ability to navigate a challenging course to execute a "soft landing" by managing to get inflation under control without causing a recession. Our base case for the US and many global economies continues to be a high probability of recession.

Our basis for this view has four components:

Firstly, we continue to see weakness in some real-time, predictive indicators, including defaults and delinquencies in housing markets — notwithstanding recent increases in home purchase and rental prices.

Secondly, we do not view recent declines in the CPI and benign readings in other short-term economic indicators to be sustainable. For example, certain components of the basket comprising the CPI, such as energy and commodity prices, have already resumed their upward trajectory which will, we believe, imminently drive the CPI higher again.

Third, US federal government budget data for the month of June came in substantially worse than expected, with outlays higher and receipts lower than had been projected. In what appears to be an accounting boost to short-term economic numbers, this may actually reflect a deteriorating tradeoff between growth and inflation, which would be a harbinger of stagflation to emerge in the medium- to long-term.

Fourth, very simply, the global economy as a whole is showing signs of weakening.

In this note, we will share our views about how macro- and micro-economic currents are interacting and how this interplay may have a sustained impact on various economies and markets.

Dynamics of the Delayed Response are at Play Again

When looking at markets and economic data, one of the key relationships to keep in mind is the time lag between cause and effect. The two are virtually never synchronized, with certain effects showing up and becoming measurable more quickly than other ones. While this is perhaps stating the obvious, it remains important to consider, especially in the context of markets and economies that depend on variables that are not generally independent.

A clear example of this phenomenon is government deficit spending, which invariably results in an instantaneous boost to GDP as it generates immediate demand. This same deficit spending, however, also causes inflation with an impact that typically lags its catalyst and notably only manifests itself in later measurement periods.

When the government makes large expenditures to purchase military equipment or to implement social transfers that we've considered in previous letters, these almost *instantaneously* result in an increased accounting measurement of GDP. This is in sharp contrast, for example, to the effects on owner equivalent rents, i.e. the amount of money a property owner must pay in rent to achieve the equivalent cost of property ownership. These *do not instantly* increase the day after government spends large sums of money, but are observable only after some passage of time.

Moreover, even when market rent prices do increase, there is an additional lag in measuring their impact on CPI as rents tend to be governed by long-term contracts. The same is true about union wages, health insurance, and other parts of the economy where prices are not negotiated in a spot market.

In fact, it may take months or longer for these changes or "shocks," as economists refer to them, to become part of a new steady-state and equilibrium. Indeed, higher deficit spending and consumption take time to impact inflation, interest rates, private sector saving rates, foreign capital flows, FX markets, and both domestic and foreign investments.

Despite this complexity, an easily observable phenomenon is that there are initial benefits tied to increases in deficit spending such as improved economic metrics. Conversely, the "costs" related to such spending, which tend to manifest following a lag, include higher inflation and slower longer-term growth. For validation of this, just ask any politician who has engaged in social spending ahead of an election. As a further example, we can look domestically at the impact of deficit spending during the 2020 Covid-era, which resulted in an immediate V shape recovery followed by higher inflation. In the case of Covid, this has generally been a global phenomenon.

We believe similar dynamics are at play in the current environment and that some data presents a kind of false positive test of real fiscal health, masking a precarious economic environment before the longer-term effects of budget deficits and misguided policy do finally materialize with considerable negative impact.

US Fiscal Picture and Budget Deficits Continue to Worsen

According to the Congressional Budget Office, the federal budget deficit was $1.4T during the first nine months of fiscal year 2023, which began on October 1, 2022. Furthermore, for the same period, receipts declined by 11% from the prior year while outlays increased by 10%.

The preliminary data indicates total revenues for the fiscal year are likely to be less than government and CBO projections.

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Table 1.

Budget Totals, October–June

Billions of Dollars

	Actual, FY 2022	Preliminary, FY 2023	Estimated Change	Estimated Change With Adjustments for Timing Shifts in Outlays[a]	
				Billions of Dollars	Percent
Receipts	3,835	3,415	−420	−420	−11
Outlays	4,350	4,805	455	432	10
Deficit (−)	−515	−1,390	−875	−852	165

Data sources: Congressional Budget Office; Department of the Treasury. Based on the *Monthly Treasury Statement* for May 2023 and the *Daily Treasury Statements* for June 2023.

FY = fiscal year.

a. Adjusted amounts exclude the effects of shifting payments that otherwise would have been made on a weekend. If not for those shifts, the budget would have shown a deficit of $1,367 billion from October 2022 through June 2023, CBO estimates.

In particular, we note that receipts collected through June 2023, net of refunds, were about $300 billion less than CBO projections, resulting mainly from reduced tax collections. During the same period, withheld taxes increased by $81 billion or 3 percent.

Amongst this data, we find the paltry 3 percent growth in withheld taxes particularly alarming. This number is more consistent with an anemic job growth report than it is with payroll data. Specifically, this 3 percent growth is less than inflation and is, therefore, more consistent with previous periods of no meaningful job creation. So how did we get here? In our view, the cause stems from a situation where jobs were created but did not result in payroll taxes, or there are measurement errors resulting from too much reliance on job creation numbers reported by the Department of Labor. We find the first possible explanation to be highly doubtful and are left to conclude that data provided by the Department of Treasury (withheld taxes) are contradicting data provided by the Department of Labor (job growth). The ultimate explanation for these differences will be better understood as additional information becomes available.

If this trend were to continue, the budget deficit for fiscal 2023 could easily exceed 2 trillion dollars. To put a finer point on it, the budget deficit for the first 9 months of 2023 has already surpassed that of the entirety of fiscal 2022. If we extrapolate this trajectory, the deficit could rise as high as 8-9% of GDP compared to earlier projections of 7%.

We believe this level of deficit spending is going to have repercussions for the inflationary environment, including a worsening trade-off between growth and inflation. Furthermore, we believe this level of deficit spending is providing an unwanted stimulus for the economy, which may postpone, but **will not** cancel a recession.

Absent this high level of government spending, the US economy would already be in a recession. For reference, historically the US budget deficit has hovered around 3% of GDP. We do not foresee a happy ending for this level of fiscal irresponsibility by Congress.

Inflation Could Be Making a Comeback

In June, the CPI registered an increase of 3% during the previous 12 months. Furthermore, the Index for all items less food and energy rose 0.2% in June, the smallest increase since August 2021. While we believe it is entirely possible, if not likely, that we will have additional soft CPI prints over the next few months, we believe inflation could continue to be a persistent challenge. Federal deficit spending will invariably impact inflation and wages which may, in turn, require a tougher monetary response from the Fed.

Part of our skepticism about inflation being under control derives from consideration of a single (prominent) component of the CPI: energy. The recent decline in the CPI was driven by declines in Gasoline, Fuel Oil, and Utility gas services. As recently as July, however, we have seen commodity prices beginning to increase again, a trend that we believe is likely to continue.

Additionally, electricity prices have shown a 5.4% growth year over year as policymakers continue to provide incentives for consumers to use electricity rather than other sources of fuel. At the same time, incentives are being provided to encourage the use of more expensive sources of power from the electric grid. We expect the impact of these stimuli, enacted through a complex set of incentives and payments, to be gradual but expensive and add to the inflationary pressure within the US economy.

In addition, certain components of inflation, such as medical care and insurance coverage, are not repriced on a monthly basis, but rather are subject to yearly resets, thus creating yet another opportunity for some lag in the measurement of inflationary impact.

At the same time, we are also seeing anecdotal evidence of various unions (e.g., pilots and UPS drivers) resetting and renegotiating their wages, which will ultimately have the effect of being part of the “wage component” of a wage price spiral.

Lastly, the housing market is also primed to become a contributor to inflation. With five months of home price and rent increases accompanied by growing interest expense, the anticipated result is self-evident. We will revisit the housing market in a future commentary, but for now let’s keep in mind that housing inflation is still alive and well.

Global Economic Picture is Increasingly Cloudy, with Parts of Europe already in a Recession

Data from across the globe also indicates an inflationary and recessionary Eurozone environment, with the two biggest economies, Germany and France, both in

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contractionary territory. Notably, manufacturing and factory output in the eurozone are declining, with manufacturing PMI dropping materially from 43.4 to 42.7. Information from China shows similar weakness.

Equity and Debt Market Rally Have Signs of Irrational Exuberance and Speculative Bubbles

Against this backdrop, we believe the current equity market rally — or "melt up" — is highly speculative and plausibly irrational. We can point to price action in various money-losing stocks as well as a various assortment of crypto and blockchain-based tokens and coins. It seems that an equity market rally which has been fueled by an AI frenzy has now spread to broader corners of equity markets.

Though not involving AI, we were particularly amused (but not surprised) at the rise of AMC in the aftermath of a court ruling challenging the conversion of preferred shares to common equity. A fairly straightforward observation is that the existence of preferred stock could be painful for common shareholders of a money-losing company. Given the dynamics of a possible short squeeze, it seems the potential for a lower supply of shares was far more important than the fundamental health of the company (yet one may argue the reverse should be the case). We have seen similar gravity-defying rallies in shares of Carvana, and other companies, each with its own farfetched rationale. While this is not an area of focus for our funds, we find this dynamic to be an apt metaphor for what is going on in markets more generally.

While this rally could last, we do not think it is supported by long-term macroeconomic fundamentals and will at some point correct and reverse itself.

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