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A Closer Look

Investing in Deficits

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In Brief

- **Tax cuts and spending increases enacted at the turn of the year materially change the U.S. economic outlook.**
- **There are clear positive implications for near-term U.S. growth; all else equal, we see this as supportive for equities.**
- **However, U.S. government borrowing is set to increase sharply at a time when buyers may prove less certain; budget deficit will widen significantly.**
- **Overall, we see so-called twin deficits creating greater risks of a weaker dollar, despite rising U.S. interest rates.**
- **Further out, the new fiscal reality suggests that the next U.S. recession will likely require even more extraordinary measures by policymakers.**

The combination of December's tax legislation and February's spending legislation materially changed the U.S. macroeconomic outlook. With two strokes of a pen, prospects for U.S. growth this year and into 2019 brightened further, helped by aggressive tax cuts and additional government spending. All else equal, this is clearly a positive for equity markets and other cyclically sensitive assets, at least near term. At the same time, prospects for U.S. deficits and government debt trajectories darkened considerably. As investors, we consider both sides of this stimulus coin as we review and update our own assumptions for global growth and financial markets. We are now expecting even higher U.S. interest rates, but also — perhaps counterintuitively — a potentially sustained weaker dollar.

Embracing Deficits Again

Throughout 2017, Bessemer's investment department (along with most investors) assumed that some form of tax cuts would get passed by the Republican administration and Congress. Importantly, though, we assumed that such stimulus would be "deficit neutral" — that is, reduced tax revenue would be offset by spending cuts or tax increases elsewhere so that the U.S. budget deficit would not grow more than already expected over the longer term. Our view reflected a sense that a material number of Republican policymakers would balk at the idea of increasing the U.S.' budget deficit and federal debt (publicly held debt was already more than $14 trillion at the end of 2016). After all, Speaker of the House Paul Ryan led a proposal, a "Roadmap for America's Future," that focused on deficit reduction, while the Tea Party had shrinking debts and deficits as key pillars of its platform.

Yet, as the recent legislative sausage-making ensued, balanced budgets moved to the back burner. The ultimate Tax Cuts and Jobs Act signed into law by President Trump in mid-December set the stage for federal deficits to increase by $1 trillion over the subsequent decade, even accounting for related stronger growth (using data from the non-partisan Joint Committee on Taxation). The Congressional Budget Office has estimated that because of the higher deficits, the federal debt held by the public could rise from 91.2% of GDP (as of June 2017) to 97.5% of GDP. (See page 8 for links to additional, related research.)

Congress was back at it in February, this time passing a two-year budget plan that would increase both defense and non-defense spending — by a total of roughly $300 billion over two years — and raise the federal debt ceiling through March 2019.

Exhibit 1: Federal Budget Deficit as a Percentage of GDP

Exhibit 2: Federal Debt Held by the Public as a Percentage of GDP

Key Takeaway: Fiscal stimulus plans are expected to meaningfully expand the federal debt and budget deficit.

As of June 2017. Projections are baseline estimates from the CBO.

Source: Congressional Budget Office (CBO)

These two efforts together suggest that the U.S. budget deficit, currently around 3.4% of GDP, may reach 5.5% of GDP by 2019. (The last time the U.S. had a similarly large budget deficit as a percentage of GDP outside a recession was in the early 1980s.) Federal borrowing will effectively double in 12 months, reaching nearly $1 trillion for this fiscal year (Exhibits 1 and 2).

Tying the Macro to Markets

What does this dramatically altered fiscal picture mean for investors? We see both near- and longer-term implications of Washington's recent actions, across a number of asset classes. First, we look near term, across equities, fixed income, and currencies.

Equities

Near term, the fiscal stimulus suggests an additional measure of support for cyclical assets including equities. Households keeping more of their income will likely spend some part of that windfall, in turn helping growth. For corporations, tax-related savings will be used toward a number of initiatives, including (1) share buybacks, (2) dividend increases, (3) capital investments, (4) higher wages, (5) increased staffing, and (6) debt reduction. Further, just having certainty around the tax regime could prompt firms to engage in more corporate activity such as mergers and acquisitions. (Just in January, the number of announced U.S. M&A deals rose by 11% from December.) Exactly how these funds are ultimately used by firms will shape how much the U.S. economy benefits from the laws, but overall, it is reasonable for investors to have higher GDP growth forecasts today versus last November. As of mid-February, the consensus forecast for 2018 U.S. GDP growth was 2.7%, up primarily because of tax-related implications, from 2.3% growth in 2017.

Expectations for faster economic momentum have led to another macro effect: higher inflation. If companies are able to hire and invest more today, with the unemployment rate at 4.1% (the lowest level since late 2000), they may well have to pay more to get those workers. Indeed, a survey of U.S. small businesses released in February suggested that finding qualified workers remains a top concern, while about a third of business respondents said it is a good time to expand (this was the strongest response to this question since 1986).

Not surprisingly, more investors are expecting U.S. wages to pick up in the year ahead, helping to lift inflation more generally. This shifting sentiment is seen in a variety of financial instruments that tend to move with inflation, as evidenced by the 10-year breakeven yield, which is currently 2.1%, up from about 1.65% in mid-2017 (Exhibit 3). Meanwhile, a basket of commodity prices has gained more than 5% between mid-December and mid-February. For equities, a critical question will be if higher wages can be "passed through" to end customers through higher prices, or if wage costs will eat into profits — the latter clearly negative for the equity market at the margin. Two views of history suggest the current equity rally doesn't face immediate risks on this front:

- First, we can look at the relationship between wages and U.S. corporate profit margins. At least over recent decades, profit margins did not start to meaningfully decline until wage growth was closer to 4% to 5%. Currently, average hourly earnings are rising at a 2.9% year-on-year pace.
- Second, we can see how equities have done in this current inflation regime. Historically, when we analyze core inflation symmetrically around the Fed's 2% target (in a 1% to 3% range), the S&P 500 has posted an average annual gain of 9%.

Exhibit 3: U.S. 10-Year Breakeven

Key Takeaway: The current 10-year breakeven yield indicates that the market is expecting inflation to average 2.1% over the next decade.

As of March 2, 2018.

Source: Bloomberg

Bottom line: We continue to expect equities to post positive returns this year, helped by recent stimulus efforts. That said, we see rising inflation (partly via wages hurting corporate profits) and borrowing costs as key risks to monitor. We remain comfortable holding equity exposure in line with strategic benchmarks, and including some defensive exposures within those equities.

Fixed Income

Stronger economic growth and rising inflation should result in more monetary tightening; as of late February, financial markets were discounting three 25-basis-point rate hikes over the rest of 2018, with more to come in 2019. Such expected and actual policy puts upward pressure on U.S. government bond yields; already since mid-December, the 2-year Treasury bill yield has risen by 35 basis points while the 10-year Treasury bond yield has climbed by 54 basis points.

The recent, rapid climb in bond yields has caused many bonds to lose value over this period, even on some days when equity markets were also falling (that is, when bonds tend to appreciate as "safe haven" assets). As we look ahead, we feel bonds can still generate positive returns as long as the rise in yields occurs more gradually, rather than a sudden step function. That said, we want to carefully appreciate the risks to this view, as well as how to optimally position in a rising rate environment. After all, this isn't just about a reflationary backdrop and gradually tightening Fed. The new fiscal environment suggests a material increase in government bond supply at the same time the Federal Reserve is reducing its balance sheet. These forces could put upward pressure on yields beyond what inflation trends imply.

In understanding how far and quickly yields will rise, it's useful to consider the buyers — beyond the Fed — who might absorb all the bonds the government is issuing. By far the largest group is foreign central banks. As of November, foreign central banks owned about $6 trillion in U.S. government debt, with China and Japan alone holding more than half of that. Historically, these central banks have kept the amount of reserves in dollar-denominated assets roughly constant (in recent years, about 55% of their total reserves in U.S. securities). However, now and then they have marginally changed the

composition of their reserves. One risk scenario for U.S. bonds would be if China decided to modestly scale back its U.S. debt purchases in favor of slightly greater non-U.S. purchases. One could see this resulting from brightening growth prospects outside the U.S. and/or political tensions with the U.S., such as those that could emanate from the recent U.S. move toward steel and aluminum tariffs.

After five months of steady buying of U.S. securities, the latest data from the U.S. Treasury on capital flows (November 2017) showed that foreign official investors net sold $8 billion in U.S. securities over the month (Exhibit 4). Obviously, we do not want to extrapolate from one monthly data point. However, we want to carefully watch regular U.S. bond and Treasury bill auctions as well as the more lagged Treasury data over the spring to gauge whether buying patterns are changing more meaningfully.

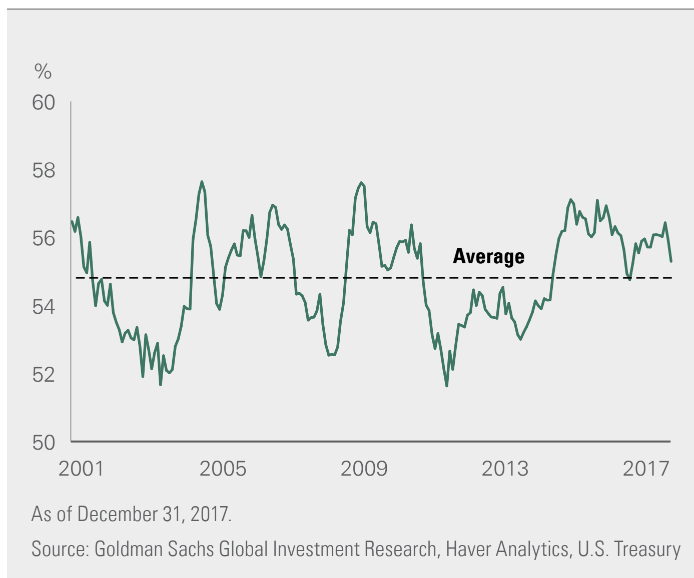
Another group of investors who could at least marginally reduce U.S. bond purchases looking ahead are foreign retail and institutional investors. Recent years saw a huge pickup in buying of U.S. government and corporate debt by investors in Europe and Japan given the zero or negative yields in these investors' home countries. Today, with the dollar weakening (this could hurt the total return for the foreign buyer of the U.S. debt) and local yields at least turning positive again, there is a risk that demand from this area may at least fade somewhat.

Other traditional U.S. debt buyers, in our view, are unlikely to go anywhere. Pension funds and insurance firms are constantly looking for longer-dated assets to match up against similarly long-term liabilities. Meanwhile, owners of U.S. bond mutual and exchange-traded funds could see higher-yielding bonds as an interesting trade-off versus increasingly expensive equities (Exhibit 5).

Bottom line: Our base case for this year includes U.S. government bond yields rising, in part thanks to monetary tightening by the Fed. We see risks of even higher yields tied to a sharp increase in bond supply and the potential for large bond buyers to at least reduce their purchases going forward. This creates some near-term risk for bond returns, though over the longer term we remain comfortable that bonds will continue to serve a valuable role in a diversified portfolio, protecting in an economically driven equity selloff. We remain modestly underweight fixed income in portfolios and with duration a touch shorter than benchmark.

Exhibit 4: Foreign Official Holdings of U.S. Securities (% of Reserves)

Key Takeaway: Recent data on capital flows shows central banks as net sellers of U.S. securities, though it is too early to tell if this will become a sustained trend.

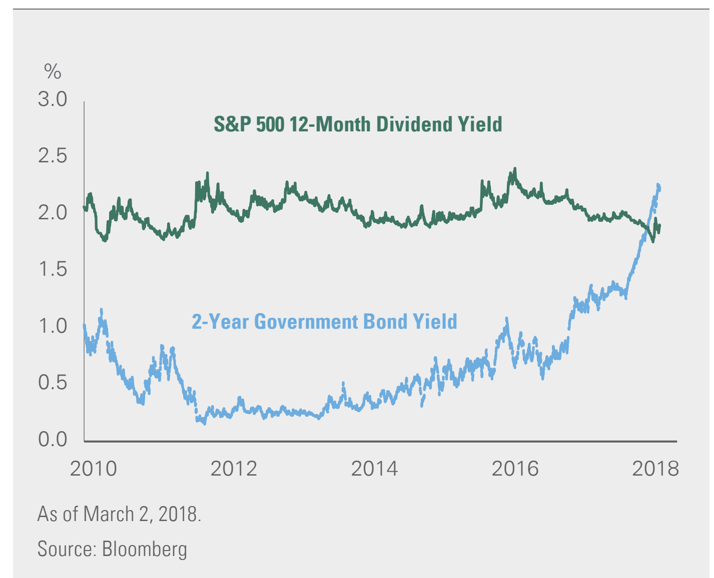


As of December 31, 2017.

Source: Goldman Sachs Global Investment Research, Haver Analytics, U.S. Treasury

Exhibit 5: U.S. Government 2-Year Bond Yield and S&P 500 12-Month Dividend Yield

Key Takeaway: As equities have generally become more expensive and rates have ticked higher, 2-year government bond yields now look comparable to the dividend yield on the S&P 500.



As of March 2, 2018.

Source: Bloomberg

Currencies

While fiscal stimulus lifting equities and bond yields seems fairly straightforward, its impact on currencies is not. One might expect a stronger U.S. economy and subsequently rising interest rates to equal a stronger currency. But history does not consistently bear this out (Exhibit 6). Consider two periods, both of which saw a strengthening U.S. economy. From 2011 through 2016, the dollar broadly gained, but from 2003 through 2007, yields rose while the dollar weakened.

Why the difference? When it comes to currencies, we always go back to cross-border capital and trade flows. Between 2011 and 2016, the U.S. economy was improving while much of the rest of the world struggled. Chinese GDP growth was moderating, Europe was dealing with crises in Greece and Cyprus, and falling commodity prices were adding pressure to many emerging markets. Not surprisingly, then, investors were biased toward relatively more attractive U.S. assets. Net capital flows favored the U.S., supporting the dollar in turn. Over the same period, the U.S. current account deficit (largely driven by the U.S. trade balance) was narrowing — that means the U.S. was selling relatively fewer dollars to purchase imports.

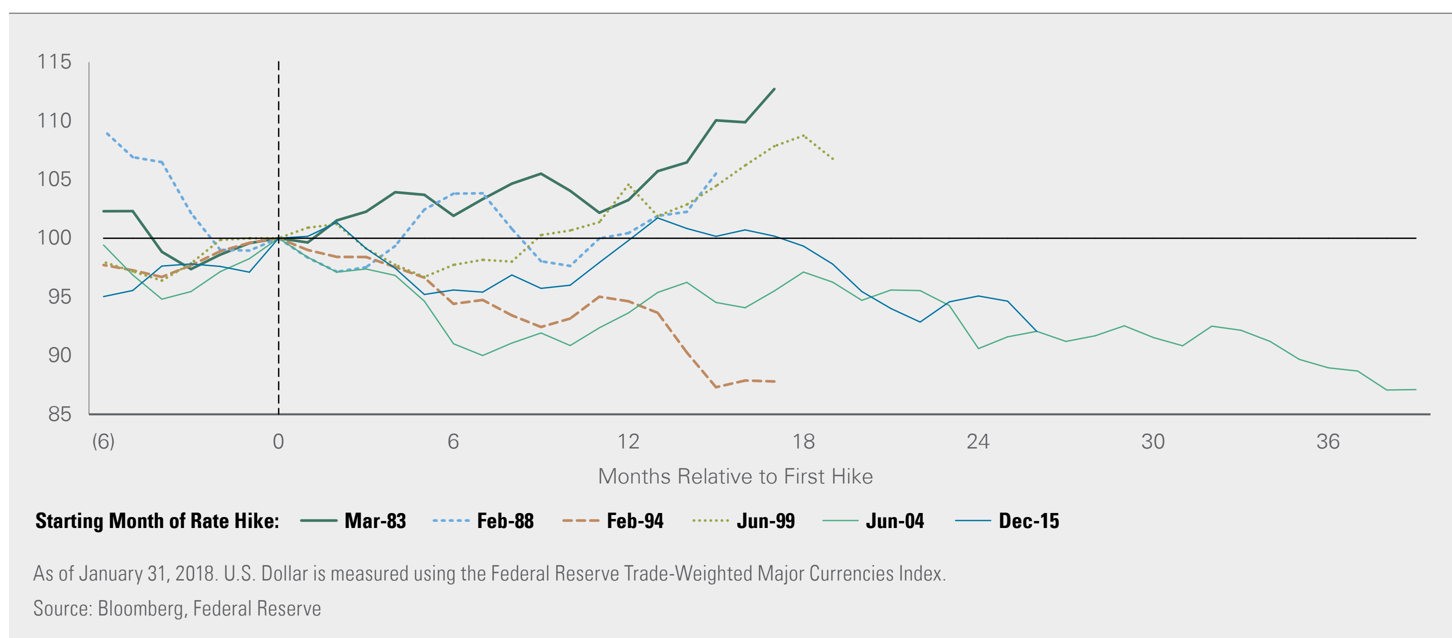
In contrast, the 2003–2007 period saw the U.S. current account deficit widen at the same time that net capital flows were favoring non-U.S. markets, the latter seeing strong growth and, in some cases, even more attractive bond yields. (Recall this was the “BRICs” heyday, when investors were enamored with exposure to key emerging markets such as Brazil, Russia, India, and China.)

As we consider the current environment and look ahead, our base case for the year remains that the dollar — against a basket of other currencies — trades within a range. That said, the latest stimulus suggests greater risks of dollar weakness than we had previously expected. Let’s stick with our cross-border flow approach:

- The U.S. current account deficit currently stands at around 2.3% of GDP and has been trending wider in recent quarters, pushed in part by rising imports as U.S. consumers have gained confidence and spent more money. Greater stimulus, to the degree it generates more household wealth and confidence to spend, should only result in further growth of imports, widening this deficit further. (Potential U.S. tariffs on a few specific imports should not, in our view, overly impact the broader deficit trends but rather influence relevant sectors.)

Exhibit 6: Trade-Weighted U.S. Dollar Performance During Fed Rate Hiking Cycles (Indexed to 100 the Month of the First Rate Hike)

Key Takeaway: A stronger economy and rising interest rates have not always led to a stronger U.S. dollar.



As of January 31, 2018. U.S. Dollar is measured using the Federal Reserve Trade-Weighted Major Currencies Index.

Source: Bloomberg, Federal Reserve

- Despite stimulus that should lift U.S. growth rates further in the near term and support U.S. equities, capital flows have turned away from the U.S. in recent quarters. We expect this is in part because investors saw fading political risk and improving growth overseas, at the same time that those equities offered relatively more attractive valuations than U.S. counterparts. Data from EPFR, as of mid-February, showed investors sold roughly $20 million in U.S. equities over the previous 12 months, versus $40 million worth of purchases of continental European equities and $50 million of Japanese equities. If overseas growth rates hold up and bond yields continue to rise (German 10-year government bond yields had been negative for part of 2016 but have recovered to levels today near 0.65%), we could see less capital reaching across the oceans for U.S. bonds and stocks, especially if those investors perceive unusual political uncertainties in the U.S.

Clearly, we need to consider other questions as we challenge our own views. Will overseas central banks get anxious if their local currencies strengthen too quickly, putting inflation targets at risk? Will the Federal Reserve view a weakening dollar as a risk to faster inflation and thus be inclined to raise U.S. interest rates more quickly? Will U.S. tax reform result in significant repatriation of corporate capital back to the U.S., with some of that capital being changed from foreign currency to dollars?

Bottom line: We continue to see the dollar in a range this year against a basket of its major trading partners. Support should come from rising interest rates and stimulus-fueled growth that makes U.S. assets look more attractive. Repatriation could prove another dollar boost. However, less U.S. bond demand from overseas for a variety of reasons, a slowly widening U.S. current account, and the potential for capital flows to remain more global given the better overseas economic outlooks, all suggest that our dollar bias now needs to be a bit more to the downside than we previously expected. We remain modestly overweight U.S. equities in portfolios, though that position has been reduced over the last year. A dollar overweight has been similarly reduced, while a small position in gold has been established, in part as a hedge against further dollar weakness.

The Eventual Recession: What Then?

All politicians want a strong economy. After all, voters tend to reward incumbents when they feel policies helped them improve their financial status. With that in mind, the tax and spending packages make a lot of sense ahead of what could prove a contentious midterm election this November.

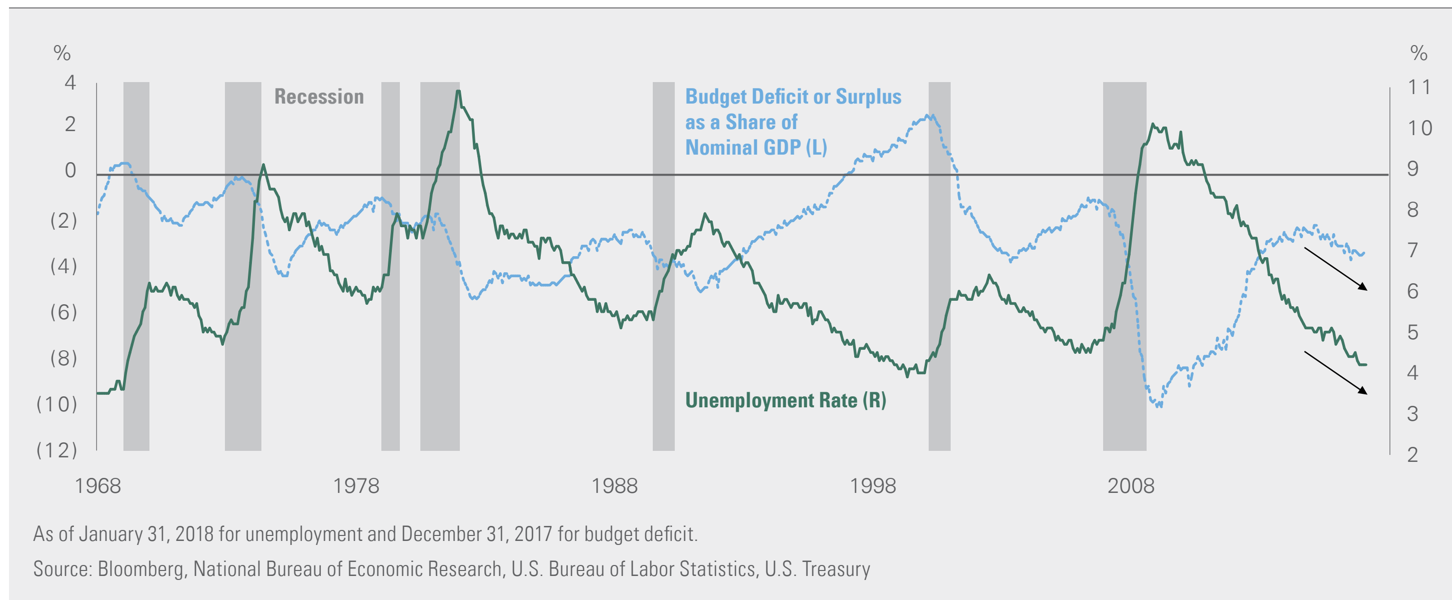
Politics aside, however, we would suggest that this stimulus was poorly timed. Even before December's tax legislation, the U.S. unemployment rate was at its lowest level in decades, consumer and business confidence were near their highest levels of the business cycle, and corporate profits were strong and growing still. The economy wasn't desperate for more stimulus in this moment. Indeed, to the degree the recently passed stimulus speeds up growth and lifts inflation further, it could force the Federal Reserve to tighten monetary policy faster, which might hasten the onset of the next recession. This is not our base case, but it is at least a risk worth considering.

Historically, governments enacted fiscal stimulus not at the peak of an economic cycle but instead mainly during recessions. Stimulus was a means to shorten the economic downturn and help kick-start growth again. Similarly, as growth improved, Washington would be more inclined to pull back on spending to build ammunition for when it would be needed next.

Today, as shown in Exhibit 7, is somewhat of an anomaly. Fiscal policy has diverged from the economy (the latter reflected in the unemployment rate). For now it may not matter. But it could become a significant policy dilemma when the U.S. next enters recession. Over the last several decades, the average U.S. budget deficit was 1.4% of GDP at the end of the business cycle. During the recession, due to less revenue and easier fiscal policy, that deficit tended to widen (in 2008 and 2009, the deficit grew to more than 10% of GDP, as revenues collapsed and as the government enacted spending measures aimed at righting the U.S. economic ship). Going into the next recession with a deficit already closer to 5% of GDP could give Washington less fiscal wiggle room. This could put more pressure, at least relatively speaking, on the Federal Reserve to get

Exhibit 7: Unemployment Rate and U.S. Budget Deficit or Surplus

Key Takeaway: Historically, fiscal policy was loosened during recessions to kick start the economy; today's policy is an anomaly.



As of January 31, 2018 for unemployment and December 31, 2017 for budget deficit.

Source: Bloomberg, National Bureau of Economic Research, U.S. Bureau of Labor Statistics, U.S. Treasury

growth going again. But as of December, the fed funds benchmark interest rate was only expected to reach 2.7% by the end of 2019, significantly lower than an average upper bound rate of 6.4% seen at the end of the last four U.S. tightening cycles.

If Washington can't kick-start growth very far with fiscal policy, and the Fed is limited in how much it can help by lowering interest rates, more creative policy will be called for. This last cycle saw quantitative easing (or QE) adopted in the U.S. and then globally as a way to fight deflation and lift growth, at one point leaving around $10 trillion worth of global bonds with negative yields. More QE during the next U.S. downturn seems highly likely. But what if a policy that's less of a surprise is not as effective? The Fed might need more asset purchases to impact investor sentiment. Or it might need to expand what is purchased. Europe's QE included corporate debt, and Japan's purchases went as far as equity exchange-traded funds (Exhibit 8).

We are not suggesting the Fed should or will start buying stocks in the next recession. However, fiscal and monetary decisions today and over the coming quarters seem likely to significantly impact how the U.S. responds to the next downturn — which in turn will shape how financial markets perform through what we know will be a challenging period. Within investments, we are constantly trying to gauge when the next recession may occur — we do not want to wait for the downturn to reduce portfolio risk. We want to understand the likely contours of the next recession and potential policy responses so we can plan how best to protect our clients' capital.

Exhibit 8: Central Bank Assets Purchased During Quantitative Easing

U.S.	U.K.
Government bonds	Government bonds
Mortgage-backed securities	Corporate bonds
Euro area	**Japan**
Government bonds	Government bonds
Corporate bonds	Japanese equity ETFs
Asset-backed securities	Japanese REITs

Source: Bessemer Trust

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