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That deficit again!

Westminster Assets Management's Investment Strategist Peter Lucas believes the top is in place for inflation, for the moment, but remains cautious on equities in the near term and positive on bonds.

The US fiscal deficit is back in the news again, widening as it has done back to 8.5% of GDP in June. Although that is small beer next to the 18%+ COVID deficit, it is now bigger than anything seen in the pre-COVID period bar the depths of the 2008 financial crisis economic slump. This is just the annual deficit mind, which is adding to the national debt, which the IMF says will reach 122% of GDP by the end of this year. The widening and size of the deficit at a time of positive economic growth and low unemployment is unusual. Normally the deficit is hostage to the fortunes of the economy, widening in tough times (and shrinking in good) as economic stabilizers like unemployment benefit kick in.

In an earlier strategy note ("Baked in the cake", September 2021) I demonstrated the close correlation between the deficit and the output gap (a measure of the amount of spare capacity in the economy). Crucially, I also demonstrated that large cyclically adjusted deficits have historically been associated with accelerating inflation. At the time the Congressional Budget Office was forecasting a shrinking output gap and biggish deficits for the next decade, a combination that I predicted would mean accelerating inflation for years to come. The Fed's favourite inflation gauge, the personal consumption expenditure prices – then rising at a year-on-year rate of 3.9% – was projected to reach 4% by the end of 2021 (actual was 5.0%), 4.6% by the end of 2022 (4.6%) and then rising steadily to double-digits by the 2030's. Although simplistic and based on forecasts that would be hostage to fortune, the conclusions of that analysis were very much consistent with my broader macro view.

As I understand it, the recent widening of the deficit has had two main drivers: (1) fiscal packages designed to, amongst other things, facilitate the switch to a cleaner, greener economy and (2) a rising interest bill due to higher interest rates and bond yields (both consistent with predictions made here in these notes). This positive fiscal thrust may explain why the economy has proved to be more resilient than many, me included, thought would be the case in 2023 and why bonds have failed to rally in the face of peaking inflation and sagging manufacturing indicators.

The immediate prognosis for inflation is positive. China remains in the doldrums and is exporting deflation; commodity price inflation is still negative; peaking/stabilizing property prices will mean lower owners' equivalent rent inflation in the months ahead; and the risk of a recession due to the unprecedented increase in interest rates remains real. However, as the above analysis indicates, the longer-term outlook is less propitious. Big deficits are here to stay given the cost of the Green Agenda and higher interest rates. China, with its low inflation rate, has significant room to support the economy and will surely do so eventually, thereby becoming a more inflationary influence on the world, partly through its influence on commodity prices. Indeed, the likes of wheat and natural gas appear to have already passed their low point for the cycle, partly because of the latest developments in Ukraine.

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The longer-term worry must be that a combination of growing debts and rising interest rates will force governments and central banks to intervene, in the same way that the Bank of England did in the 'Truss gilt melt-down.' A combination of financial repression (forcing institutions to buy government bonds) and Japan-style yield curve control would undoubtedly darken the outlook for inflation further.

Like inflation, the immediate outlook for bonds is positive. Inflation has clearly past its high point and is trending lower, for now at least; value is reasonable, or good in the case of gilts; positioning in the futures market is at levels consistent with a short-term trough in bond prices. Meanwhile, equities look less compelling: having been negative at the start of the year, investor sentiment is now very bullish by historical standards; valuation, particularly amongst the tech heavyweights, is poor; recession forecasts, which were all the rage at the start of the year, have been ditched or pushed back to 2024. Any bad economic or geopolitical news here could produce a meaningful reaction from the markets. Several high-profile equity bears have admitted defeat of late, but I am not inclined to do so. That said, if we do get a decent-sized rally in government fixed income, I will be looking to use that as an opportunity to switch into other assets, including inflation-linked bonds.

Peter Lucas

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