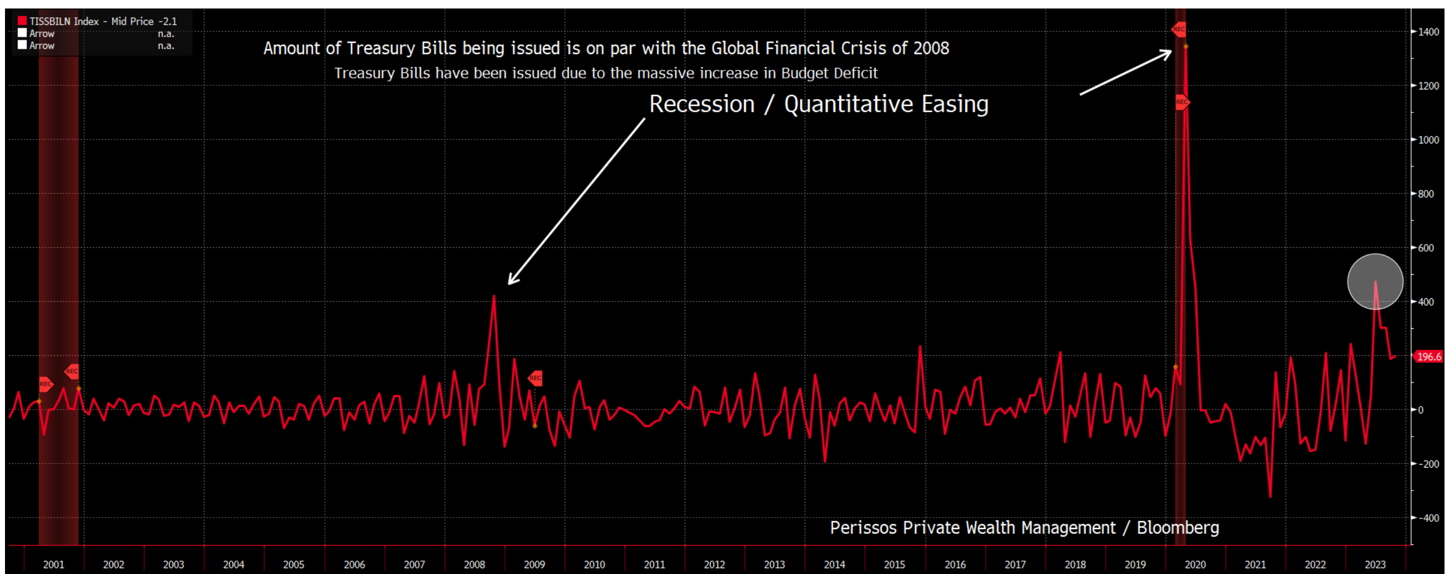
November 10, 2023

Market Memo

Research and Insights

In my last memo (you can read it here), I wrote about the massive surge in the Government's budget deficit and that they would have to issue an enormous amount of debt to fill the gap. I went on to explain that the yield on treasuries would rise if there were not enough demand for the needed supply. Yields on 10-year government bonds went up 1% since that memo was written back in August. Yields have since slowly come down by about 0.40% this last few weeks due to Treasury Secretary Yellen's announcement that the Treasury would skew their debt issuance towards shorter-term instead of longer-term debt. The amount of debt that will be needed to fund the ever-growing deficit will still put upward pressure on interest rates, even if inflation continues to fall.

Outside a Financial Crisis/Recession, the amount of Treasury Bills being issued is historic. The chart below shows the last three recessions and the amount of Treasury Bills issued.



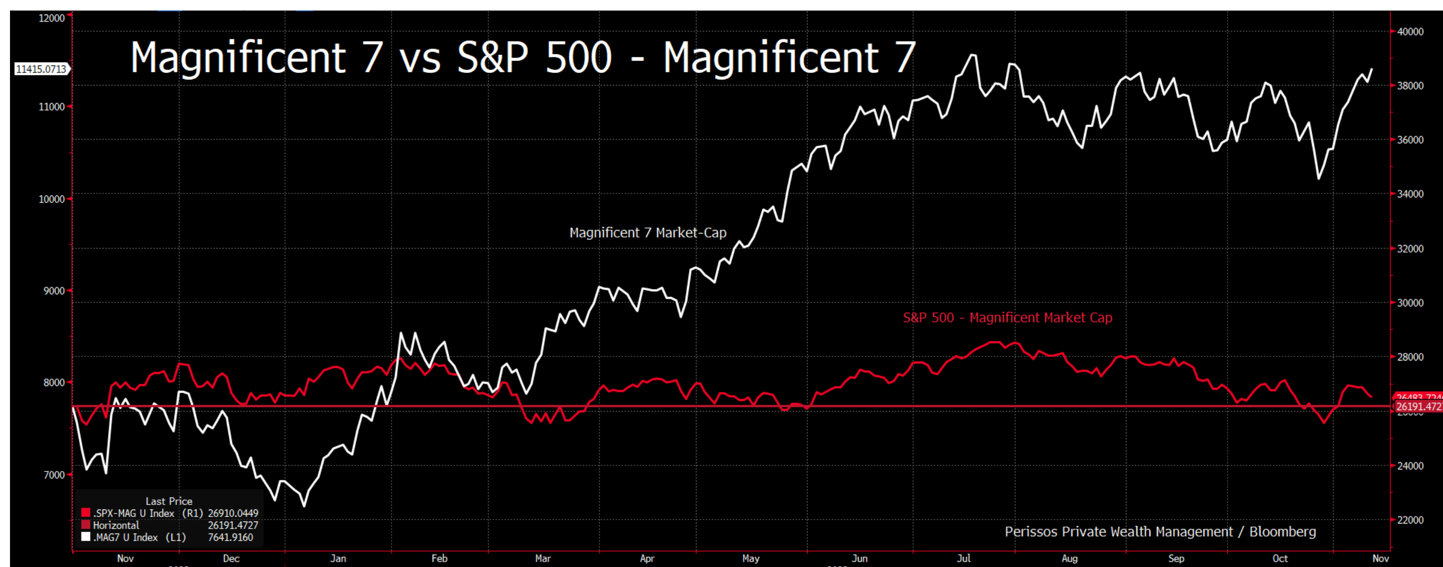
The government is issuing debt as if it were fighting a deflationary recession. This, too, is unsustainable. At some point in the future, the government will need to either cut spending or expect higher interest rates and/or higher inflation.

While the amount of debt being issued is still a primary concern, the amount of interest the government will need to pay has more than doubled in the last 18 months. The chart below shows that estimated annualized US debt payments are expected to reach $1 Trillion by the end of this year. A good question to ask is, "What happens when we are faced with a recession?" I believe it will be harder for them to spur growth with interest rate cuts during the next recession. Typically, during a recession, the budget deficit shoots up since the government still has to fund entitlements, but tax revenues are down because corporate profits are falling. This time around, the budget deficit is already at a level associated with a recession, and the government is having a hard time issuing an increased amount of debt without interest rates shooting higher.

If the government has to issue even more debt at a time when they are cutting interest rates, there will be a tug of war with upward pressure on rates because of the supply and demand issue; at the same time, the Fed is cutting the Fed Funds rate.

To me, these are the greatest factors impacting interest rates, now and in the future. Right now, the markets have priced in two rate cuts for next year. For the above reasons, I believe rate cuts will only materialize at the onset of a recession.

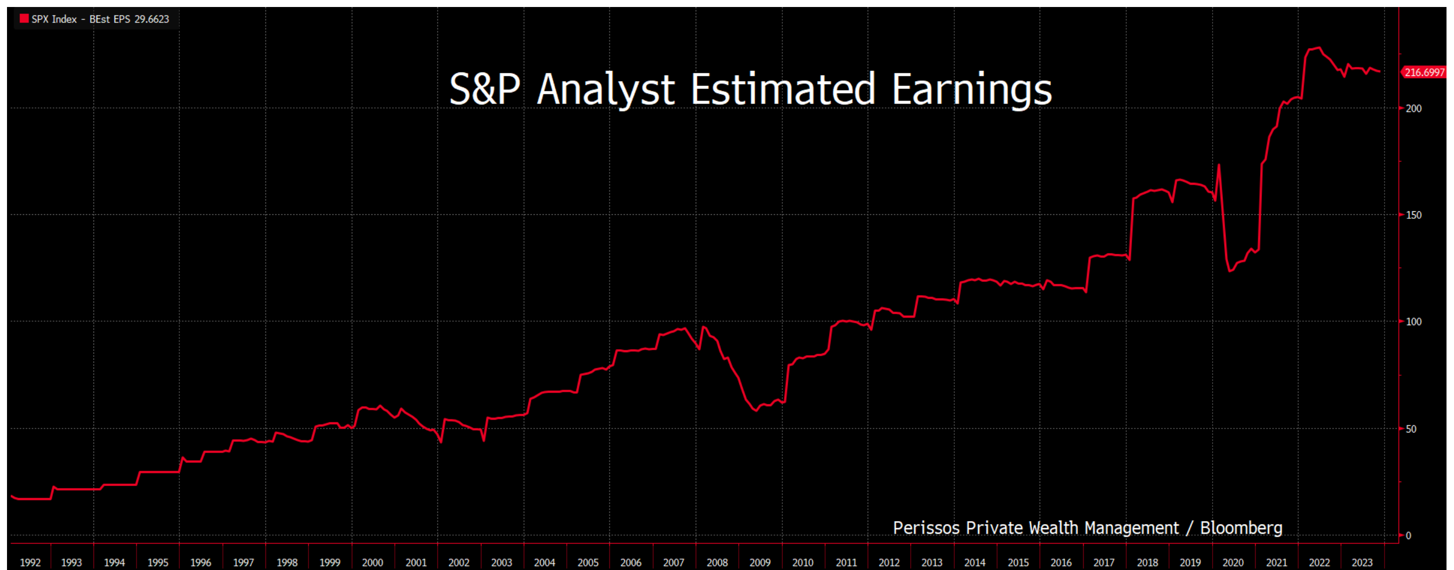
Many have pointed out that the S&P 500 index has done quite well this year in spite of interest rates being held at 5.50%. It is true, but other stock market indexes have not done nearly as well. If you look at the Dow Jones Industrial Average index (30 Large Cap Stocks), as I write this, it is up about 2% for the year. The Russell 2000 index (2000 Small and Mid-cap Stocks) is down -3+%. Where is this discrepancy coming from? The chart below is self-explanatory.



The Magnificent 7 Stocks are Tesla, Apple, Microsoft, Google, Nvidia, Meta, and Amazon. If you subtract the Magnificent 7 from the S&P 500 index, you can see from the chart above the S&P 500 index is barely positive. This means that 493 out of 500 stocks as an index are flat for the year.

With such a large portion of the market returns due to such a small number of stocks, it doesn't bode well for overall market breadth. In this type of investing environment, many investors get frustrated with owning a diversified portfolio since most of the returns are concentrated in a very small number of stocks.

We can see from earnings estimates that corporate profits have not been growing over the past few quarters, which should lead to lower stock returns. The chart below shows analyst earnings estimates for U.S. stocks.



I believe stocks face numerous headwinds heading into 2024. That doesn't mean equity prices can't continue to move higher; as we know, investors are always attempting to price in future expectations.

Next week's inflation report will be telling. Analysts expect it to come in lower than last month, and if so, we could see even more upside to the latest market rally. As always, I will keep you updated as new economic information comes available.

All my best,

Brandon VanLandingham CFA, CMT, CFP®

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