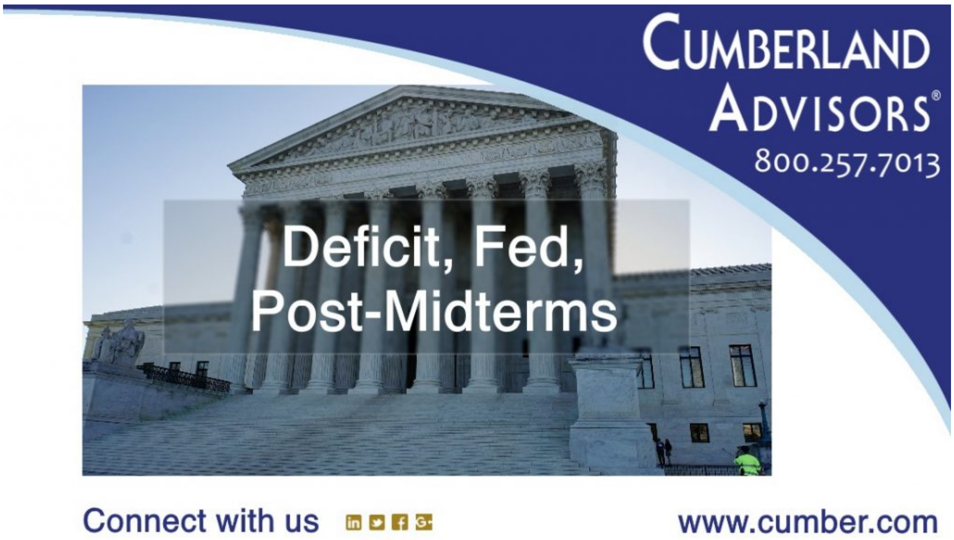
# Deficit, Fed, Post-Midterms

"In 2016, President Trump pledged to eliminate the national debt 'over a period of eight years' ("In a revealing interview, Trump predicts a 'massive recession' but intends to eliminate the national debt in 8 years," https://www.washingtonpost.com/politics/in-turmoil-or-triumph-donald-trump-stands-alone/2016/04/02/8c0619b6-f8d6-11e5-a3ce-f06b5ba21f33_story.html).




He then signed a $1.5T tax cut bill and a two-year spending deal that could push annual deficits above $2.1T, according to the CRFB ("Budget Deal Could Lead to $2 Trillion Deficits," http://www.crfb.org/press-releases/budget-deal-could-lead-2-trillion-deficits).

"For the rest of his term, Trump plans to add $8.282T more to the federal debt, which will push the debt levels to about $30T in total ("New White House Report Shows Deficit Projections Have Doubled," http://www.crfb.org/press-releases/new-white-house-report-shows-deficit-projections-have-doubled). That represents a 41% increase from the $20.245T debt under the Obama administration. Trump will add as much debt in four years during a time of economic prosperity as Obama did in eight years while fighting a recession. That will make Trump the second biggest contributor to debt in history." ("Obama: US spends more on military than next 8 nations combined," https://www.politifact.com/truth-o-meter/statements/2016/jan/13/barack-obama/obama-us-spends-more-military-next-8-nations-combi/). Source: https://seekingalpha.com/article/4204900-drowning-debt-road-30-trillion.

Some of my fishing buddies like to write alarmist newsletters and wring their hands over debt. One of those newsletters hit my inbox on Saturday morning, November 3. That one forecast dire future outcomes.

My fishing buddy may be right someday, but I will bet my fly rod against his bait-casting device that, for the next few years, the increased debt financing of the United States will not be a problem for markets. That will remain the case as long as the US dollar is the unchallenged world reserve currency, as it has been for decades.

When you survey the world and look at other countries' economic systems and current situations, the US emerges as the best or, if you are a hand-wringing detractor, the least troubled. It is true that the expansion of debt slows down productivity growth. Debt service, even at low interest rates, is an allocation of a cash flow away from growth investment in capital deepening. There, the newsletter writer was correct. But by itself, rising debt issuance will not trigger a debt-service crisis for the US.

Comparisons with Italy or Greece are dramatic. But they are neither helpful nor accurate. And they are not true of our political system versus European systems.

It is true that the US is likely to run deficits exceeding $1 trillion annually. It is also true that President Trump said one thing about the deficit and did the opposite. It is true that the cyclically adjusted federal deficit is probably a lot larger under Trump than it was under Obama. Of course, Trump will never admit such a thing. And expect no such admission from a Republican Senate, nor from a Pelosi-led House.

And it is true that we are approaching a debt-ceiling fight, which will break out shortly after the 116th Congress is sworn in on January 3. Note that the new Congress will commence this activity amidst the ugliness of a politically divided government. The coming debt-limit fight will occur in the shadow of the recent nasty midterms and as the 2020 presidential election cycle fires up in earnest. No serious deficit-reduction measures are expected to advance in the forthcoming lame duck session. If anything, the deficit will be increased by the outgoing 115th Congress if they have a way todo it

Estimates are that the US Treasury will end 2018 with a cash balance of $410 billion (source: US Treasury and Barclays). That balance will be reduced to about $200 billion by March 1, 2019. Note that a reduction of the Treasury cash balance acts as an increase in bank reserves since it is an actual transfer of the cash from the Treasury to the banking system. That's right: the higher the Treasury cash balance at the Federal Reserve, the lower the excess reserves in the banking system and vice versa. Remember: The Fed acts as the banker for the Treasury.

The deficit is being financed mostly by the rising issuance of Treasury bills, so a small shock is coming to the short-term funding markets in the next few months. We will see this in the spreads among the various measures in the short-term, riskless end of the yield curve. We may also see the Fed have to make another adjustment in the spread between the upper end of the fed funds limit and IOER (interest on excess reserves) as rates press the upper bounds of the Fed's policy target. Note that for many technical reasons the Fed's task is becoming more and more difficult as the Fed shrinks its balance sheet.

There is a debate among observers about the Fed’s policy direction and an additional debate about the Fed’s trying to do two things at once. It is hard enough for the Fed to get one thing “right.” Yet this Fed persists in trying to shrink its balance sheet and raise the target policy rate at the same time. We think by March or April or May the Fed will have reached a point where the short-term funding markets will no longer have the luxury of those large balances of excess reserves. The timing is uncertain here, and the list of factors that could change things stretches longer than a page. That said, the short-term funding markets are already showing increasing pressures, albeit small ones. I agree with Zoltan Pozsar, at Credit Suisse, that the additional pressures will soon be apparent.

When we see these pressures surface, there will be many who point to the rising federal deficit as the cause. We can almost hear the chorus now. But that will not be the reason, in our view. The reason will be that the Fed is doing two things at once, with impacts that are likely to collide. Therefore the Fed will add to the confusion about causality. As Ben Bernanke rightly pointed out, the Fed will eventually have to increase the size of its balance sheet. Any shrinkage now is temporary and counterproductive for the longer term.

Will there be a policy change? Will the Fed stop shrinking its balance sheet soon? I would like to say yes, but I doubt that it will. The Fed seems hell-bent on maintaining its schedule unless some shock occurs. Why we might need the shock as a wake-up call is beyond me. Will a new Congress ask that question?

President Trump hasn’t helped matters by bashing the central bank, though the decisions of the Fed are not likely to be influenced by any bashing. Most of the central bankers that I personally know take their roles very seriously and see themselves as avoiding politics and focusing on policy outcomes. But they are also doing two things at once without really explaining how the two policies intersect and interact. The Fed hasn't explained, for instance, the market impact of raising rates while forcing duration into the market. But that is exactly what they are doing, and that is why they are risking a shock.

It would help if the Fed could offer markets clarity on the pathway to normalcy in the US. My expectation is that we won't get it. And the task of interpreting the Fed will be increasingly difficult. Key indicators to watch are the spreads among the short-term funding instruments in markets where credit risk is not the issue. In our firm we review them daily. We look for a shift of a few basis points as a sign of pressure. And we look for nuances in Fed policy changes.

For the average investor these are difficult tasks. They require a lot of data surveillance. One has to track spreads between T-bills and repo and SOFR and fed funds and IOER. For those who wish to dig deeper into this subject, there are discussions and serous research papers at the websites of the Fed Board of Governors and the twelve reserve banks. The NY Fed is the center of this daily activity.

In the management of bond and ETF portfolios at Cumberland, we rarely make changes based on these minor basis-point shifts in funding markets, but we do watch them carefully. Our clients' portfolios are separately managed accounts structured with investment objectives that are not adversely affected by these very small shifts. The opposite is true for very large institutional portfolios. Still, for us the daily watchful waiting remains critical, since it provides early-warning signs of trouble.

Right now there is little pressure evident in the high-credit-quality funding markets. There is excess liquidity, though it is being gradually withdrawn. As of now, the federal deficit is easy to finance, and there is no rollover risk (that is, no risk in refinancing short-term debt).

We don’t expect such risk to surface in the US in our post-midterms period. My friend who likened the US to Greece and Italy is in error. They have rollover risk; we don’t.

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# Markets and Midterms

The countdown to midterms is now in full force, and the ads, emailings, snailmailings, and robo-phone-call invasions into our personal lives will all combine to show us the worst of America's political ugliness as it now descends on our country. For confirmation, one need only be in Florida and watch the blur from Nelson (https://www.nelsonforsenate.com/) versus Scott (https://rickscottforflorida.com/) or DeSantis (https://rondesantis.com/) versus Gillum (https://andrewgillum.com/) or (in my town and county) Buchanan (https://buchanan.house.gov/) versus Shapiro (https://voteshapiro2018.com/).


I will comment on the last one. I've met both incumbent Buchanan and challenger Shapiro.

What I see is a repeating TV ad where Buchanan walks along a pretty Florida-esque backdrop holding hands with an (apparent) grandchild and offers a soft message. He does not disclose any Republican Party connection, doesn't promote his role in the House, and never mentions Trump. That tack may change over the next 60 days, but that is what I have personally seen so far.

Meanwhile, Buchanan's attack ads on Shapiro are mean-spirited and vicious. They rely on visual distortion, innuendo, and charges that are intended to entice the viewer emotionally into a love-Buchanan / hate-Shapiro mindset. Thus Buchanan's ads portray the same incumbent person with two different personalities. The messages were each professionally created, and they were approved by Buchanan. Shapiro seems more muted so far. He may not have the money for an ad war. And he is challenging a strong, multi-term incumbent who is in a Republican-leaning district, while Shapiro is new to this game. We shall see how this contest unfolds.

Suffice it to say, we expect the next two months to be extremely ugly and full of campaign deceit and distortion.

In Florida, all the incumbents and all the challengers are running as environmentalists. In Florida, two issues loom large: the red tide and blue-green algal blooms, and the sugar lobby's funneling money to candidates while the sugar biz continues to poison Lake Okeechobee.

Detailed research shows that both political parties and their leaders have repeatedly promised action on these issues during their campaigns and subsequently done nothing about them once they've been elected. That includes the current governor, Rick Scott, who as a now-term-limited governor wants to defeat Nelson and be a US Senator. Scott portrays himself as an environmental champion. The messaging doesn't include his history of echoing disbelief on the climate change issue or mention how he is now distancing himself from Trump on these issues. The press in Florida has documented this history and published it in editorials and columns. (See https://www.washingtonpost.com/energy-environment/2018/08/09/florida-an-environmental-crisis-takes-center-stage-tight-senate-race/ for an analysis of the tussle between Scott and Nelson over environmental issues.)

We expect huge money will be spent on campaigns in Florida. We also want to see how the newly immigrated Puerto Rican population will turn out and participate. Massive voter registration initiatives are underway. A visitor can encounter them daily. This Saturday, four different people nicely approached me while I was walking in town to the morning market. In some areas of Florida we have seen record turnouts in the primary campaigns of both political parties. Sarasota is one of those areas.

Okay, what is an investor to do?

Here are scenarios and some strategic factors to think about.

Scenario 1 has Republicans holding the House and the Senate. This scenario, should it come to pass, obviously strengthens the Trump trade, tax, and deregulation agenda. Stocks markets don’t seem to expect it, so this outcome would be a surprise that could add huge volatility to 2019–2020, with a likely upward bias in US stock prices and downward pressure in foreign markets and especially emerging markets. Markets would assume that the trade war outcomes would worsen.

Scenario 2 seems the most likely one. Democrats capture the House but not the Senate. Currently, the betting odds show this is the majority view of those who are wagering money on the outcome. (Here is a website where you can place bets on the House and Senate outcomes: [https://www.predictit.org](https://www.predictit.org)) But betting trends don’t make the betters right (note the Brexit vote). The betting odds do, however, provide a market-based pricing of opinion.

In scenario 2 we run up against stalemate for two years, likely investigations and subpoenas, and a possible impeachment process in the House. We have history here. Nixon and Clinton are notorious examples. Government comes to a stop. The media circus intensifies and gets uglier. The political charade ramps up for the 2020 elections. Meanwhile, nearly everyone knows (or can read) the constitutional definition of impeachment and the rules which require a 2/3 majority in the Senate. Think of it this way: The House impeachment process is akin to a grand jury investigation, but held in public. The Senate is the actual jury. Note that no President of the United States has ever been convicted by the US Senate, even though the House impeachment process has been activated several times.

In scenario 2, the investor has to assume that there are no more positive changes in the tax code or the investment climate. There will be initiatives introduced that will raise taxes and alter deregulation. These may pass the House but are not likely to get through the Senate, nor would they survive a Trump veto.

Scenario 3 is the game changer. In number 3, Democrats gain majorities in both the House and the Senate. The fight over budgets and funding, government shutdowns, and continuing resolutions comes again to the fore. Betting odds suggest that this scenario is also not the most likely outcome.

What is important for investors to realize is that any of these three scenarios are possible. Set aside your personal leanings if you can. A coldly objective and calculated risk analysis suggests that scenario 2 or 3 is much more likely than scenario 1. What action to take now is the question.

First, investors must realize that they are managing a risk profile when uncertainty is huge and events are unfolding at a blistering pace.

Next, they must try to set aside emotions (hate Trump, like Trump, don’t care – but making investment decisions on those emotions gains nothing for the investor). Markets are highly susceptible to headline risk, and it is intense. Markets are also transitioning in anticipation of trade war, trade war rhetoric, and economic changes, while central bank policy is also changing and diverging (US Fed tightening, ECB resisting any tapering).

Lastly, and for planning purposes, any additional stimulus is likely to come only from the lame-duck congressional session that occurs after the midterm and before the winners in scenario 2 are sworn in. Therein lie the mechanisms by which special interest groups can influence legislative outcomes. We will also see leadership fights in both parties. Example: What would you do with housing stocks and banking and mortgages and the GSEs if you saw that Maxine Waters (scenario 2) was going to chair the House Financial Services Committee? Would you buy, sell, or hold?

One final thing. For planning personal financial decisions, discussions with your attorney, adviser, accountant, and planner are important right now. You want to identify what action you can take now to implement some decisions under present law and before any of these scenarios are in force next year to change that law. Remember that on the day a bill is introduced in the new Congress, the outcome from it can be retroactive to that introduction. Also remember that Congress has repeatedly backdated implementations. That is especially true of extender provisions under certain tax laws, which were made retroactive during a lame-duck session.

We close with the famous quotation offered by Sir Winston Churchill in the House of Commons in 1947 when he rose and said, "[I]t has been said that democracy is the worst form of government except for all those other forms that have been tried from time to time…" ([https://winstonchurchill.org/resources/quotes/the-worst-form-of-government/](https://winstonchurchill.org/resources/quotes/the-worst-form-of-government/)).

Sir Winston's wisdom applies. Please register and vote. We will do so early if we can, to be sure nothing derails our intention to express ourselves in the one way that is still protected (hacking notwithstanding) in this great country of ours.

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