# Fiscal Boom

March Cut Less Likely, Inflation as a Fiscal Limit, Unwinding Financial Repression, Retailer Disruption, Equal Weight S&P Relative Value

JAN 20, 2024

## Return of the Insidious Bear Steepener

Since the December FOMC 'pivot party' rally, incoming data is best characterized as uncooperative for our four fours yield curve disinversion thesis. The first week of January ended with above consensus December nonfarm payrolls, a decline in the unemployment rate to 3.7% and a second consecutive 0.4% monthly increase in average hourly earnings. The second week brought a hotter than expected December CPI. This week delivered a strong December Retail Sales report for the most important month of the year for retailers. The Fed's Beige Book was filled with qualitative evidence that demand for labor is softening, unfortunately the FOMC participant's general view that labor supply is improving was an accurate assessment during 1H23 when prime age participation increased from 82.5% to 83.5%, however, in 2H23 it eased to 83.2%. Additionally, the layoffs & discharge rate of 1.0% is below last cycle's low, the 1.2% insured unemployment is 0.1% above last cycle's low and weekly initial jobless claims are showing no evidence of excess supply of labor. The evidence that labor demand is softening is convincing, if not compellingly obvious. But it is increasingly apparent, with the stall in wage disinflation the most compelling data, that the recovery of the supply of labor also stalled, thereby pushing us further from the 4% unemployment rate and 4% wage growth necessary for the FOMC to reduce the policy rate to 4% and keep the 1-year Treasury rate near 4%. Until and unless the labor market data begins to cooperate, the 49% market implied probability of a March rate cut is too high and the latest round of FOMC participant speeches prior to the quiet period ahead of the January 30-31 meeting suggested March is a stretch. There are three releases with the potential to soften Chairman Powell's tone in the press conference: the 3Q23 advanced GDP estimate on the 25th, the December personal consumption deflator report on the 26th and 4Q23 employment cost index on the second day of the meeting.

With the return of bear steepening early in the week until the ‘final word’ from FOMC participants prior to the quiet period battered 2s, equities are behaving like much of 2023, at least until the Treasury Department’s October Quarterly Refunding Announcement and FOMC communicated an end to the rate hike cycle. Tech and related sectors are leading, with small caps and regional banks lagging. Bank earnings, with 14 of the 15 S&P components having reported, are tracking -11.2% on +1.2% revenue growth even with a 10.1% earnings surprise rate. The deeply inverted yield curve and ongoing battle over Vice Chair for Supervision, FDIC, OCC and NEC Director Brainard’s increased capital proposal are likely to pressure earnings and preclude any return of capital to shareholders. In short, banks have a profitability issue, not necessarily a liquidity or solvency problem, as was the case with US banks from 2014-2018 following the post-crisis regulatory ‘reform’ and European banks in following the sovereign debt crisis. To get to the ‘healthy broadening out’ likely requires a deterioration in the labor supply and demand imbalance that starts the rate cut cycle. Until that point, we expect a low velocity bear steepening of the Treasury curve and underperformance of financials and small caps. The selloff in the Treasury market is not yet deep enough to drag the tech sector lower, particularly given that better than expected labor market and consumption data is an integral part of the story. Keep an eye out for discussion of the Fed’s balance sheet at the press conference, post meeting speeches and minutes. We detailed our outlook for an eventual return to a ‘bills’ only policy that would reduce longer maturity rate suppression in last week’s note, Ripping off the Band-Aid.


*Figure 1: The most underappreciated, but exceptionally important given the outsized role core goods price deflation is playing in disinflation in CPI and PCED, inflation report is import prices. As the chart illustrates, the deflationary shock from China and mid-year dollar strength is dissipating.*

## Fiscal Boom

Fed Governor Waller, in a Brookings event last week, said what we wished Chairman Powell would, that $6 trillion of fiscal expansion in 2 years had to have had a significant impact on inflation. The simplified version of his view is that if supply chain disruption were the sole factor that caused CPI to go 9%, the price level would have returned to pre-pandemic levels. Card carrying members of team transitory (generally new-Keynesians) claim the 2009 fiscal stimulus wasn't large enough, but this time they went big and the drop in the rate of inflation is vindication of this view. While significantly larger direct transfers to individuals in 2009 might have stabilized aggregate demand and prevented the unemployment rate from reaching 10%, given the required deleveraging in the household sector, those transfers would have gone primarily towards paying down debt (for a study of 15 post-war financial crises see the link below). In other words, profligate households would have been bailed out by transferring debt to the public sector. That is ultimately what occurred over time, but larger stimulus that would have accelerated the process was politically unfeasible, as evidenced by the Tea Party movement and one of the largest landslides in the House (GOP) in 2010 in history. The pandemic was different, the mistakes were in the policy response, households were clearly not complicit in causing the crisis, consequently there was no resistance in 2020, and in 2021 the Democrats controlled the White House, Senate and House and used reconciliation to circumvent the filibuster.

Ignoring the supply-side of the economy is a mistake both sides make, tax cuts in 2001 & 2003 did not accelerate the recovery following the technology investment bust, instead they contributed to another boom/bust cycle, this time in residential real estate. In 2021, the $1.9 trillion stimulus with global supply chains disrupted, and ongoing mobility restrictions capping the supply of services, the cash transfers to households caused asset and goods price inflation. Curiously, no lessons appear to have been learned as Congress appears close to an agreement to increase the child tax credit with few income requirements, reinstate the R&D tax credit and restore immediate equipment expensing, 'paid for' by an early end to the fraud plagued employee tax credit. We don't have an issue with the R&D tax credit. Immediate expensing of equipment is unnecessary. When the Tax Cuts & Jobs Act was passed, the equipment tax expenditure was our second least favorite provision after the top individual rate reduction. Equipment investment was running at trend through the '10s, the investment short fall was in physical plant. Physical plant, known as structures investment in the GDP report, is most sensitive to the tax rate, intellectual property products (software and R&D) is generally funded out of cash flow. Consequently, the cut in the corporate tax rate was the best part of the deal. The individual tax cuts appear to have been intended to sell the deal to the public. We suspect the child tax credit deal is the same approach, to get the broad-based tax incentives restored the public needed an expensive gift. There remains very large public sector spending in the pipeline from the infrastructure, renewable energy (we can't call this the Inflation Reduction Act with a straight face) and CHIPS Act. In other words, Congress is going to reinstate broad supply-side tax expenditures alongside modern supply side economics spending (industrial policy) and add in additional direct transfers to individuals to sell the tax expenditures to the public. Boom.

Transfer payments to individuals went to 33% of disposable income during the pandemic and at 17% remain a percent above pre-pandemic levels. This is a key part of the Great Inflation story, in 1965 when LBJ began his Great Society spending boom, transfer payments were 5.9% of disposable income, by the time Nixon resigned they were 13.1%. Medicare and Medicaid were the opening salvo, they were targeting a market failure, but the cost was readily apparent in medical services inflation which jumped from 3% to 10% in the years following passage in 1965. The government spending contribution to GDP averaged 0.82% over the last 4 quarters even as the Fed was tightening policy to the most restrictive level since the Volcker Fed. Turns out the fiscal expansion began in 2019 after the Trump Administration agreed with Senate Majority Leader Schumer and Speaker of the House Pelosi to bust the 2011 Budget Control Act 2% annual spending increase cap. During the first two years of the Trump Administration the government spending contribution averaged 0.29%, in 2019 it was 0.82%. A fiscal spending boom even as the Fed tried to control inflation, at least until the mid-'70s, is the story of the '60s and '70s Great Inflation, whether 6-7% deficits lead to a debt crisis or not, they are inflationary. Goods deflation is flattering headline inflation at present, but lingering underneath the surface is damage to the supply side of the housing market as evidenced by existing home sales at the slowest rate in the history of the series beginning in 1999, and a fiscal boom that will surely boost domestically determined non-housing services inflation.

*AFTER THE FALL, Carmen M. Reinhart Vincent R. Reinhart*

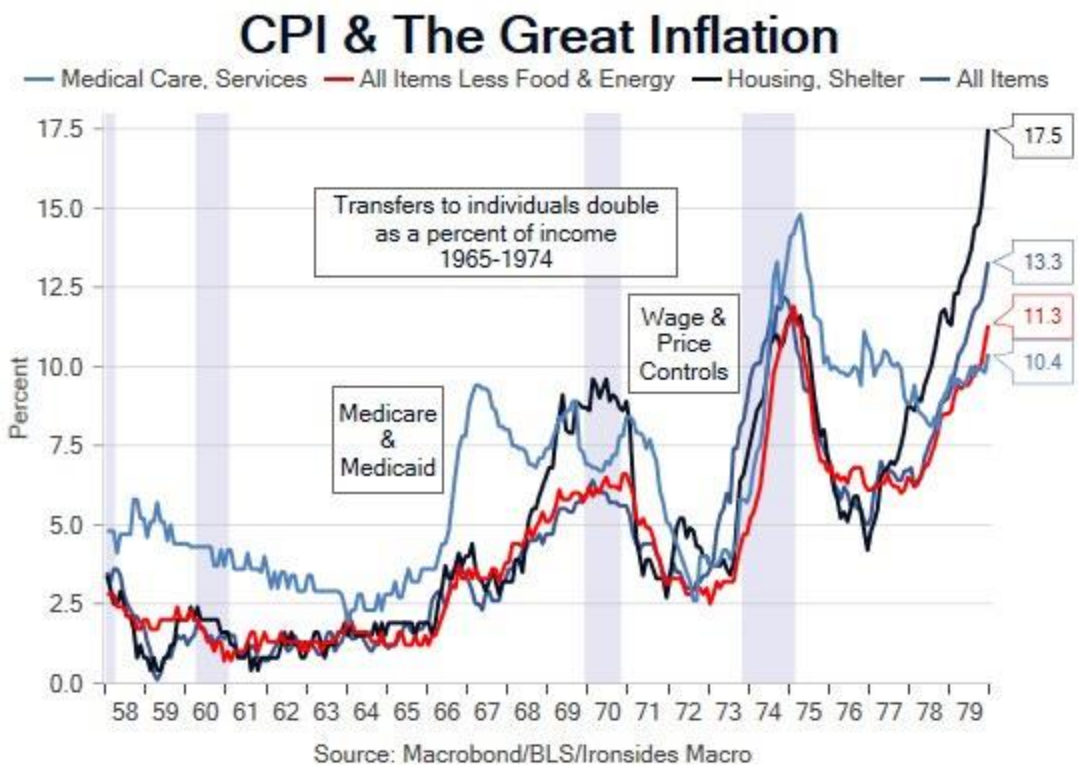


*Figure 2: The over 65 population was underinsured in the early '60s, Medicare filled a market gap, but the costs were shared by the entire population through rapid medical care services inflation.*

## Unwinding Financial Repression

In a discussion with a client this week about the path for the Treasury market we looked back at the '50s and '60s as the effect of the World War II rate caps dissipated. The Fed/Treasury Accord capped bill rates at 3/8% from 1942-1947 and longer maturities at 2 1/2% until 1951. Because of the rate cap structure banks, rather than the Fed, monetized the majority of the debt, at the end of the War 70% of bank credit was invested in government securities. The divestment of government securities to 20% of bank credit took 30 years. As banks slowly unwound their holdings and the Fed moved to a 'bills only' balance sheet policy, rates worked higher during expansions, retraced a portion of the increase during recessions, making a series of higher highs and lows for nearly 30 years. Forecasts of 10-year USTs returning to 3% are only likely to be realized if there is a consequential recession and are unlikely to remain near that level unless the Fed ends paydowns of mortgage-backed securities and holds the duration of their Treasury portfolio constant. Such an approach would be a massive mistake that would cause Hayek to roll over in his grave.

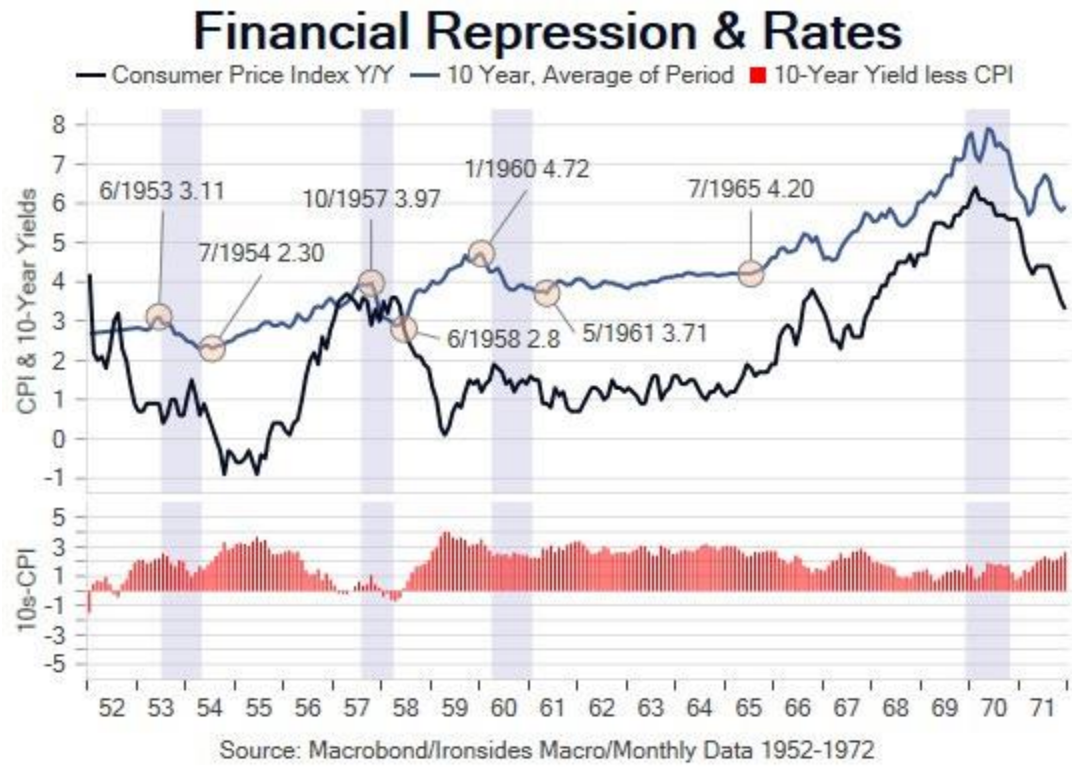


*Figure 3: As the effects of financial repression faded, rates steadily increased through the '50s and early '60s, prior to the increase in the rate of inflation.*

## Retail Sales: Goods Demand Stabilization & Technology

Stronger than expected December retail sales increased the Atlanta Fed 4Q23 personal consumption expenditure tracking model from 2.555% to 2.846% and the GDP model from 2.233% to 2.412%. While the report was a setback for the Treasury market and the implied probability of a March rate cut, the report had little to no impact on our outlook. With government deficits at record non-recessionary levels, Congress nearing another increase in transfer payments to individuals (child tax credit) and households in an exceptionally strong position due to 15 years of deleveraging as evidenced by financial obligation ratios (interest payments/disposable income) near all-time lows, a drop in consumption is unlikely to be the catalyst for a significant deceleration in growth. The chart below shows the annualized rate, deflated using Consumer Price Core Goods, while the current rate is above trend, that is likely attributable to below trend growth in 2022. The quarterly annualized rate (GDP methodology) is right on the longer-run trend.


*Figure 4: The increase in the annualized rate of retail sales looks like a recovery in goods consumption more than an acceleration in aggregate demand.*

We expected stronger goods consumption relative to services in 2023 as the pandemic policy response related imbalances normalized. In 2020 the combination of mobility restrictions and massive fiscal stimulus led to a surge in goods consumption. In 2021, following the removal of restrictions, services consumption surged and continued to run above goods throughout 2022. Through 3Q23, using mid-2014 when household sector deleveraging dissipated as our base, services consumption is running $216 billion above the $9.86 trillion trend. Goods spending is $54 billion below the $5.41 trillion trend. On balance, it appears the revenge travel and date/family night dinners at your favorite restaurant are winding down. Next week brings the advanced estimate of 4Q23 GDP and the December monthly consumer spending report, keep in mind the preliminary quarterly services survey is not available until 50 days after the end of the quarter. Last quarter's advanced estimate for services was 3.6%, the first revision was 3.0% and 'final' was 2.2%. The first two monthly guesstimates for 4Q services spending were the same rate as the average 3Q monthly change, we suspect trend services is ~2%. Not exactly booming growth.

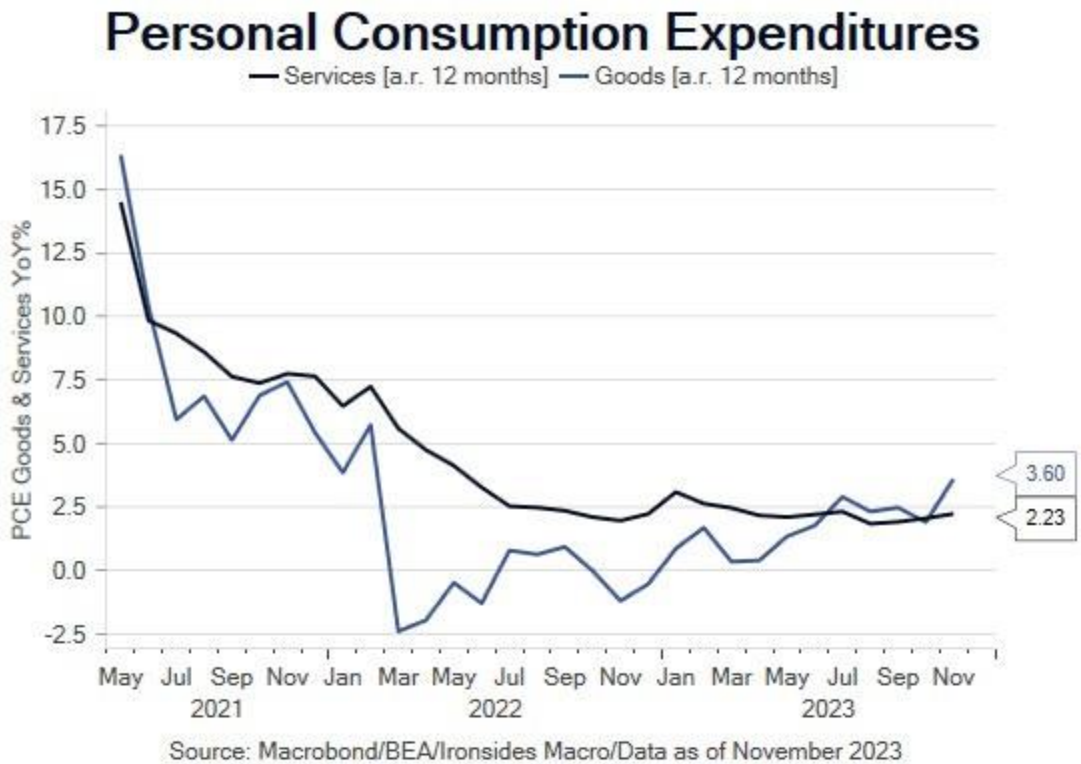


*Figure 5: The monthly personal spending numbers show the relative recovery of goods consumption. We get more data next week but would caution that the services numbers are subject to large revisions until the advanced quarterly services survey 50 days after the end of the quarter and final report a month later.*

One final thought on retail sales that offers some evidence of the pandemic accelerating technology innovation adoption leading to faster productivity growth. The '90s buildout of internet infrastructure generated tremendous excitement until the early '00s bust when investors realized at that point, Amazon was little more than an online bookstore that drove Barnes & Noble out of business. We recall a multi-client idea dinner in 2003 where a hedge fund detailed massive retailer bricks & mortar floor excess capacity. It was 10 years and a massive recession before retailers began to rationalize excess floor space. Shortly after the financial crisis, the trendline of ecommerce market share accelerated from linearity to exponential. In Alexander Field's excellent book, "A Great Leap Forward", he describes how the '90s productivity boom was largely contained in three sectors, technology, telecommunications and finance. In the '00s, excess capacity in fiber optics cables facilitated the emergence of the streaming industry.

Late in the ‘10s, productivity growth recovered to the post-war trend after running at a very low rate for most of the cycle as technology innovation adoption in the delivery of consumer services. In this sense the post-financial crisis cycle was similar to the main topic of Field’s book, how the plunge in demand masked technology innovation of the prior decade (intermodal transportation was a big part of the story) and disruption of business practices facilitated innovation adoption. We expect to see further evidence developing in the ‘20s of substitution of technology for labor. When we looked at Truist Financials’ investor presentation after earnings Thursday, the first slide was about client penetration of their on-line services. While that is an anecdotal example, we expect banks to realize having a branch as the anchor tenant for every strip mall in the country might have worked as an advertising tool when the cost of deposits was zero, in the ‘20s they need to get more efficient. We suspect the buildout of cloud infrastructure in the ‘10s to diffuse across additional sectors including healthcare, finance and manufacturing. The process seems likely to begin slowly and persist for the next couple of decades. Meanwhile, we suspect the generative artificial intelligence excitement may fade into the Amazon bookstore analogy. Maybe we sound like Luddites, but let’s begin with your doctor using electronic health records rather than paper folders before we get too excited about mRNA shots that don’t work.

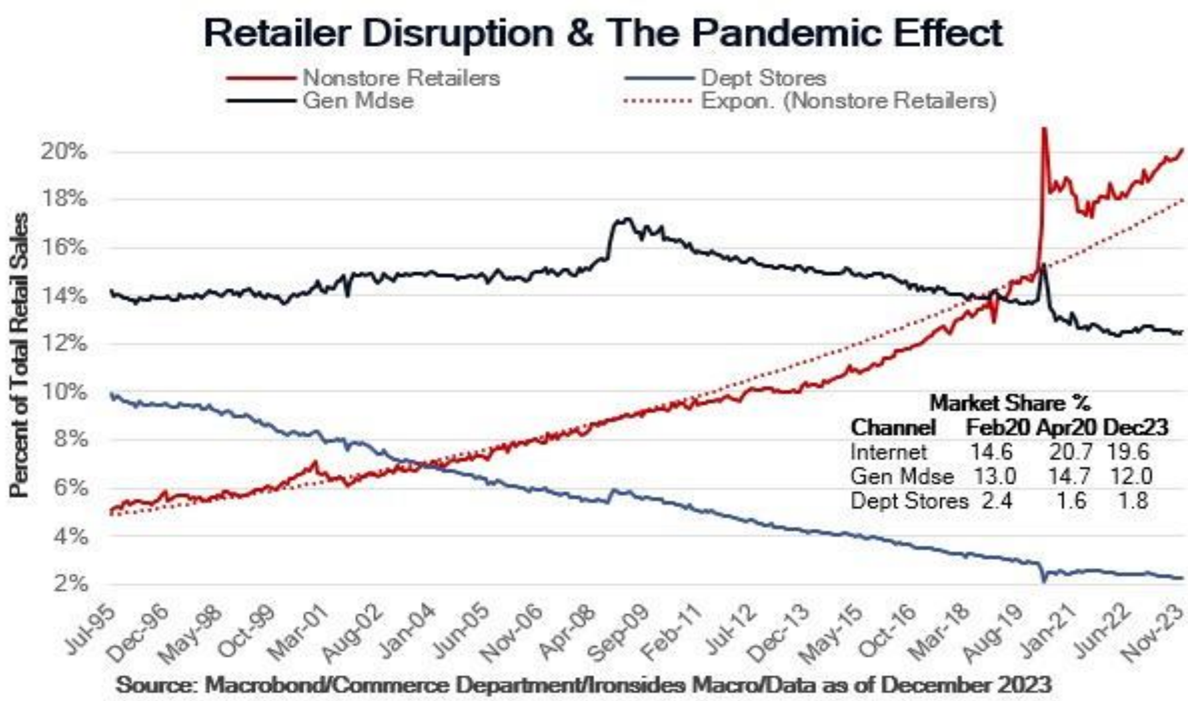


*Figure 6: The pandemic converted even boomers into ecommerce shoppers.*

## Final Thoughts

Next week brings the advanced guesstimate of 4Q23 GDP, the Fed's preferred PCED inflation measure, $162 billion of supply in the belly of the curve (2s, 5s and 7s), earnings from multi-line industrials, rails and the start of the technology sector results and the Fed quiet period. The chart below shows the relative multiple of the equal weighted S&P 500 to the cap weighted index measured in standard deviations from the median. While it is stretched, one standard deviation is unlikely to be sufficiently stretched to preclude the current trend from persisting. Tactically, the rally of the last few weeks does raise the hurdle for big tech's results the week after next just as the Fed seems likely to dampen the market's mood. That said, the equity market is likely to outperform Treasuries, until and unless the move in USTs picks up downside velocity.


*Figure 7: The equal weight S&P is cheap, but not extremely.*

| US Equity Market Valuation Index/Sector | PE | Fwd PE | P/S | P/B | EV / Sales | EV / EBITDA | Z-score | Ironsides Strategic Weighting | ERP | ERP Z-Score |
|---|---|---|---|---|---|---|---|---|---|---|
| SPX | 23.80 | 20.45 | 2.63 | 4.55 | 2.90 | 14.99 | 1.40 | Underweight | 2.67% | 1.51 |
| SPW (equal weight) | 16.09 | 15.77 | 0.02 | 2.90 | 1.98 | 11.17 | 0.30 | Underweight | 3.71% | 1.70 |
| Discretionary | 29.25 | 24.12 | 2.26 | 9.34 | 2.53 | 16.27 | 1.68 | Market | 2.08% | 1.13 |
| Financials | 16.75 | 14.80 | 2.29 | 2.05 | 2.33 | #N/A N/A | 0.27 | Underweight | 4.55% | 1.11 |
| Technology | 38.15 | 30.39 | 8.03 | 11.67 | 8.13 | 25.80 | 2.21 | Market | 1.11% | 1.41 |
| Comm Services | 21.97 | 17.72 | 3.42 | 4.03 | 3.81 | 13.76 | 1.43 | Market | 3.08% | 1.63 |
| Industrials | 22.80 | 19.74 | 2.15 | 5.54 | 2.57 | 16.34 | 1.48 | Overweight | 2.80% | 1.25 |
| Materials | 19.03 | 18.64 | 1.98 | 2.86 | 2.35 | 12.28 | 0.91 | Overweight | 3.32% | 0.83 |
| Energy | 9.85 | 10.93 | 1.14 | 2.06 | 1.31 | 5.90 | -0.04 | Overweight | 7.69% | -0.60 |
| Healthcare | 23.58 | 18.40 | 1.75 | 4.90 | 1.90 | 16.90 | 0.29 | Overweight | 2.78% | 1.30 |
| Staples | 20.63 | 19.67 | 1.37 | 5.80 | 1.60 | 15.98 | 0.64 | Underweight | 3.14% | 1.12 |
| Utilities | 17.00 | 15.25 | 2.09 | 1.83 | 3.98 | 12.32 | 0.88 | Underweight | 4.30% | 1.02 |
| Real Estate | 41.87 | 36.23 | 6.48 | 6.48 | 8.93 | 20.35 | -0.70 | Underweight | 0.85% | 1.20 |
| Russell 2000 | 32.64 | 23.50 | 1.20 | 2.00 | 36.44 | 1.68 | 0.17 | Underweight | 1.34% | 1.22 |

Source: Bloomberg/Ironsides Macro/Data as of January 2024

*Figure 8: No changes*

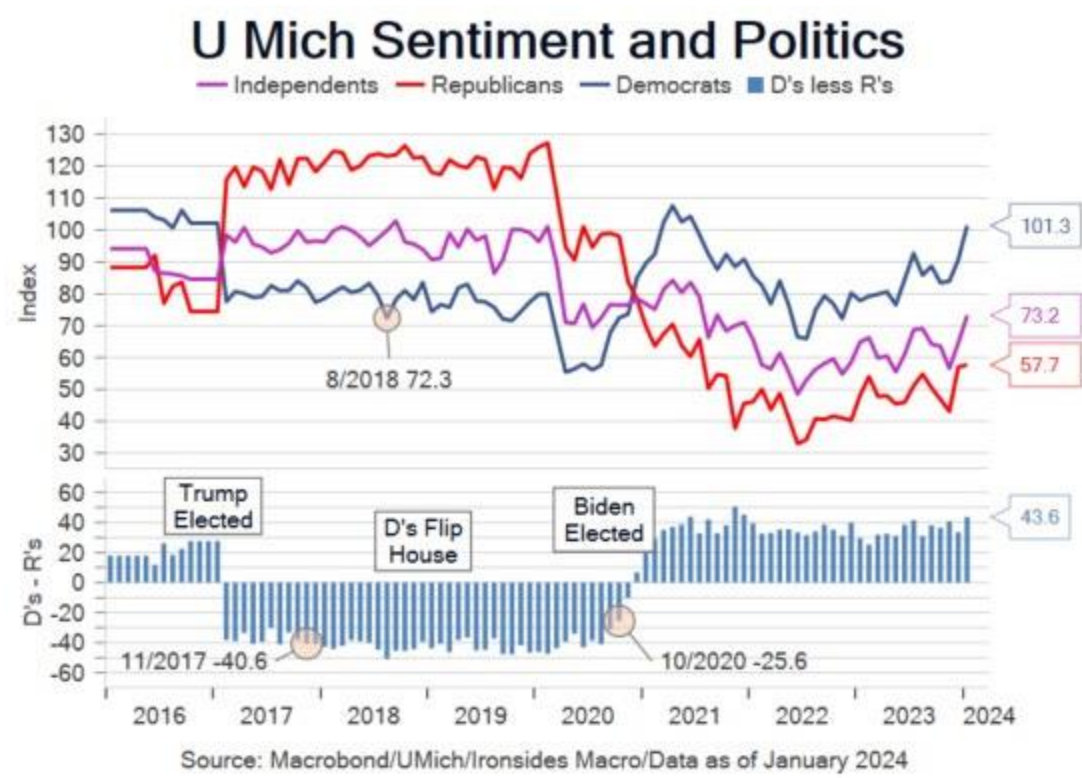


*Figure 9: The energy/anger still favors R's over D's but the recent bounce in sentiment, particularly for independents, should be a warning sign for R's who appear to be on the verge of nominating a candidate who contributed to the loss of the House in '18, the White House and Senate in '20. Bank capital is the most pressing investor issue at stake in November in our view.*

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