Zacks
INVESTMENT MANAGEMENT

WEEKLY CLIENT COMMENTARY | OCTOBER 20, 2023

Mitch on the Markets

Portfolio Manager Investing Insights

What Ballooning Deficits Mean for the Economy and Markets

Rising deficits have been a major story in the headlines recently, and for good reason. According to the Congressional Budget Office, the gap between spending and revenue was $1.7 trillion in fiscal year 2023, which means the deficit grew by $300 billion year-over-year—even as the economy was expanding.[1]

Federal budget deficits keep growing

Source: Federal Reserve Bank of St. Louis[2]

ABOUT MITCH ZACKS

Mitch Zacks, MBA
CEO, Senior Portfolio Manager

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

The on-again off-again student debt cancellation program resulted in some distortions to deficit calculations. In 2022, student debt cancellations resulted in a $300+ billion addition to the deficit, but following the Supreme Court decision that ruled the program unconstitutional, Treasury accounted for those dollars as a spending cut in 2023. Even still, accounting for these quirks, the federal deficit was more than 7% of GDP in fiscal 2023. Rarely do we see deficits this large during an economic expansion.

Without legislation to curb spending or raise revenues, some estimates show U.S. debt rising from 96% to 123% of GDP over the next 10 years. Nearly all of the increase would be driven by the primary deficit.

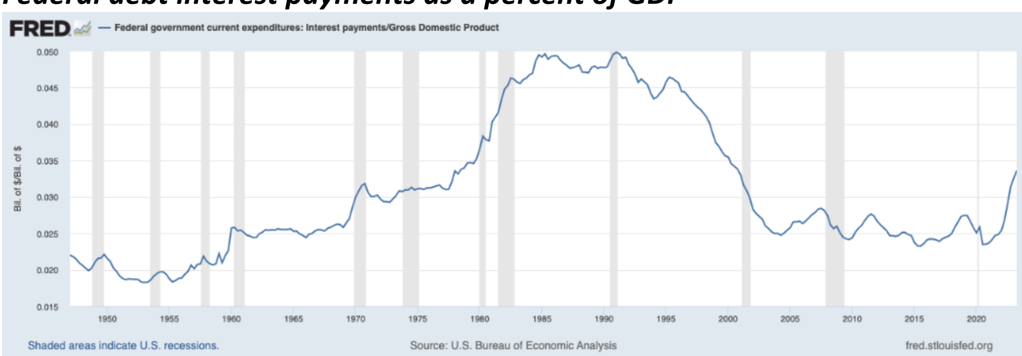
Last week, I argued that stronger-than-expected economic growth was putting upward pressure on interest rates, but I also cited growing deficits as a factor to monitor. The U.S. Treasury Department announced over the summer that it would gradually increase the size of its debt auctions to account for the increased spending, which led to some jitters over whether the market could absorb all of the new debt without demanding higher interest rates.

As I wrote last week, the latest Treasury bond auctions show that the market is indeed absorbing new issuance with little issue, and foreign holdings of U.S. debt are up over $500 billion since October 2022 and approaching an all-time high. It may not be a major issue now, but if deficits only continue to rise from here, debt issuance will need to go up too—and the market's appetite for U.S. Treasury bonds isn't infinite. Rates would need to go up, too.

For now, it's important to scale the deficit issue and think about it in relative terms when considering the economic and market impact. To do that, the key data point to hone in on is how much the U.S. government is paying for its debt, i.e., interest costs as a percent of GDP. Interest payments – looked at in a vacuum – point to ballooning costs, with Treasury spending $711 billion in interest payments in 2023 compared to $177 billion in 2022. Higher rates are playing a central role, and the issue could get costlier going forward as more than half of government debt matures in less than three years. If rates stay elevated, this debt will become significantly more expensive.

If we look at interest payments as a percent of GDP, however, the situation looks a bit less alarming. As seen in the chart below, high rates in the late 1970s and early 1980s pushed interest costs as a percent of GDP to levels much higher than we're seeing today, and the U.S. economy managed to work its way through it—though not without some turbulence along the way.

Federal debt interest payments as a percent of GDP



Source: Federal Reserve Bank of St. Louis[3]

BOTTOM LINE FOR INVESTORS

The upshot looking forward is that higher interest costs on U.S. debt could result in a greater appetite for fiscal tightening. Ongoing congressional gridlock and an upcoming presidential election may not make deficit reduction legislation likely in the coming year, but history suggests Congress may soon view it as an economic imperative. The elevated interest expenses cited above in the chart led to several rounds of deficit reduction legislation in the mid-1980s and in the years following, which ultimately resulted in a budget surplus in the mid-1990s. A key motivation for deficit reduction during that period was that ballooning interest payments were “crowding out” other more productive—or at least more popular—areas of spending. We could see this scenario play out again soon.

No administration wants to accept the reality that spending needs to go down and taxes need to go up, or at least economic growth needs to accelerate swiftly (which would result in higher tax revenues) without additional deficit spending. However, recent history suggests the market will respond accordingly if fiscal policy heads in the wrong direction. Last fall, a new government in the U.K. proposed a tax cut amid rising spending and inflation, and British bond yields surged immediately. The proposal was scrapped within a few days.

---

[1] Wall Street Journal. October 5, 2023. https://www.wsj.com/economy/central-banking/rising-interest-rates-mean-deficits-finally-matter-74249719

[2] Fred Economic Data. September 13, 2023. https://fred.stlouisfed.org/series/MTSDS133FMS#

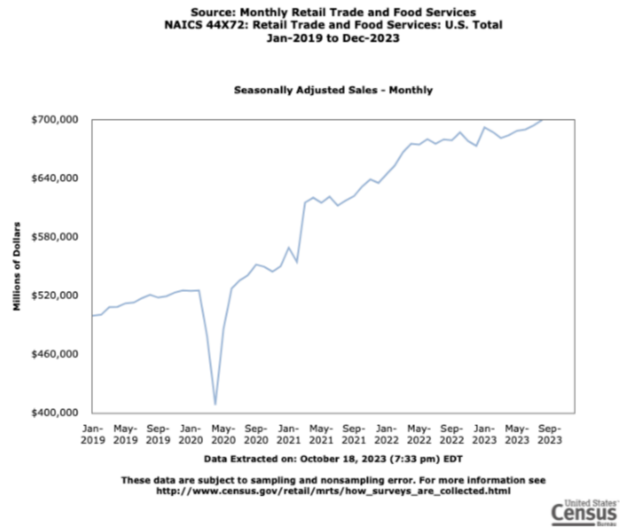
[3] Fred Economic Data. September 28, 2023. https://fred.stlouisfed.org/series/A091RC1Q027SBEA#

STEADY INVESTOR WEEK

- **U.S. retail status**
- **China's economic growth**
- **Weak year for U.S. home**

U.S. Retail Sales Blow Past Expectations

A major theme of the U.S. economic growth story in 2023 has been consumers who just keep on spending. September was no different. According to the Commerce Department, U.S. consumers kept splurging last month, with spending at stores, online, and restaurants (retail sales) jumping 0.7% from August to September. This figure was more than double economists' estimates, signaling that the U.S. economy continues to expand at a stronger pace than most expect. Nearly all retail categories posted gains last month, and when you exclude gas stations, car dealers, building-materials stores, and food services – which is known as the 'control group' economists use to track the underlying pace of spending – retail sales still rose 0.6%. The takeaway here is one we've made in previous weeks, which is that the U.S. economy likely expanded at a far faster pace than just about everyone estimated in Q3. We've also made the argument that long-duration interest rates rose in August and September in response to this stronger-than-expected growth, which appears to have been verified by these strong consumer spending figures. As seen in the monthly retail trade and food services spending chart below from the U.S. Census Bureau, the spending recovery in the wake of the pandemic has yet to lose any steam[1]:



Census[2]

There is one specific area of spending, however, where Americans are starting to cut back: live entertainment. According to a survey from *The Wall Street Journal* and Credit Karma, nearly 60% of Americans said they have cut back on live entertainment like sporting events and concerts because of rising costs.

China's Sputtering Economic Growth and Potential Crisis

China's National Bureau of Statistics reported that the world's second-largest economy grew 4.9% in the third quarter. While 4.9% GDP growth registers as consistent with China's goal of 5% GDP growth for the year, mounting headwinds have many economists questioning China's fundamental strengths. Let's start with the positives. In the latest Q3 data, business surveys pointed to improving factory output, retail sales rose 5.5% in September year-over-year (compared to August's 4.6% rate), and industrial production has been posting a strong recovery in the wake of weak export activity. Domestic travel has also picked up, as has lending to households and businesses. On the negative side, however, exports declined for the fifth straight month, and China's real estate market is in distress. Home sales by value fell 3.2% in the first three quarters compared to a year ago, and major developers Evergrande and Country Garden have essentially collapsed. China's government has been responding by cutting interest rates and scrapping restrictions on home purchases, but consumers are wary given real estate's year-to-date performance.[3]

A Weak Year for U.S. Home Sales

If China's real estate market can be described as battered in 2023, the U.S. might be aptly characterized as moderating. In September, existing home sales – which account for a majority of home sales each year – fell by 2% from August and 15.4% year-over-year. Meanwhile, the median existing home price increased by 2.8% year-over-year in September, to $394,400. Higher prices, combined with the highest mortgage rates in over 20 years and low inventories, are all working together to pressure sales in the market. By some estimates, total existing home sales in the U.S. could land at around 4 million in 2023, which would be the least number of existing homes sold since 2008. As Americans are reluctant to leave their homes given high mortgage rates, it has resulted in an increasing number of housing permits to build new single-family homes – which have risen for eight straight months.[4]

[1] Wall Street Journal. October 17, 2023. https://www.wsj.com/business/retail/retail-sales-get-real-6a794a95

[2] Census. 2023. https://www.census.gov/econ/currentdata/?programCode=MRTS&startYear=2019&endYear=2023&categories[]=44X72&dataType=SM&geoLevel=US&adjusted=1&notAdjusted=1&errorData=0#line015

[3] Wall Street Journal. October 18, 2023. https://www.wsj.com/world/china/chinas-economy-grew-4-9-in-third-quarter-3e504ab0?mod=djemRTE_h

[4] Wall Street Journal. October 19, 2023. https://www.wsj.com/economy/housing/home-sales-report-to-show-how-much-high-rates-squeezed-market-54f64ea1?mod=hp_lead_pos2

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.

Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns, which will be reduced by fees and expenses.

The ICE U.S. Dollar Index measures the value of the U.S. Dollar against a basket of currencies of the top six trading partners of the United States, as measured in 1973: the Euro zone, Japan, the United Kingdom, Canada, Sweden, and Switzerland. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm that acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable. Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large-company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor. An investor cannot invest directly in an index.

The Russell 1000 Growth Index is a well-known, unmanaged index of the prices of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Dow Jones Industrial Average measures the daily stock market movements of 30 U.S. publicly-traded companies listed on the NASDAQ or the New York Stock Exchange (NYSE). The 30 publicly-owned companies are considered leaders in the United States economy. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The ICE Exchange-Listed Fixed & Adjustable Rate Preferred Securities Index is a modified market capitalization weighted index composed of preferred stock and securities that are functionally equivalent to preferred stock including, but not limited to, depositary preferred securities, perpetual subordinated debt and certain securities issued by banks and other financial institutions that are eligible for capital treatment with respect to such instruments akin to that received for issuance of straight preferred stock. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.