Weekly Investment Insights

February 20, 2024

Key Takeaways:

- Inflation increases more than expected.
- Consumers slow spending.
- Consumer sentiment relatively unchanged.
- U.S. equities underperform global counterparts.
- Treasury yields rise on bets for less aggressive Fed cuts.
- Natural gas plummets on weak demand.

Weekly Economic Recap –

Inflation Remains Sticky but Sentiment Remains Unchanged

Consumer prices increased more than expected to start the year as the headline Consumer Price Index increased 0.3% MoM (vs. 0.2% est.) and 3.1% YoY (vs. 2.9% est.). Food and shelter costs were the largest contributors to the jump in inflation, climbing 0.4% MoM and 0.6% MoM, respectively. Core CPI, which excludes volatile food and energy prices, increased 0.4% MoM, the most in eight months led by shelter costs.

Small business optimism declined in January as the NFIB Small Business Index fell to 89.9. Owners' expectations for sales fell 12 points in December and inflationary pressures remain a key headwind to operating businesses.

Consumers pulled back on spending to start the year as retail sales fell at the fastest monthly pace since March 2023. Consumers slowed spending at supply stores and gas stations the most, however spending increased at restaurants and bars.

Homebuilder sentiment increased to its highest level since August with all major categories increasing for the month. Sentiment on the present situation and prospective buyers' traffic rose the most.

Prices paid to producers, as tracked by the Producer Price Index, increased more than expected in January (0.3% vs. 0.1% est.) and by the most since August 2023. The increase was attributed to prices paid for services, which increased the most since July 2023.

Consumer sentiment was relatively unchanged from January according to the University of Michigan Survey. Expectations for better business conditions increased to its highest level since December 2020.

Weekly Market Recap –

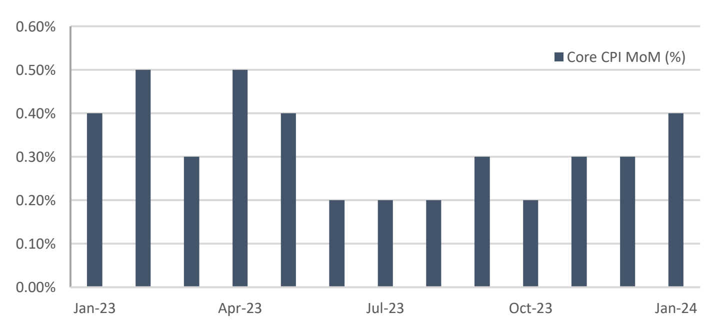
U.S. Equities Underperform as Expectations for Aggressive Fed Rate Cuts Dwindle

Equities: The MSCI AC World Index was higher for the foruth straight week despite inflation remaining sticky in the U.S., raising doubts about the Fed's ability to cut interest rates. The S&P 500, the Nasdaq and the Russell 1000 Growth Index were all lower for the week. Small-caps as tracked by the Russell 2000 were higher for the second straight week.

Fixed Income: The Bloomberg Barclays Aggregate Index was lower for the second straight week as Treasury yields increased after data showed inflation increased more than expected in January. Floating rate instruments were higher for the second straight week as yields increased on bets the Fed won't be able to cut interest rates as fast as anticipated.

Commodities/FX: The Bloomberg Commodity Index was lower for the second time in three weeks. Natural gas prices continued to fall for the sixth straight week as demand remains relatively low given a warmer than expected winter season. Crude oil prices were higher for the second straight week as fighting in the Middle East continues.

Core Inflation Increases at Fastest Pace in Eight Months



Footnotes: Data is as of January 2024.
Data Source: Bloomberg Finance LP, Verdence Capital Advisors

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Past performance is not indicative of future returns

Key Takeaways:

- Congressional Budget Office puts out new 10 YR budget projections.
- Deficit is expected to get better before it gets worse.
- U.S. debt levels to soar.
- Net interest costs a major burden.
- Higher taxes, cuts to entitlements and spending to be a growing debate.

Closer Look at the Alarming Fiscal Health of the U.S.

Last week the Congressional Budget Office (CBO), a non-partisan independent organization, released its 10 year projections on the federal budget. This report is full of information about sources of government revenues, outlays and the deficit. Unfortunately, the fiscal situation in the U.S. does not look to get any better as we now have information through 2034. In this weekly, we offered the key takeaways from the report.

- **Deficit better before it gets worse:** According to the CBO, the deficit as a percentage of GDP is expected to improve from the current level of 6.2% to as low as 5.0% (in 2029) before worsening again into 2034. By 2034, the deficit is expected to be back to 6.2% of GDP. To put this in perspective, historically the deficit, on average, has been 3.2% of GDP. At 6.2% of GDP, it would put us in the same category that Hungary and Romania are currently (as of 2022).

- **Outlays to outpace revenues:** The deficit situation will be due to a 56% increase in outlays over the next 10 years and only a 51% increase in revenues, including individual and corporate income taxes.

- **Debt to surge:** To fund the deficit, debt held by the public (Treasuries) is expected to rise 73% over the next 10 years. As a percentage of GDP, it is expected to rise from 97% to 116% by 2034. However, our country owes more than just our Treasury debt. We owe money to ourselves as we have borrowed from social programs. Our gross federal debt (including both) is expected to reach $54 trillion by 2034 or 131% of GDP. There are few developed countries that are in that type of debt (e.g., Japan, Greece).

- **Net interest a major issue:** Net interest costs to fund the burgeoning deficit are expected to increase 87% over the next 10 years. Net interest costs are the biggest increase expected in all the government outlays. They are expected to make up 16% of government outlays, a record high and nearly double what the historical average has been since 1940 (8.8%). These estimates are factoring the average interest rate on Treasury debt to rise from 3.15% currently to 3.5% in 2034. What is more troublesome with these forecasts is that we will spend more servicing our debt than we do on our military within the next five years.

- **Overly optimistic on growth:** The deficit is making optimistic predictions on economic growth from 2024-2034. They are expecting the economy to grow almost 4% per year from 2024-2034. Since 1945, the average annual growth of the U.S. economy has been ~3.0%.

The Bottom Line:

The unnerving fiscal situation in the U.S. is not a new story. In fact, the credit rating on U.S. debt has been downgraded twice by major rating agencies. We have been able to fund reckless government spending for decades because of the near zero interest rate policy we were lucky to have for so long. However, that is over as we enter into this new interest rate regime. While the Fed cuts interest rates as we move through different stages of the economic cycle, getting back to zero with the money printed after COVID is unlikely. There will need to be a change. We can not forecast how or who will get that done but we are on an unsustainable path. Higher taxes and cuts to entitlements and spending will likely be the growing debate over the coming years.

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