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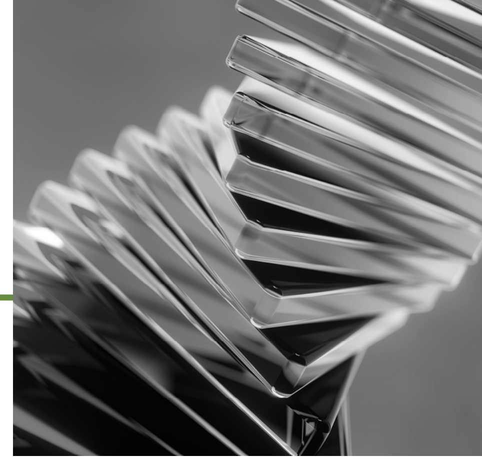
MARKET SIGHT*LINES*



One Headwind to AI Optimism: The Looming U.S. Fiscal Transition

By Michael O'Keeffe, *Chief Investment Officer*

The S&P 500 is up 15.6% year to date, with many attributing these strong results to the optimism about the long-term economic benefits of artificial intelligence (AI). In periods of such broad optimism, it is important to monitor potential short-term headwinds, like slowing consumer spending in the current environment. Perhaps more importantly though, we should look to identify issues that may serve as a long-term headwind to the economic environment. And a Congressional Budget Office (CBO) budget update brings the focus back to our deficit spending and debt. In this week's Sight|Lines, we review the concept of *Fiscal Transition* and discuss the implications of the latest CBO budget update.

THE TAKEAWAY: USING DEBT TODAY IS SETTING US UP FOR FUTURE PAIN

The buildup of debt and higher rates spell trouble. In summary:

- Following the Great Recession, the Federal Reserve (Fed) adopted an accommodative monetary policy that brought market interest rates down, lowering the cost of debt.
- Each segment of the U.S. economy – consumers, businesses, and our government – added significant debt during this period of lower interest rates.
- In the wake of the pandemic recovery, inflation heated up, requiring the Fed to reverse course, raising interest rates and the cost of debt.
- We believe consumers, businesses, and our government must work through a painful *Fiscal Transition* to rein in debt, and the cost of debt, going forward.
- The latest CBO 2024 budget update brings this into focus, as we see firsthand how components of spending push the deficit and debt dramatically higher.
- Market forces will drive consumers and businesses to manage debt better, but political leaders have thus far been unwilling to focus on true fiscal discipline, begging the question: When will this change?

IN-DEPTH: DEFICITS AND INCREASING DEBT TO FUEL SPENDING TODAY IS SETTING US UP FOR PAIN IN WHAT NOW MAY BE THE NOT-TOO-DISTANT FUTURE

The buildup of debt across our economy and higher rates for longer will translate to economic pain in what may be the not-too-distant future. Going deeper:

- Following the Great Recession, accommodative Fed policy brought down market interest rates:
  - The fed funds rate was set at a range of 0% to 0.25% from 2008 to 2015.
  - The 10-year Treasury yield averaged 2.4% over the decade following the Great Recession and 1.8% in the three years from the start of the pandemic.
- Each segment of the U.S. economy added significant debt during this period:
  - Consumers added $5.3 trillion in debt.
  - Businesses added $8.6 trillion in debt.
  - Through deficit spending, our government has added an additional $25 trillion in debt.
- Higher inflation has meant a more restrictive Fed policy, higher rates, and a *Fiscal Transition*:
  - The fed funds rate sits at 5.25%-5.50%, the 10-year Treasury yield is at 4.3%, and forward rates from the yield curve imply the 10-year will remain above 4% for decades.
  - Consumers, businesses, and our government must bear higher debt costs, a period of painful *Fiscal Transition* as each area must learn to manage debt better.
- The latest CBO 2024 budget update brings this into focus:
  - The CBO increased its 2024 budget deficit estimate by 27% to $1.9 trillion, $400 billion more than its February estimate.
  - Most of the increase can be attributed to (i) aid to Ukraine, Israel, and Taiwan, (ii) student loan relief, (iii) FDIC support of failed banks, and (iv) increased Medicaid spending.
- Each segment of the economy must learn to manage debt better as debt costs increase:
  - Consumers and businesses will experience pain immediately if debt is managed poorly.
  - Our government deficit and debt management is more complex:
    - The CBO estimates our annual debt cost will increase to $1.7 trillion in 2034.
    - So far, voters are not prioritizing fiscal discipline during elections.
    - We believe this topic will become a priority for voters within the next five years.

CONCLUSION

There's been a lot of the optimism about artificial intelligence (AI), driving markets higher. During periods of optimism and market strength, we must be mindful of potential headwinds like slowing consumer spending. We must also identify longer-term headwinds, and a recent CBO budget update brings focus back to the idea *Fiscal Transition*, or the need for our economy to better manage debt going forward. And the question remains: When will voters and our political leaders prioritize fiscal discipline?

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