WEEKLY ECONOMIC COMMENTARY

APRIL 12, 2024

IN THIS ISSUE:

- **Higher, For Longer**
- **Keys To Fixing The U.S. Budget**
- **China's Currency Challenge**

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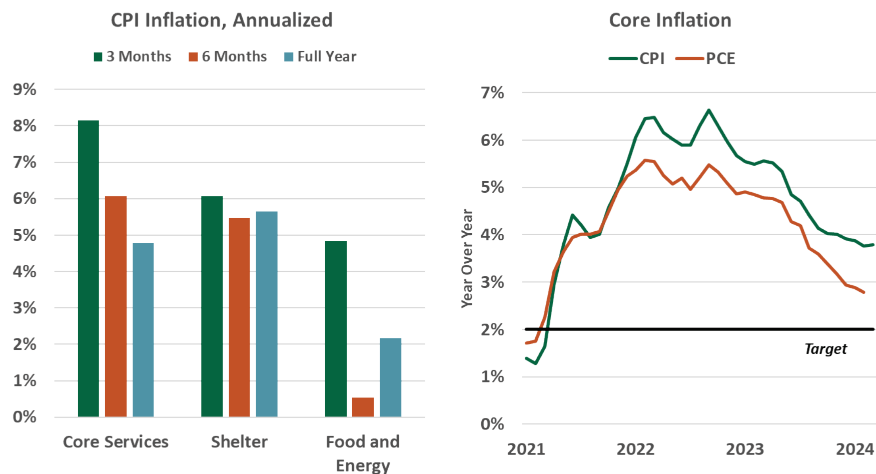
Parents of young children will recognize the danger of a one-word question: "Why?" By persistently asking why, a child can frustrate and unravel the thinking of their caregivers.

We are re-learning the power of that simple question. We had expected the Federal Reserve to start cutting rates in June. But as more of our audiences asked why, we saw the case was not strong. This week's inflation reading seals the deal: we now expect the easing cycle to start in September.

The consumer price index (CPI) for March was above expectations, rising 0.4% for the month on both a headline and core basis. The details were all too familiar: shelter inflation remains stubbornly elevated. Core services excluding housing ticked upward, led by volatile categories like vehicle maintenance and insurance. On a year over year basis, core service prices have been rising since October 2023; components of this category share a common dependency on labor. New immigration has not yet relieved the limited supply of skilled workers, and their wage gains are passing through to prices.

While the Fed targets personal consumption expenditure (PCE) inflation rather than CPI, the two indices have moved in tandem in this cycle. And while the target excludes the volatile categories of food and energy, higher gasoline prices will keep this matter top-of-mind for consumers.



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis, Haver Analytics

Another factor arguing against reducing rates is the persistent strength of the American economy. In 2019, the Fed cut rates by 75 basis points in anticipation of weakening growth. We see no softening today, and no need for a similar proactive cut. Employment and personal income are both exceptionally strong. Sectors that were shocked by the rise

in interest rates, like banking and homebuilding, have adjusted to the new rate regime. Risk assets are rallying, credit spreads are narrow, and financial conditions are easy.

The Fed has emphasized their data-dependent approach, but they do risk putting too much weight on recent readings. The uncooperative start to 2024 follows a good disinflationary run in 2023. The risk of a new reflationary cycle remains low, absent any further supply shocks. A dovish policymaker could make a case for cuts in light of the long-run improvement. On this basis, we do still expect to see easing later in the year. However, the current Fed governors remain committed to their objective of taming inflation. Further progress will be needed, more than can be seen between now and June.

Firm inflation adds to the reasons for the Fed to defer rate cuts.

The last mile of the inflation recovery always loomed to be the hardest. Initial progress down from the peak was easy as stimulus programs ended and supply chains healed, but the remaining distance will require policy discipline. If we ultimately achieve a soft landing, holding rates higher for even longer will be an important reason why.

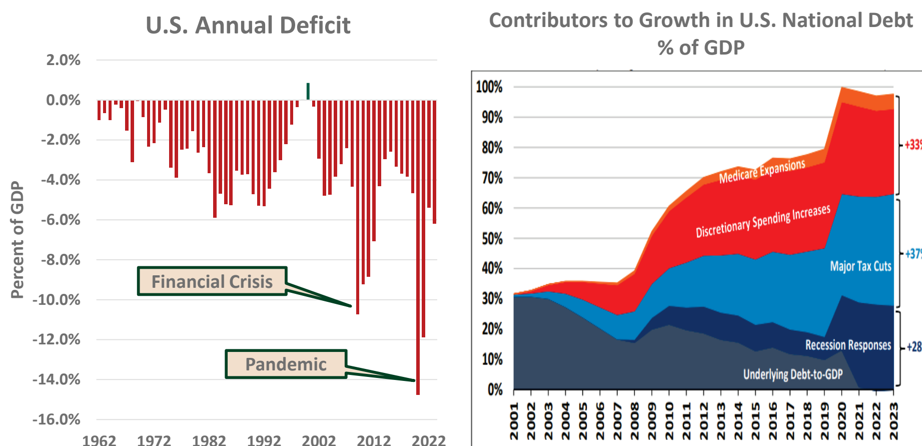
Angling For Answers

I've just concluded two weeks of client briefings in Florida. We covered nine cities, spread across more than 700 miles. It was a challenging itinerary, but it was a treat to visit with so many clients and partners.

I did get a respite during a weekend in Key West, which features a buoy marking the southernmost point of the continental United States. I thought of that icon as I reflected on the fortnight of conversations. The most frequently asked question (by far) was how much further south the finances of the United States might drift in the years ahead.

We've covered some of the issues related to America's fiscal crisis in recent months. (Two entries in that catalogue can be found here and here.) Clients raised some additional questions about the national debt, answers to which I thought it would be useful to share formally.

- **How did we get into so much debt?** It is hard to recall, but the United States had a budget surplus in the year 2000. But rather than use the excess to retire debt or shore up Social Security, Congress chose to rebate the amount (and then some) to taxpayers and initiate new programs. That re-started the red ink, which has flowed freely ever since.



Sources: Congressional Budget Office, Committee for a Responsible Federal Budget

The Committee for a Responsible Federal Budget estimates that tax cuts and spending increases have added debt equal to 70% of gross domestic product (GDP) during this century. Had those measures not been taken, the national debt might have been retired by now.

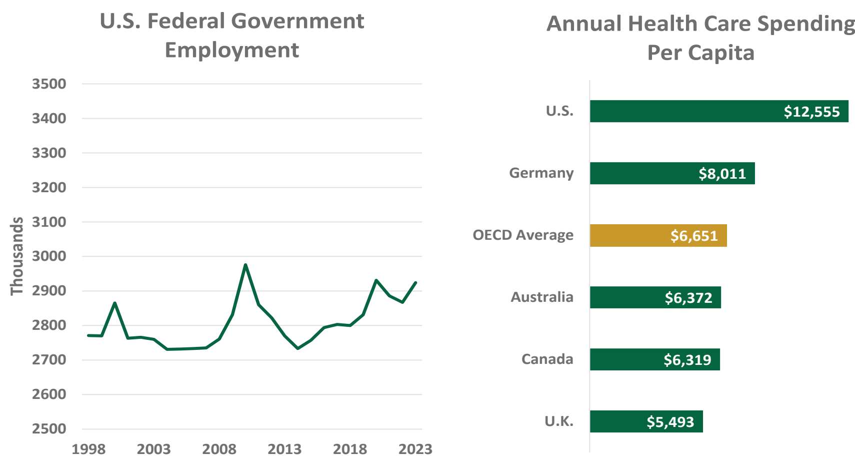
The magnitude of the debt is even more frightening when viewed in the context of very strong economic and market performance during the past two decades. We may not be able to count on that kind of performance persisting into the future.

- **Whose fault is it?** It is certainly tempting to lay blame for deepening deficits at the feet of one party or another, and plenty of people do. But leaders of both parties have contributed to the situation. The four presidents who have served during the 21st century are responsible for about 70% of our national debt. Two of them have been Republicans, and two have been Democrats. During the past 23 years, the Senate has been in Republican hands for 12 years, and the House has been led by the GOP for 15 years. The bottom line: neither party can claim a high road when it comes to fiscal discipline.

Progress on the national debt will require compromises on both taxes and spending.

The early polls suggest that divided government is the most likely outcome of this year's U.S. election. Further, recent history suggests that neither party is likely to have full control over the government for very long. What this illustrates clearly (at least to me) is that a durable solution can only come through collaboration between the parties. The two sides are going to have to compromise if lasting progress is to be made.

- **Why is it so hard to shrink the size of government?** Some people gauge the size of government by the number of federal employees. By that metric, government hasn't grown much at all in the last 35 years. It is the scale of government programs that has mushroomed.



Sources: BLS, Haver Analytics, OECD, Kaiser Family Foundation

Discretionary spending that is not related to defense accounts for 15% of federal outlays. A review of this segment is certainly warranted, but meaningful spending discipline cannot be achieved without tackling the other 85%: defense, Social Security, Medicare/Medicaid, and interest. Defense is a poor candidate for cuts amid geopolitical uncertainty, and interest on the debt can't be reduced by fiat. That leaves the two big entitlement programs.

Social Security has required significant restructuring on three occasions since 1977. Each time, some combination of changes to eligibility, retirement ages, payroll taxes and benefit levels was employed to return the system to long-term solvency. Means-testing benefits has some appeal,

as Social Security is an insurance program, not an entitlement program. (People do not have individual Social Security accounts, despite popular perception; the system relies on working age people paying retirees.)

The good news is that longevity in the United States has improved, and the new class of GLP-1 drugs (like Ozempic and Mounjaro) are likely to extend life spans. But the average American now spends almost 20 years as a retired person, as opposed to about 13 years when Social Security was initiated.

Medicine is considerably more complicated. The United States spends almost twice as much per capita per year than the average developed country on health care, but outcomes (life expectancy, infant mortality, the incidence of chronic disease) are often worse. Stakeholders in the system agree on one thing: we are not getting our money's worth.

Shrinking government will require tackling entitlement programs.

There are formulae that would begin to bend the health care cost curve, but any reform would come at the expense of at least one stakeholder. Each group has strong lobbying interests in Washington, which serve to slow progress.

Social Security and Medicare are often referred to as the third rail of American politics. Those who dare to tread on them risk paying a costly price at the ballot box. We'll need some courageous legislators to begin addressing these two behemoths.

While in Key West, we visited Ernest Hemingway's home. The walls were festooned with pictures of the author catching game fish: marlin, grouper and tuna.

The United States is fishing for solutions to its budget crisis. We'd better bring strong tackle, and use the right lures.

Resistance

We recently highlighted how Chinese equities have fallen out of favor, amid lingering economic concerns. Investors have turned sour on prospects for China's growth, reflected in elevated capital outflows.

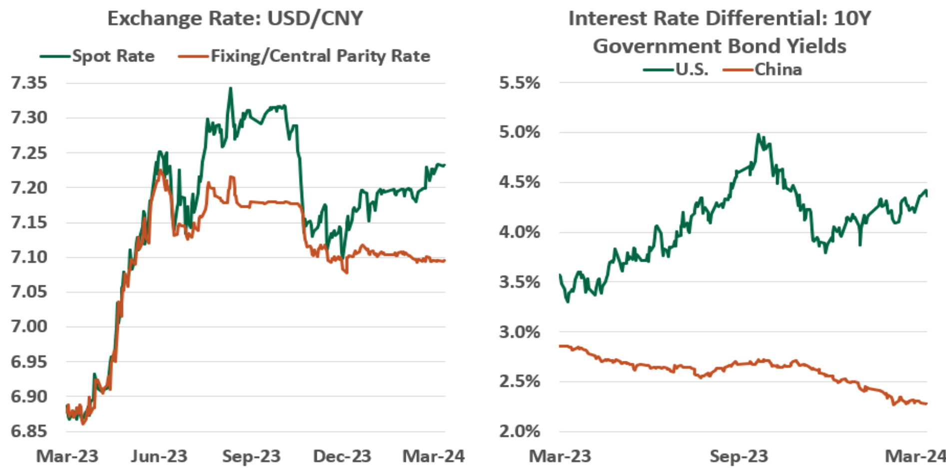
The apprehension appears to have spread to currency markets. The Chinese yuan (CNY) breached 7.2 against the dollar last month, a level that policymakers had been defending for months. The CNY is not free-floating like other major currencies: it is actively managed by China's central bank (the PBoC). The PBoC establishes a starting level (or fixing) each day, and the yuan is allowed to trade 2% above or below the fixing.

The CNY has been trading close to the weaker end of the of its daily band in recent weeks. The yuan's poor run is largely explained by the widening U.S.-China interest rate differential. U.S. Treasuries are offering much higher yields than those in China, driving investors toward American bond markets. Prospects of a delayed and more gradual easing cycle by the Fed, along with expectations of proximate easing from the PBoC, have added to the downward pressure.

A weak currency should be good news for an economy which is referred to as the world's factory, as it could help China export its way out of trouble. But Chinese exports are already garnering increased scrutiny from the West. Concerns over excess production and dumping were at the core of talks during U.S. Treasury Secretary Yellen's recent visit to Beijing. By allowing the CNY to depreciate further, China faces the risk of being labeled a currency manipulator by the U.S., a declaration that would initiate additional trade restrictions.

Lasting currency weakness will further dent sentiment, as the yuan is often considered an indicator of confidence in China's domestic economy, and make Chinese equities even less attractive for global investors.

These factors explain why the appetite for another bout of currency depreciation is low. The PBoC has been continuously setting a stronger fixing to support the yuan.



Source: Haver Analytics

One simple way for central banks to prop up the value of their currencies is by raising interest rates. The PBoC lacks that option, as it has been forced to ease rates in an attempt to stimulate activity. Instead, policymakers have been relying on tools such as asking state-owned banks to sell dollars to prop up the value of the CNY. As in the past, the PBoC can also cut banks' foreign currency reserve ratio and boost the cost of shorting the currency.

Letting the CNY depreciate would do more harm than good to the Chinese economy.

Another potential action step would be to tighten controls over its capital account. Substantial amounts of money have been departing China, on the instruction of both foreign and domestic investors. Bringing the gates down would stop the flow, but such an action could be seen as a desperate measure. It would also make attracting new investment much more difficult.

With the Fed unlikely to cut before September 2024 and China trying to fend off deflation, the pressure on the currency is likely to persist in the near term. While some see manipulation behind the yuan's decline, it is more likely the result of natural causes. The United States, and China's other trading partners, should keep this in mind.

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