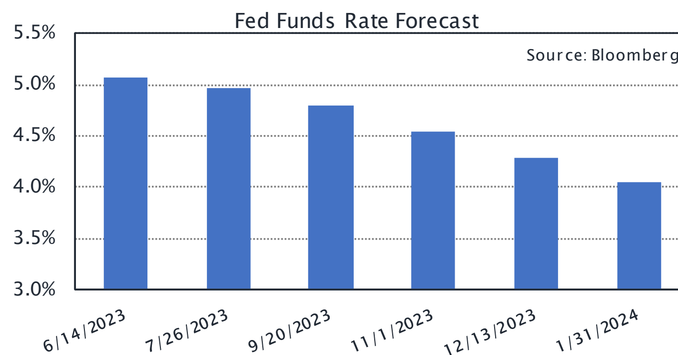
MAY 2023

INVESTMENT UPDATE

This month's *Investment Update* will touch on two separate topics while providing our thoughts on the current state of the bond market.

First, let's discuss the Federal Reserve's battle against its nemesis, US consumer price inflation. Since March of 2022, the Fed has raised its target for the Fed funds rate—the overnight rate that banks charge to borrow funds from each other—at every meeting, with the result being that today's target range of 5.00% to 5.25% is a full 500 basis points above the near-zero level of 15 months ago. To put that into perspective, that is the fastest and highest ratcheting of the Fed funds rate in more than 40 years, going back to the Paul Volcker-led Fed of the early 1980s.

As you probably know, central banks have no way to directly dial back inflation when it gets too high; the best they can do is to try to bring down demand for consumer goods and services by making it more expensive for households and businesses to borrow money. Borrowing costs are an important input, but they aren't the only factor driving demand, obviously, so the linkage between the Fed funds rate and consumer prices is tenuous. That's why economists use terms like "long and variable lags" to describe the impact of Fed policies.



Even the Fed isn't sure what level the Fed funds rate needs to be to bring the US economy closer to equilibrium. During the press conference following this month's meeting of the Fed's Open Market Committee (FOMC), Fed Chair Jay Powell hinted that the FOMC might be inclined to stay put with the current funds target for the next few months to allow the cumulative impact of current monetary policy to have its full effect on inflation. But he made it clear that there's no consensus among the FOMC or even the Fed economic staff whether enough monetary restraint is in place, even after the Fed's most aggressive push in years.

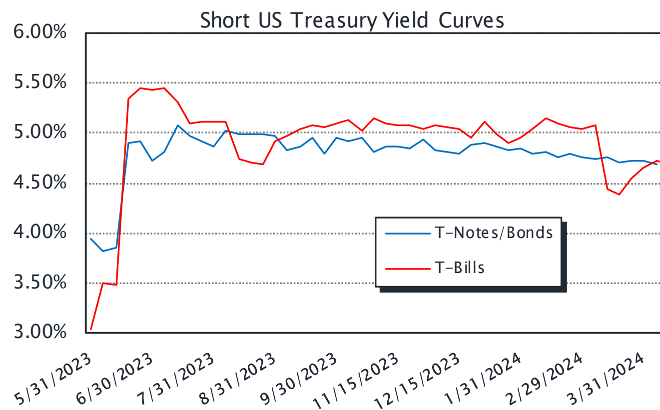
There's always some uncertainty about how tough monetary policy should be when inflation is running hot, but this cycle has been particularly challenging for policymakers. As we've covered in previous *Updates*, the degree of fiscal and monetary stimulus during COVID was unprecedented, with more than $4 trillion in COVID relief provided to businesses and households, while the Fed supersized its large-scale bond purchase program, and in the process increased the US money supply (M2) by nearly $7 trillion. Those funds stimulated consumer spending, which in turn created shortages in a global economy racked by broken supply chains and shuttered factories. All that money is yet to be completely "assimilated" into the economy, and to this day continues to spur consumer spending.

Clearly, though, the cracks are forming in certain sectors of the economy, particularly those most sensitive to higher interest rates. Most notably, market forces are pushing US banks to pay interest on deposits or face a loss of customers, while these same banks are also navigating the impact of falling bond prices in their investment portfolios and a darkening outlook in commercial real estate. As the kids say, this is a "feature, not a glitch" of tight monetary policy. Tightening credit conditions and the squeeze on bank net interest margins are now doing a lot of heavy lifting for the Fed. The Fed's base case is that there will be no cuts in the Fed funds rate any time soon, while further hikes are a possibility. But as the chart on this page shows, based on the futures market, where investors can place bets on the path of the Fed funds rate over coming months, expectations are that the Fed will have to reverse course soon—with three 25 basis point cuts in the fund rate priced in before year-end 2023.

We're of the opinion that the Fed will eventually tighten policy enough that it will lead to an economic recession, but we'll also admit that the timing of that is still an open question, due to the uncertainty surrounding the impact of the banking sector pulling its collective boats back to shore, as well as the lingering effects of COVID-era money still sloshing around. The Fed may have more work to do, but we won't know until we see some consistency in the data that the broader economy is stuttering to a halt. In the meantime, US GDP continues to chug along, while the labor market remains remarkably strong, even after 500 basis points of Fed tightening. Caution is warranted; aggressive selling of risky assets is not. At least not yet.

The other topic we wanted to spend some time on this month is the debt ceiling crisis. If you've followed this story, you know that the Biden administration is facing what has become a recurring problem faced by each of the past five administrations: namely, the growing mountain of Federal debt is once again bumping up against its statutory ceiling, a ceiling that can only be raised by Congress. The current US House is refusing to raise the debt limit, threatening to force a government shutdown unless the president agrees to spending cuts. The administration (naturally) wants to avoid a shutdown, which would likely furlough thousands of Federal employees, and—under a worst-case scenario—could lead to a default on existing Treasury debt if the impasse goes on for an extended period.

Again, this is nothing particularly new. According to the Treasury, the debt ceiling has been raised 78 times since 1960. A quick Google search shows that there have been at least 22 "funding gaps" since 1976, with ten of those episodes leading to a government shutdown and a furlough of non-essential Federal employees. The longest shutdown was also the most recent, from December 2018 until January 2019, when then-president Trump was battling for funding of the Mexican border wall, resulting in nearly 800,000 employees either furloughed or otherwise working without pay for as long as 35 days. Perhaps the most damaging episode was in 2011 during the Obama administration, which was fought over the funding for the Affordable Care Act, which led to a downgrade of US Treasury debt from "AAA" to "AA+" for the first time in history. Even though there was no default, the mere threat of one sent the S&P 500 down by 17%.



Treasury Secretary Janet Yellen has warned that the without the ability to issue new debt (which is typically issued every week of the year), and with no revenue coming in at least until July's quarterly tax receipts, the Treasury could run out of money in early June. As the chart on this page shows, that is already impacting the prices of short-term Treasuries. Both Treasury Bills and Notes with maturities falling after June 1 are trading with yields at least 100 basis points higher than those maturing in May, as investors appear to be avoiding bonds maturing after June 1. Yields begin to drop for maturities beyond six months or so, but that's reflecting the expectation of rate cuts late this year, as discussed on page one.

There are payments that can be delayed, and furloughs of federal employees can help postpone certain outlays for a while, but default will occur eventually unless something can be worked out. The damage to the US economy and the reputation of the US from an actual default of US government debt are difficult to overestimate. It would severely undermine the confidence in the role that the US dollar plays in global finance. No other currency is as readily accepted as the dollar; it is the de facto universal currency in world trade, without substitute. Likewise, Treasury securities are considered the ultimate safe haven for global investors.

What's more, a default is unconstitutional, prohibited by the 14th Amendment, which established, in the wake of the Civil War, that "The validity of public debt of the United States…shall not be questioned." Yet, here we are, once again, watching politicians on both sides of the aisle play a game of chicken with hundreds of thousands of jobs and the global monetary system in the balance. Yes, fiscal discipline is vital, but Congress controls the purse strings and has already passed legislation earmarking funds to be spent this fiscal year. How can Congress, with one hand, instruct the executive branch to spend money and with the other prevent that money to be spent?

That last point—the degree by which the debt ceiling forces the executive branch to choose from a slate of bad options—is getting a new look from some constitutional scholars (most notably Laurence Tribe and Robert Hockett). The solution, according to these folks, is for the president to choose the "least bad" option available to him: Namely, ignore the debt ceiling and issue debt as needed to cover the spending that Congress has approved. They claim that the alternative to not fund programs shows contempt for Congress' hard work in crafting legislation for the 2023 budget, while forcing the executive branch to cherry-pick among the appropriations bills that fund government services and programs. By contrast, adhering to the debt limit and allowing the Treasury to default on its debts is by far the worst option. Overriding Congress on the debt ceiling would certainly be subject to a legal challenge, but one likely to ultimately favor the executive branch, according to these analysts.

We don't think it will come to that. There will be a compromise eventually, and both sides will find a way to declare victory. But we do wish there was a permanent solution to this issue as it is disruptive, if not outright irresponsible, to threaten default in order to bring the other side to re-negotiate what has already been appropriated in the budget process. Like a lot of things that Congress does, we're left scratching our head.