WSL Family Office & Private Wealth Management

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Views From the Stream

September 30, 2023

The Wild West & The Return of Vigilante Justice, Part 2: The National Debt, The Earps and the Clantons, & The Coming Shootout At The OK Corral

"Vigilantism: The act of preventing, investigating, and punishing crimes without legal authority."

Wikipedia

For those of us of a certain era, the cowboy movie on the big screen never ended. It just resurrected itself in a new format. Movies like Star Wars and Indiana Jones and, more recently, Marvel's Avengers stood cowboy movies translated to outer space and the world of today. For, at their essence, the cowboy movies focused on good vs. evil as their main theme. And, of course, there existed a romance or two simmering in the background to add spice to the story line. In the 1980s, the leading roles became transformed. Instead of John Wayne and Jimmy Stewart coming into town to vanquish their foes, it became Harrison Ford and Arnold Schwarzenegger taking on the evil foes or starring as the villain. Today, actors such as Robert Downey, Jr. and Chris Hemsworth star in the big budget action thrillers. At the same time, over the last 50 years, the heroines became less feminine and every bit as tough as their male counterparts with actresses such as Linda Hamilton destroying The Terminator and Sigourney Weaver surviving, despite all odds, in Aliens. Today's equivalent stand Gal Gadot in Wonder Woman and Scarlett Johansen in The Avengers. No matter the star, whether heroine or hero, good and evil struggled to vanquish each other until a final clash in which good triumphed over evil, but usually at great cost.

All of this stands as a background to the United States current fiscal position. Currently, The National Debt to GDP stands at the highest level since World War II:

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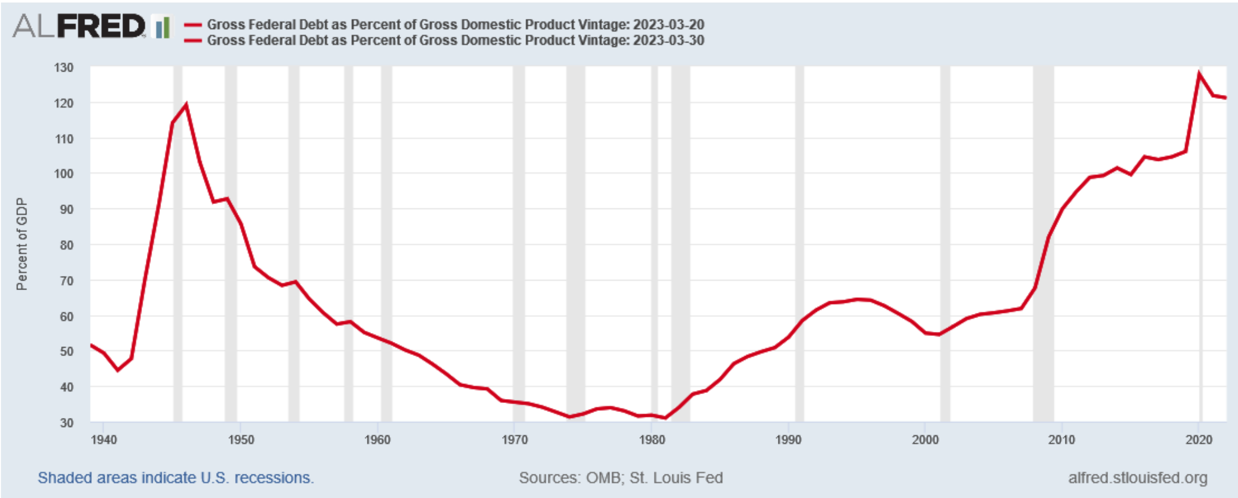
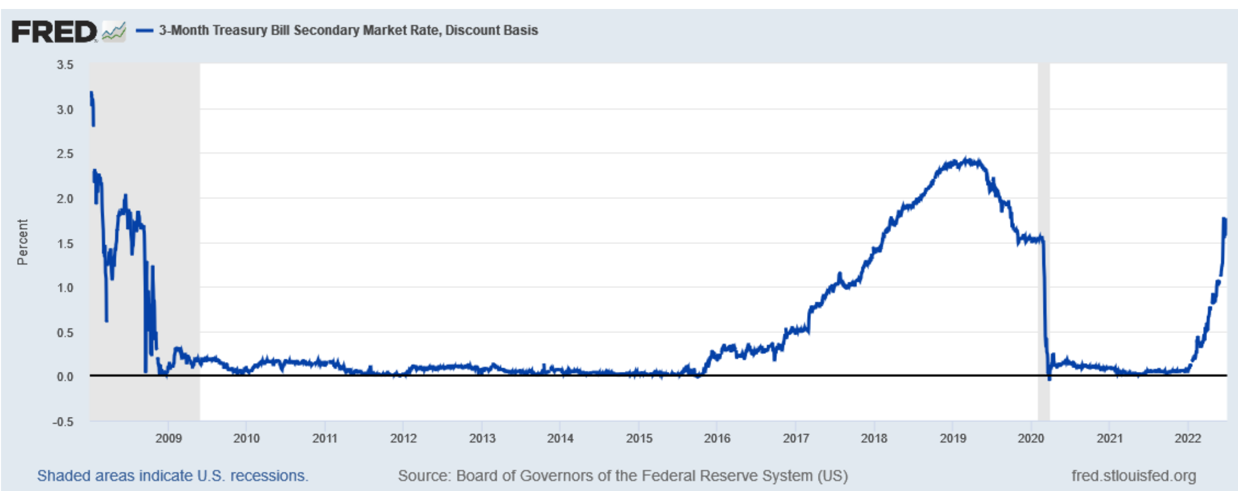
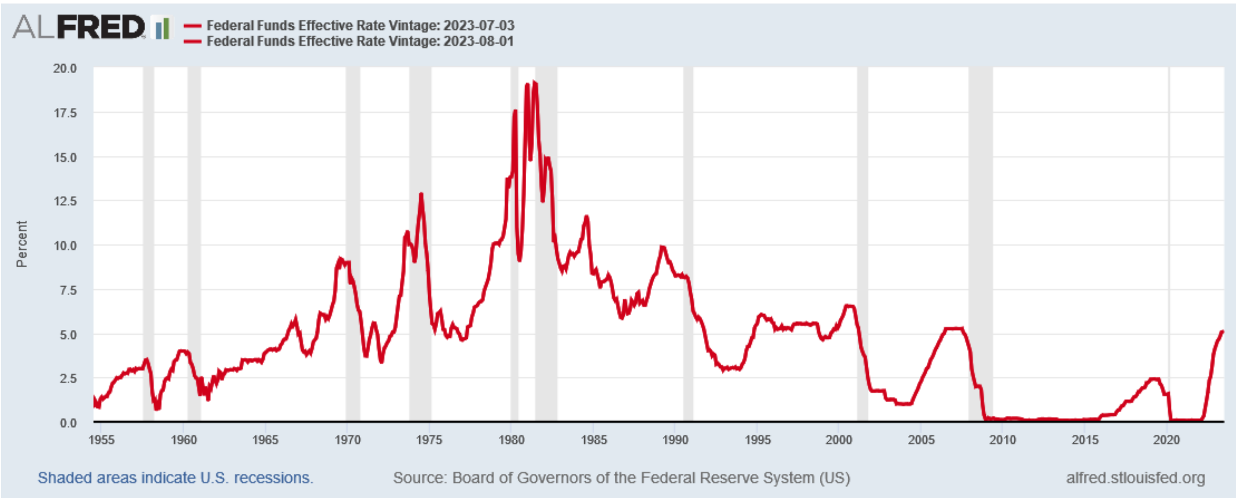


For the U.S. Government, the true costs of this rising level of debt did not appear courtesy of the Federal Reserve. The Fed drove interest rates down to levels last seen during the Great Depression. This allowed the Federal Government to fund it's massive deficits with little or no additional interest cost and no political ramifications for over a decade:

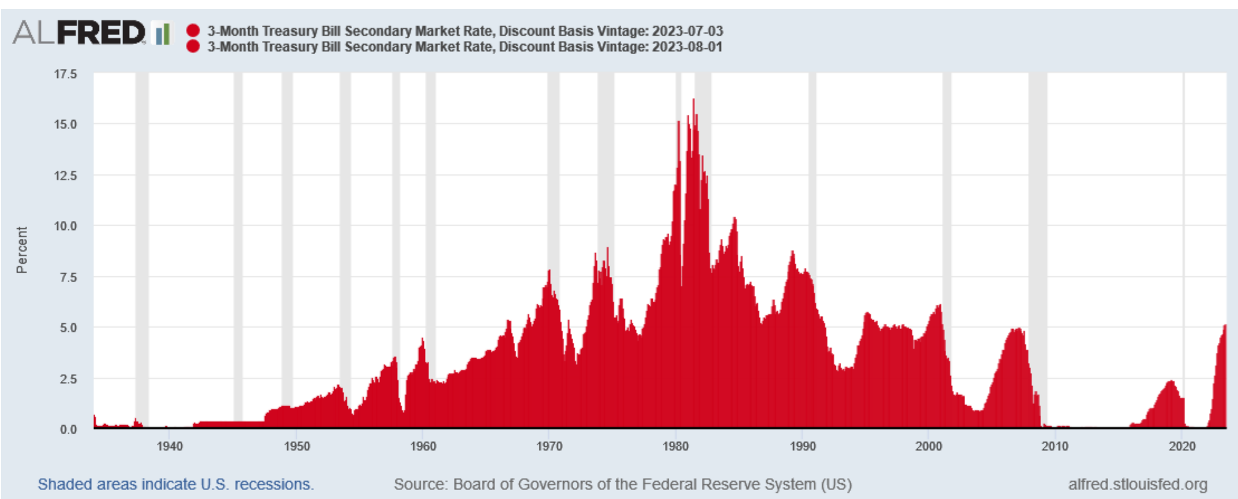


Thus, despite the National Debt to GDP rising from 60% in 2005 to 127% in 2020 and standing at 3.45x its 2005 level, the interest paid by the Federal Government only rose from $89 billion in Q4 2005 to $130 billion in Q4 2020 or just 46%.

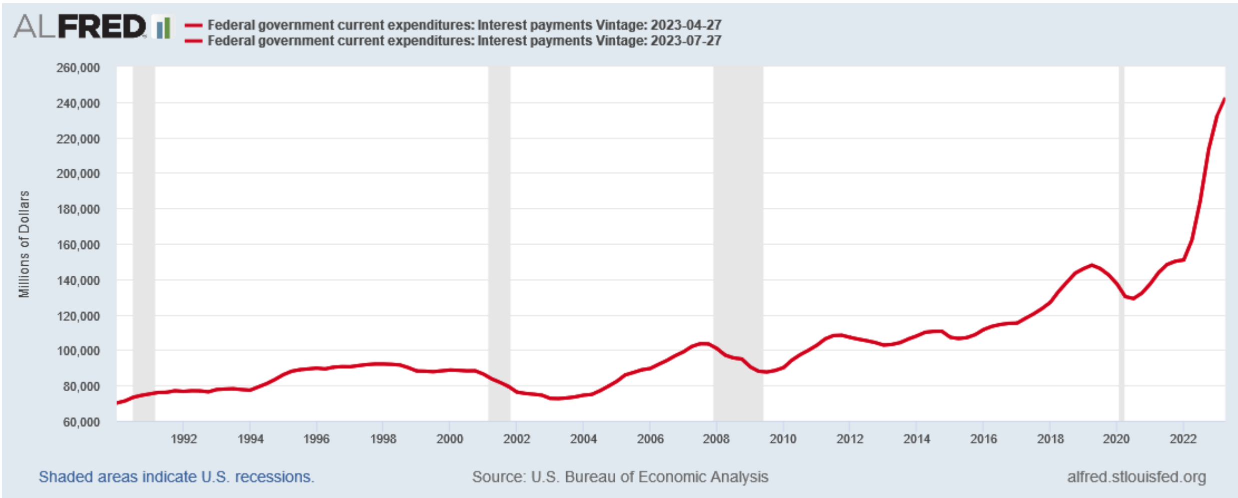
Of course, with the Federal Reserve on a mission to tame inflation, regardless of the impact on the economy or the government, this changed dramatically over the past 18 months, as Interest Rates reverted to their 2005 – 2006 level:



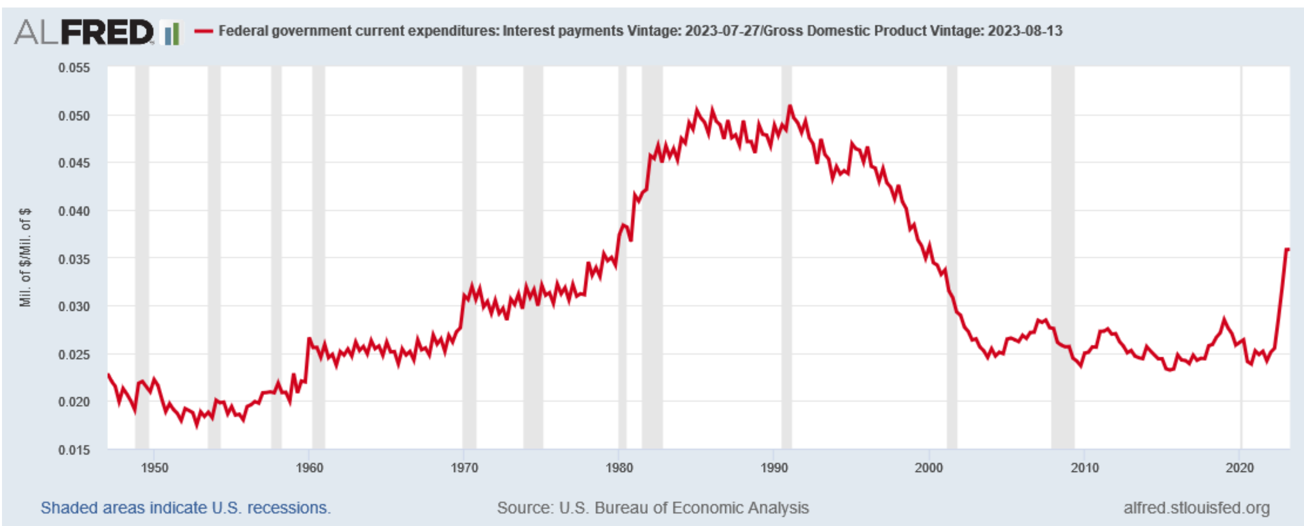
The impact of this policy change on the U.S. Government comes as a shock to the system. Interest Rates on Treasury Bills rose dramatically:



And Interest Costs doubled over the past year:



This doubling in nominal Interest Payments produced a significant rise in Interest Costs relative to US GDP, as one might expect:



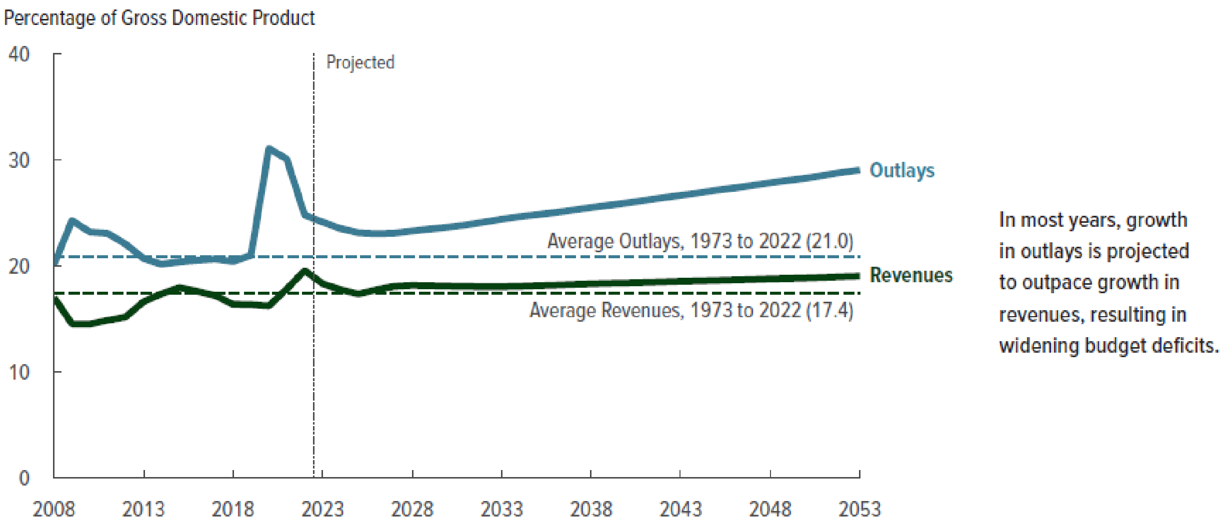
While above the level seen from 2003 – 2021, they remain reasonable by historical standards, sitting somewhere near the mid-point of the range seen since World War II.

Despite this, there appears an issue going forward that, if not addressed, will produce pyrotechnics similar to what occurred between the Earps and the Clantons. Already, initial skirmishes appear underway between the two sides in the forming of the Vigilance Committee by the Bond Markets, as occurred during the 1980s. While they have yet to send out their Bond Market Vigilantes to dispense justice, already initial skirmishes between the two sides are evident.

Recently, the Congressional Budget Office (CBO) issued its annual Long Term Budget Outlook. (Please see https://www.cbo.gov/system/files/2023-06/59014-LTBO.pdf .) In the document, the CBO lays out its analysis of the long term outlook for U.S. Government Revenue and Spending. The following chart illustrates its analysis:

Figure 2-1.

Total Outlays and Revenues

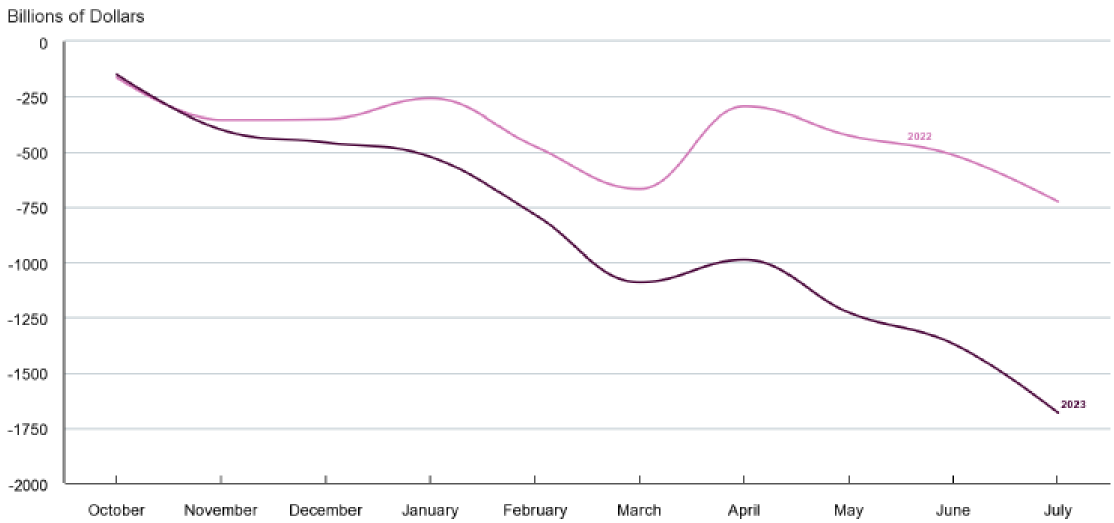


Data source: Congressional Budget Office. See www.cbo.gov/publication/59014#data.

As in all analyses, care must occur in interpreting the results. The CBO only assumes 1.8% Long Term Real GDP Growth through 2033 and then assumes this falls to just 1.5% in the period 2044 - 2053. Except for the period from Q4 2009 to Q4 2019, when the U.S grew at a 2.5% compound annual rate (CAGR), the U.S. economy grew at a rate in excess of 3% on average since World War II. The following analysis puts some perspective on the likely course of future US growth, that contrasts with the CBO's anemic projections. Given population growth of 1%+, which merely assumes 0.5% organic growth plus 0.5% from immigration, consistent with the last 20 years, add in productivity growth of just 1%, which stands below the long term average, then U.S. Real GDP Growth easily exceeds 2%. Assume Productivity Growth of 1.5%+ combined with increased Capital Investment into the U.S. through Reshoring Manufacturing, which would easily add another 0.5% - 1.0% to U.S. GDP Growth, as imports are displaced and Investment rises, then GDP Growth could easily reach 3.0% - 4.0% for the long term, its historical rate of growth pre-2008.

Interestingly, even assuming higher GDP Growth, the issue in the graph does not go away. This stands due to Congress's attachment to spending but its disdain for raising taxes to pay for it. Or, to put it more bluntly, the key issue highlighted in the above graphic stands the rise in Outlays relative to Revenue. This stands illustrated in its Monthly Budget Review from August 8, 2023 (For the complete report, please see https://www.cbo.gov/system/files/2023-08/59377-MBR.pdf .) As this graphic illustrates clearly, despite a growing economy, the Federal Budget Deficit grew significantly in F2023 compared to the prior year:

Figure 1.
Cumulative Monthly Deficits
Fiscal Years 2022 and 2023

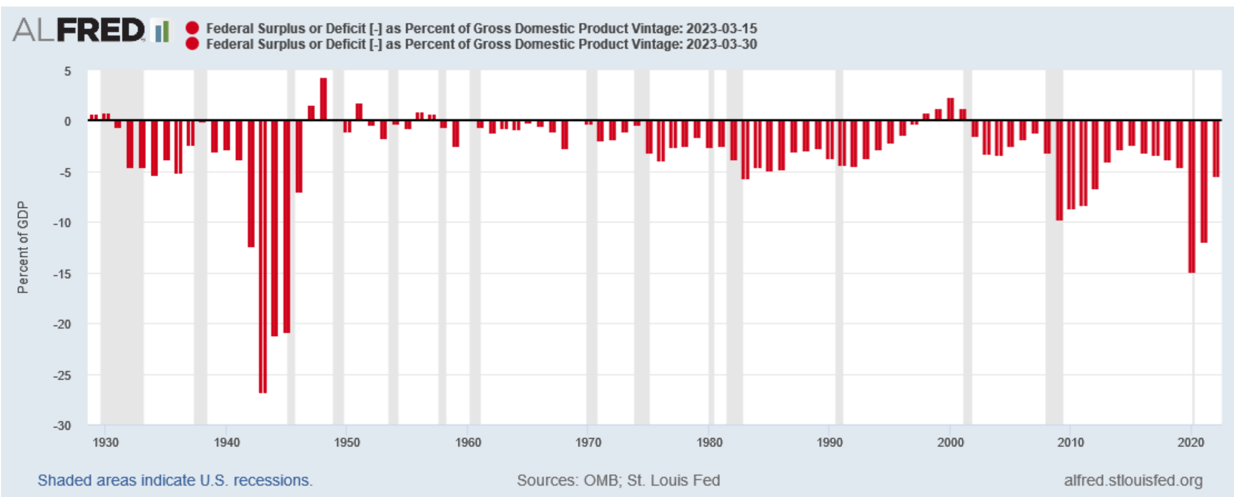


Data Sources: Congressional Budget Office; Department of the Treasury.
The value shown for July 2023 is CBO's estimate.
Values for all months have been adjusted to exclude the effects of timing shifts.

And the proximate cause stands clear. Revenue fell year over year at the same time as Outlays increased, as the following data demonstrate for October to July:

$ billions	***FY 2022A***	***FY 2023E***	***Change***
Receipts	*$4,105*	*$3,687*	*($418)*
Outlays	*$4,831*	*$5,304*	*+$473*
	======	======	======
Deficit	*($726)*	*($1,617)*	*($891)*
	======	======	======

This surprising result, that deficits would rise significantly in a growing economy combined with the lack of any attempt to address this issue by the U.S. Congress, led Fitch to downgrade the Credit Rating of the United States. The following graph demonstrates how large today's deficit, projected to exceed 8% of GDP in F2023, stands over the long term:



Deficits of this size relative to the economy, while normal for the period since 2010, last occurred during World War II, when the U.S. stood in a fight for its survival. While years behind the downgrade of S&P, this downgrade should send a warning shot across the bow of the U.S. Congress. And other warning shots have begun to appear in the Markets, as investors sense little effort by the Federal Government to address this fundamental imbalance. The 10 Year Treasury Yield continues to head higher reverting to the range it held before the 2008 – 2009 Recession:

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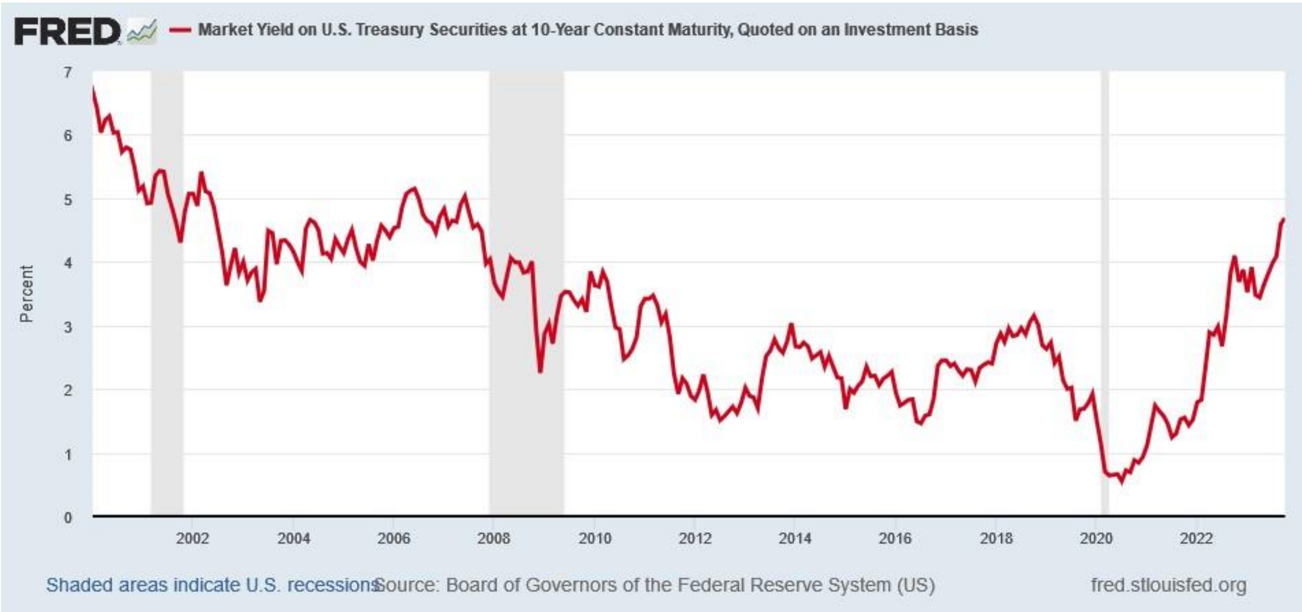
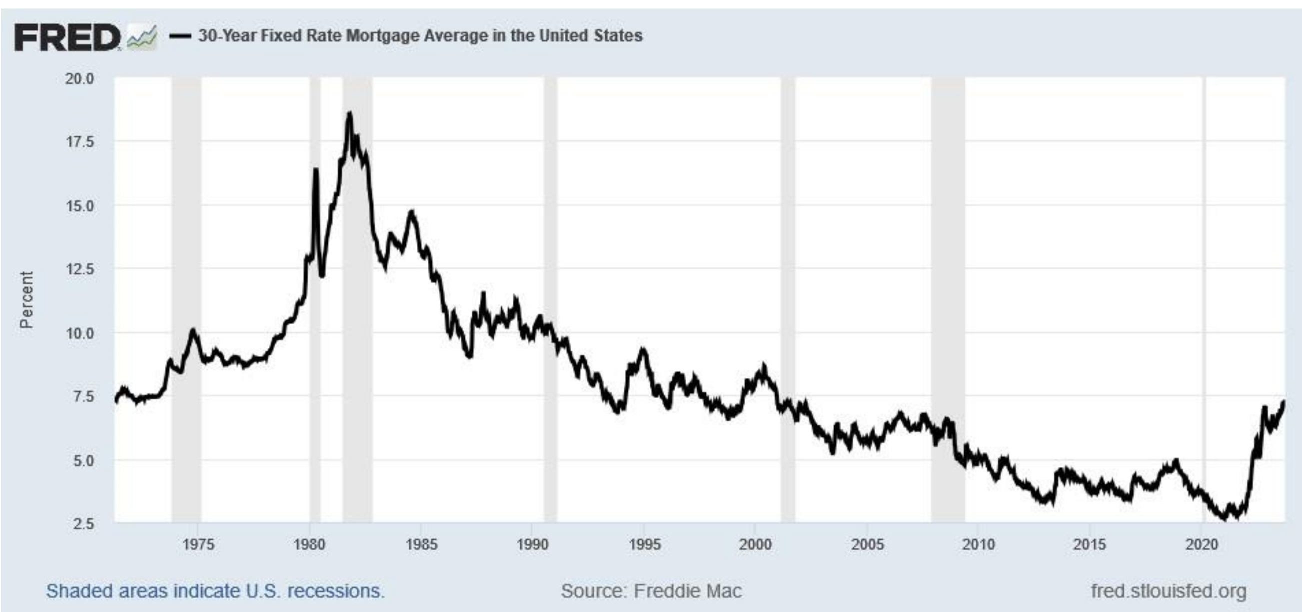


Homeowners looking to finance a Home Purchase using a 30 Year Mortgage find that Mortgage Rates stand at their highest level since 2000, exceeding 7%:



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And, while not choking off Housing yet, Housing clearly entered a downturn as Mortgage Rates rose, despite the bounce this year:

Other areas of the U.S. Economy clearly exhibit strain under the rise in rates, such as Commercial Real Estate. Other economic slices, such as Small and Mid Sized Businesses should start to feel the pinch this year.

In addition, to the above deleterious impact on the United States directly, foreign creditors continue to diversify away from the US Dollar. The downgrade from Fitch only highlights the issues facing the US in maintaining its status as the Global Reserve Currency of choice. Typical ratings and sovereign debt levels for top tier Country Ratings are as follows:

Rating	***Median Debt to GDP***
AAA	*39.3%*
AA	*44.7%*

Data from Jefferies, LLC

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Over the past 20 years, as China's share of Global GDP rose and the US's share fell, the US Dollar continuously lost share in the Currency Composition of Official Foreign Exchange Reserves, according to IMF data. For the US, fortunately, countries around the world continue to prefer the US Dollar for commerce than the Chinese Renminbi. Thus, China's currency share of global trade remains well below its trade share. China currently continues to address this mismatch trying to force foreign countries to use its currency. Its success here stands mixed. However, over the past 20 years. The US Dollar's share of Foreign Exchange Reserves fell from 72.7% in Q2 2001 to just 59.0% at the end of Q1 2023. Should the U.S. continue to mismanage its balance sheet, its share of Foreign Exchange Reserves likely will continue to erode. Ultimately, this will impact the ability of the US Dollar to maintain its status as Global Reserve Currency.

With a Presidential Election Year ahead, little action to fundamentally address this issue appears likely. As a result, should the U.S. Congress continue on its current path, the Bond Market Vigilantes will return in full force, dispensing justice as they did in the 1980s and 1990s, effectively recreating The Shootout at the OK Corral. The casualties would run deep as Congress scrambled to balance the budget by controlling spending and raising taxes. And many groups, that believe their donations stand high enough to prevent them having to pay the piper, may find that donations pale in value compared to voter wrath when the public faces tax increases. In that case, the bullets will fly indiscriminately, wounding friend and foe alike, as the public demands that corporations and the wealthy share their pain. And no politician will feel safe as the sharp crack of political repercussions rings across the land. While action in 2024 seems unlikely, unless things get out of hand, the Year 2025 appears the Day of Reckoning when the bond market, acting as the Earps, and the Congress, representings the Clantons, clash in furious struggle as the Shootout at the OK Corral re-enacts itself in a modern day movie coming to the home TV screen near you.

(*For those wishing a copy of "*The Wild West & The Return of Vigilante Justice", *published on March 15, 2021, please contact us. We will be happy to provide the piece to you.)*