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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