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Financial and Government Sins and Virtues

- Carol Roth

In this informative newsletter, Carol covers why long-term stagflation may be likely; the role construction is playing in this economic cycle; how the government needing to finance deficits and refill the TGA may cause more banking chaos this year; how financing government overspending is crowding out other assets; the stark reality on who is actually funding our debt; how to prepare for what's ahead; and more, wrapped up in sins and virtues.

Financial and Government Sins and Virtues

The financial sins of the government and the Fed can only be combatted with financial virtue.

Temperance. The Federal Reserve decided to take a pause from their rate hiking last week, getting an assist from May's headline CPI at 4%, and perhaps also trying to give the banking sector a little breathing room.

Pride. Based on Powell's commentary, which hinted that their rate hiking may not be over, the Fed is still hoping their policy magic wand will entirely fix inflation. Despite their monetary policy wreaking havoc on the banking system, inflation is still too high. PCE inflation, the Fed's favored measure of inflation, had moved up in its last reading. And the jobs market remains generally tight and strong, despite layoffs in industries like tech that over-hired during the pandemic. Job openings moved back to almost 1.8 jobs available per job seeker, and the non-farm payroll jobs data showed 339,000 jobs added in May. While we can debate the way this data is collected and presented, it still creates issues for the Fed.

It also creates issues for families across America, who are struggling from the cumulative effects of inflation. While the growth rate is slowing against very high growth a year ago, inflation itself is persistent and sticky.

Diligence. With government spending remaining high (discussed below) and consumer spending continuing with the cushion of a tight labor market, the economy may just sputter along with a little growth and persistent elevated inflation, a scenario known as stagflation. This long-term stagflation scenario is one of several possible outcomes, and creates a real need for hedges, like gold. Imagine if inflation just settled at a permanent 3% growth rate—over 10 years, something that costs $100 today will, all else equal, cost around 35% more. In 15 total years, that pops up to almost 56%. You want to make sure you are prepared for this type of an outcome.

Avarice and Financial Gluttony. In the meantime, the government's various sins, including greed and gluttony, are creating pressure on the foundations of the financial system. First, their stratospheric level of spending, which was not tamed in any meaningful way by the so-called debt ceiling deal, is working against what the Fed is trying to accomplish.

The Fed's historic, rapid raising of interest rates- 500 basis points in 14 months- should have been more than a signal to the government to stop its excessive spending; it should have been a neon red sign.

Not only is the government not slowing its spending to help the Fed cool the economy and tame inflation, the government's spending remains elevated as a percentage of overall GDP. Per the CBO, the average government spending as a percentage of GDP from 1973 to 2022 was 21%. In FY 2022, that was 24.8%, and it is expected to remain at near 24% to almost 25% for the next decade.

Construction is usually a sector that brings down the job market in an accelerating interest rate environment, but it is being propped up via the government. According to the Wall Street Journal, “Construction spending and employment have risen to new records this year, boosted by government outlays for infrastructure…” along with other segments of the market. They continue, “The persistent strength in a sector that is usually among the first to suffer job loss when borrowing costs rise is undermining investor hopes that the Fed’s aggressive interest-rate increases would quickly slow inflation.”

Pride. The government leaning into spending is happening despite financing costs increasing. In 2022, the average duration of Treasury debt was about five to six years, and the interest rate was around a mere 1.4%. By the end of May, that was up to almost 2.7%.

Gluttony. The government’s gluttonous spending is crowding out other capital in the market as well. The government has to finance its massive deficits. The Treasury General Account (TGA), which is like the cash management or checking account for the government, also needs to be refilled. Analysts at Deutsche Bank estimated that could amount to another $1.3 trillion in T-Bills to be issued this year. The implications of this are severe.

As more Treasury securities are issued, the substantial increase in supply should bring down the price of the securities and increase their interest rates (as the price of bonds and their yields move inversely). The impacts of this could include, among other things:

-Deposit flight, whereby more depositors leave banks to secure higher interest rates on T-Bills;
-Further depression of the mark-to-market value of Treasury assets on banks’ balance sheets; and
-The crowding out of investors from going into riskier assets.

This may add pressure on the already stressed-out banking sector. This pressure laid out above is just from government financing needs; that could be worsened by any reduction of the Fed’s balance sheet (something Powell alluded would continue in last week’s press conference) or continued selling of Treasurys by foreign sellers.

Pride. Moreover, who is going to buy these securities? Despite the near-term demand for the high-rate, short-duration securities, in the mid-to-long term, who has the money to keep financing the US government’s reckless spending?

FFTT’s Luke Gromen said in a recent report, “there does not appear to be enough global private sector balance sheet globally to absorb all the effective net UST issuance above without selling other assets globally,” with the “above” he references being his own calculation of second half 2023 required Treasury issuance. If we go with Gromen’s estimates, we are talking about a debt financing issuance that is larger than the GDP of every country but seven (six others plus the US). The US banks are in a precarious position. So, who is buying up this debt, whether that be this year or in the future, as overspending is not expected to be curtailed.

In the same report, Gromen shares that “In 2004-08, foreigners were financing substantially all of the US government’s deficits. In 2009-13, the portion of US Federal deficits not being financed by foreigners was being substantially financed by Fed QE.” Gromen shares in another FFTT report that from 2014 to the present, global Central Banks haven’t been net buying Treasurys. Moreover, he says that when these foreign central banks have US dollar needs, they have been choosing to sell Treasurys rather than gold as a mechanism to raise those US dollars. That is a bullish data point for gold, and not so much one for the US financial system.

Sloth. Government spending becoming a larger part of GDP also means less productive money in the economy, which is not good for the US's long-term growth. The government debt is being used for financing costs, transfer payments and in the areas where there is actually some limited "investment", government money is going into less productive industries and sectors (such as funding "green" initiatives, with less productivity than dollars to fossil fuels, for example).

Wrath. Back to the Fed, it still has many competing issues to continue juggling. How will they manage to tame inflation, have properly functioning Treasury markets, and make sure the banking sector doesn't implode? Will they find themselves continuing to tighten policy after this June meeting pause at the same time they have to do something that resembles easing to continue to support the banks? Note an April Myrmikan Performance research report from Myrmikan Capital talked about the competing actions the Fed has been taking.

Myrmikan shared, "The growing banking failures have put the Fed in an awkward place both practically and intellectually. In the two weeks following the failure of SVB, the Fed was forced to undo 63% of the quantitative tightening it had performed over the previous year in order to support banking resolutions.

Meanwhile, it continued raising interest rates. That is not supposed to happen: for over a century, more money issuance has resulted in lower rates, not higher, throwing the whole theory of central bank management into crisis."

In layman's terms, this means that the Fed is taking actions to lower inflation yet undoing those actions by doing the exact opposite in terms of policy to support the banks.

Diligence. This all supports the idea that in the short run, T-bills and hedges such as gold and other metals make sense in a portfolio, and in the long-run, precious metals and scare commodities are worth considering.

If you haven't had an opportunity to hedge your own portfolio for the short- or the long-term, or perhaps you haven't hedged enough, consider giving my friends at Goldline a call to help you (they are the only place from which I personally get my precious metals).

And don't wait on this; hedges should be continually evaluated and adjusted on an ongoing basis, dependent on your current portfolio, your risk tolerance, your objectives and of course, the changing economic backdrop.

Humility. While it's clear that the government and the Fed are more sinners than saints, we can look to our own virtues to try to combat the fallout. Judgment day will come, so make sure you have prepared; their financial sins and actions have consequences that can't be avoided.