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No ceiling, no landing: 3-5% inflation cruising altitude

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IN A NUTSHELL

– Debt ceiling suspended until Jan 2025: Fiscal health to be general election issue
– Inflation is unlikely to land on target this year or next with loose fiscal discipline
– Slowflation: It's not cyclical inflation, it's structural: Real growth will be very slow
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Debt ceiling suspended until Jan 2025: Fiscal health to be general election issue

Republicans ask for very little to suspend the debt ceiling. Their strategy appears to be let federal debt grow into a major issue for the Nov 2024 general election. House Speaker Kevin McCarthy and President Joe Biden announced an agreement in principle to suspend (not lift) the debt ceiling by freezing non-defense discretionary spending through Sep end 2024. Their accord boosts defense spending by 3.5% next fiscal year. Other aspects of the tentative deal are of small budgetary significance and not binding to a future Congress. No limits specified for other 70% of federal spending, e.g. Social Security, Medicare, Medicaid, Veteran Benefits; nor executive spending under emergency and no new boundaries. This spending will rise as entitlements and need require, so blue sky for Treasury bond issuance until Jan 2025.

Inflation is unlikely to land on target this year or next with loose fiscal discipline

Before Memorial Day weekend, April's Personal Consumption Expenditures and inflation measures surprised to the upside. The U.S. Federal Reserve's (Fed) most favored measure of inflation, core PCE accelerated to 4.7% y/y and 4.5% m/m annualized. The details of consumption suggest households are depleting savings to spend more on essential goods and services. We think the Fed will take this most recent and important datapoint and likely stare at it. For over two years, the Fed has hoped for reopening normality or productivity upside surprises to tame inflation. The Fed was too late to hike, too early to shrink the size of hikes and will likely err again by being too early to pause. Despite many hikes since March 2022, the Fed Funds rate is only where it was in 2006-2007 before the financial crisis. Oil prices were a problem back then, but inflation was nowhere close to today's breadth and persistence.

Slowflation: It's not cyclical inflation, it's structural: Real growth will be very slow

If the Fed chooses to pause for summer, we don't know if the economy will slip into recession later this year or not. But given the data, at this stage we are convinced it will take at least a small recession to put inflation under 3% this year and next. Despite tighter credit conditions from smaller banks suffering net interest margin pressures from the jump in deposit base costs, we think a no landing scenario now has a 1/3 chance or roughly the same for soft landing (small recession w/ Unemployment Rate

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<5%) and hard landing (bigger recession w/ UE 5%+) if the Fed doesn't hike more this summer. Our no landing scenario has inflation between 3-5% through 2024 with no definitive recession, but real growth stuck around 1%.

Stubborn inflation, deteriorating US fiscal health: 10yr Treasury yield likely rising

May was the month that short-term Treasury investors got the message that without a large recession the Fed was unlikely to cut overnight rates until probably spring of 2024. We think June & July, if the Fed doesn't hike, will be months that longer-term Treasury investors realize that without a recession this year inflation is unlikely to fall below 2.5% over the next few years and real interest rates are likely to stay over 1% for the rest of the decade. Without conviction in imminent recession, we'd be uncomfortable owning 10yr Treasuries yielding under 4%. While the Fed has signaled that the terminal rate and angle of ascent are uncertain, we think they've been clear in desire to stay at that rate for at least a year, like past plateaus, and that positive real interest rates are likely appropriate for much longer than that, just as before the surge in globalization and the financial crisis. We think longer-term real interest rates (Treasury Inflation-Protected Securities, or TIPS) should be about 1.5% and that Treasury breakeven should be about 2.5% with inflation risk premiums being approximately offset by risk hedge value. But, Treasury risk hedge value is uncertain until yields normalize, wherever that might be.

Higher short and long-term nominal & real interest rates underlie debt problem

The deficit remains too high for a full employment economy and the debt to gross domestic product (GDP) ratio is at levels that would give fiscal hawks from the 1980s a heart attack. But rising debt to GDP wasn't a problem when interest rates were descending and then spent years at 0% and negative real rates. This is not the case with interest rates today and with the debt ceiling suspended, we expect Treasury to issue more than $1trn of notes before year end and the deficit to exceed 5% of GDP this year and next. Unless inflation is 4% or more, we expect the debt to GDP to climb. More importantly, we expect interest expense on debt and as a share of GDP to rise. This was under 3% until this year and we expect it to be over 4% by next year. Treasury will need to decide on whether it wants to issue mostly short-term debt at 5% or longer-term debt still under 4%. Unless a recession that quickly tames inflation is expected, we'd suggest issuing more toward the long end. But we hear they'll likely issue mostly short, which is more costly and might stay more costly than long-term rates are now. It could be a muggy summer for long-term bonds, if it gets too hot it will also burn stocks.

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Glossary

The debt ceiling is the maximum amount of money that the United States can borrow cumulatively by issuing bonds. The debt ceiling was created under the Second Liberty Bond Act of 1917 and is also known as the debt limit or statutory debt limit.

Fed Funds rate refers to the target interest rate range set by the Federal Open Market Committee (FOMC). This target is the rate at which commercial banks borrow and lend their excess reserves to each other overnight.

The financial crisis refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Medicaid is an assistance program providing health coverage to people with low income. It is run by state and local governments within federal guidelines.

Medicare is the U.S. national health insurance program for people aged 65 and above and younger people with disabilities or kidney failure.

The personal consumption expenditure (PCE) measure is the component statistic for consumption in gross domestic product (GDP) collected by the United States Bureau of Economic Analysis (BEA).

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

A soft landing is when an economy's rate of growth slows in a controlled fashion without major disruptive effects on employment, external balances etc.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

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