# Weekly Market Commentary

## *September 28, 2020*

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It was another tumultuous week in Washington, highlighted by the controversial move by Republicans to quickly appoint a Supreme Court justice to replace Ruth Bader Ginsburg following her death over the weekend. In the current highly-polarized environment, this is another battle that is inflaming tensions and perhaps could affect the outcome of the election. From a macro perspective, it also dims the outlook for a pandemic relief bill that many believe is critical to sustain the recovery. As Senator Roy Blunt (R.,Mo) so aptly put it, “there’s just not enough oxygen left in the room to get that done.”

Despite ongoing overtures from House Democrats, who are poised to introduce a recalibrated $2.4 trillion bill next week, a more modest compromise proposal by the so-called bipartisan House Problem Solvers Caucus and the ongoing lobbying efforts by Fed chair Powell before Congress this week, the prospect of additional fiscal aid seeing the light of day before the election is long. Simply put, the wall of worry is growing, as is the list of uncertainties buffeting the financial markets. Despite an impressive rally on Friday, the stock market declined for the fourth consecutive week and is on track for the worst September showing since at least 2011.

To be sure, political bickering is not the only influence shaking up the financial markets. The COVID-19 risk remains front and center, as cases are once again rising in parts of the nation, prompting renewed social distancing mandates that could stifle the reopening process. Election uncertainty is also becoming a more palpable influence, as the candidates have distinctly different fiscal priorities that would have a huge influence on the economy in coming years. Then there is the matter of how legislators view the current state of the economy as well as their conflicting attitudes on deficit spending. Some believe that the economy is doing just fine, thank you, as validated by the outsized growth rate underway for the third quarter. This group would prefer to wait a while to see if momentum can be sustained in the fourth quarter without further blowing up the federal budget, which is already absorbing more of the economy’s resources than any time in the post-World War II era.

But the issue of burgeoning government deficits may be camouflaging a potentially more ominous trend in the private sector, namely the escalating volume of debt that businesses have been taking on this year. According to the Federal Reserve’s latest flow of funds data, nonfinancial business debt increased at the fastest rate on record over the first half of the year, posting annual gains of 18.4 percent and 14.0 percent in the first and second quarters, respectively. Those increases lifted total debt outstanding to $17.6 trillion, fully 90 percent of GDP. That outsized share dwarfs anything seen in the post-war era and comes at a time when the recovery is entering a perilous phase of slower growth that could well deprive companies with the revenues needed to service debt.

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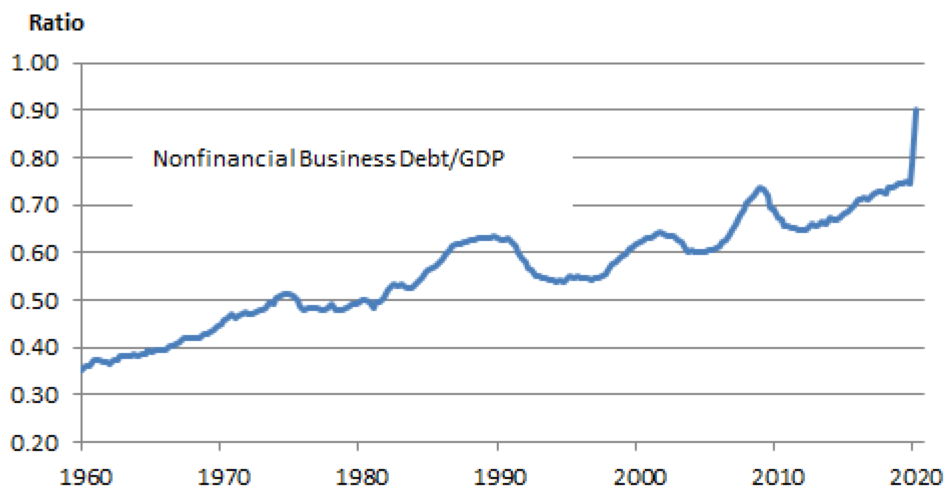
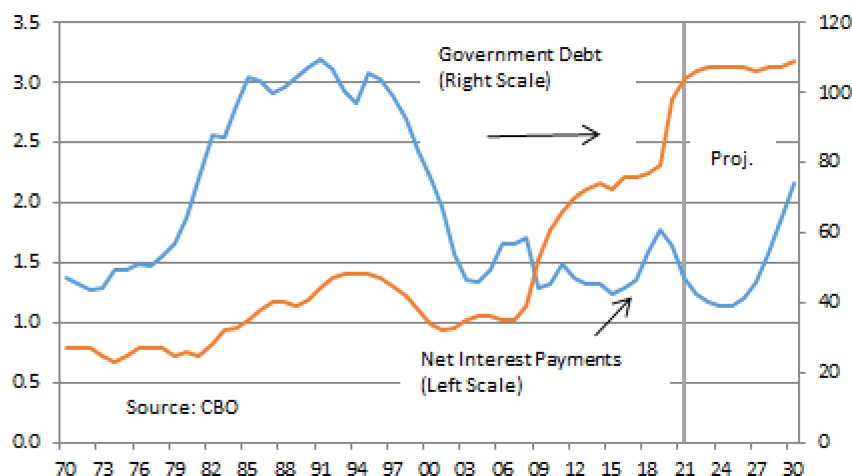



Not surprisingly, record increases in corporate bond issuance drove the debt increase, fueled by historically low interest rates and eager investors seeking higher returns than the skimpy yields on Treasury securities. But the outsized debt build-up also comes at a time of weakening corporate profits. Indeed, corporate cash flow slipped below capital spending, resulting in the first negative financing gap since 2018 in the second quarter. Of course, the economy suffered its worse contraction during the period since the Great Depression, which vaporized business revenues. It remains to be seen how much of a revenue boost the third quarter rebound in activity has generated.

That said, legions of companies have been able to raise copious amounts of funds at historically low rates that are locked in for years to come. But it's also noteworthy that a less credit-worthy group of borrowers accounted for an ever-larger share of these issuers, as lower-rated bonds dominated activity in the new issue market. Despite the heightened risk of default should the economy falter in coming quarters, credit spreads have tightened considerably since the second quarter, with the yield premium on junk-rated bonds over Treasury issues about half of what it was in late March. More recently, however, investors have demanded a larger premium, as spreads widened by about 70 basis points over the past three weeks. Still, the current six percentage point spread between high-yield bonds and Treasury securities is well below the 11.4-point spread on March 23.

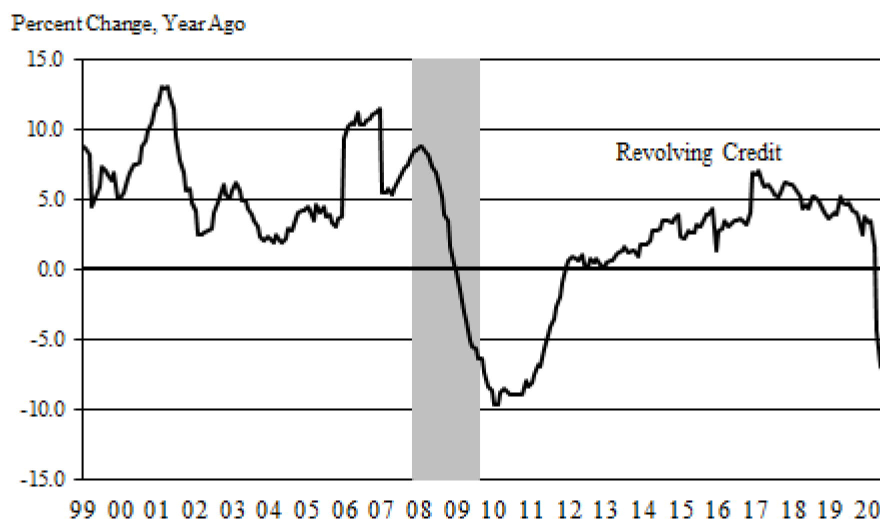
No doubt, the Federal Reserve stands ready to backstop the markets if a flight to quality threatens to destabilize financial conditions. Hence, the fear of another global financial crisis producing an avalanche of defaults that drove credit spreads up to 22 percentage points in late 2008 is not on the radar screen. Nor for that matter should the burgeoning budget deficit, projected to hit $3.3 trillion in the 2020 fiscal year by the Congressional Budget Office, deter Congress from providing another dose of fiscal stimulus. Yes, the deficit is expected to account for the largest share of GDP since 1945 and boost the debt to GDP ratio to over 100 percent next year. But like the business sector, the government is benefiting from a low interest rate environment that is expected to put a lid on the debt-servicing burden.




Indeed, the CBO projects that net interest payments as a share of GDP will actually decline to the lowest levels on record over the next several years before resuming an undesirable climb later in the decade. Unlike the business sector, however, the federal government does not run the risk of running out of revenue to service its debt. It does behoove Washington to limit the rising share of GDP that interest payments will absorb later in the decade, but that's an issue that can best be tackled when the economy emerges from a pandemic-induced crisis that requires immediate remedial action. By sidestepping the need for more fiscal stimulus now, Congress runs the risk of incurring deeper scars from the crisis that would actually amplify the budget shortfall down the road.

Perhaps the more concerning aspect of the accelerating pace of business and government borrowing is that the economy is becoming increasingly dependent on debt to fuel growth. Following the record volume of funds raised by businesses and the federal government over the first half of the year, total domestic nonfinancial debt in the U.S. surged to just under $60 trillion, an increase of almost 70 percent since the end of the last recession. To put that in context, GDP equaled $19.5 trillion in the second quarter. Hence, it required $3 in debt to generate $1 in goods and services in the U.S. That's up from $1.84 at the turn of the millennium and from under $1.50 from 1950 through the mid-1980s.

Importantly, even as the overall economy has become more reliant on debt to fuel growth, households have been moving in the opposite direction. Household debt rose by a modest annual rate of under two percent over the first half of the year, reflecting in large part the complete collapse of credit card-financed purchases during lockdown restrictions in the second quarter. However, even with the rebound in consumer spending over the past several months, households have continued to pay down credit card debt through July. Most likely, many consumers used their stimulus checks as well as their $600 supplement to weekly unemployment benefits for that purpose.




While those funds are now running dry, we don't expect households to start pulling out their credit cards to finance purchases. With the job market turning softer and layoffs running stubbornly high, consumer sentiment is starting to weaken, which is not a recipe for assuming more debt. The good news is that the financial condition of households has improved markedly, as net worth surged by a record $7.6 trillion in the second quarter, recovering all of the $7.2 trillion wealth destruction incurred with the stock-market rout in the first quarter. True, the improvement was not equally distributed, as the astonishing rebound in the stock market mostly benefited upper-income households who hold the vast majority of stocks. But median-income homeowners also reaped the rewards of a sizeable gain in property values, which boosted their equity share up to a 20-year high.

The property boom is continuing, as sales are roaring ahead amid limited supply, which is driving up house prices. However, this source of strength of household wealth will not translate into a source of strength for spending. Unlike the housing boom that preceded the Great Recession, homeowners are not tapping into their housing equity to finance purchases. Refinancing activity is rising, but mostly because homeowners are exploiting record low mortgage rates to reduce debt-servicing payments. Spending decisions in coming quarters will be primarily influenced by the performance of the job market and the growth in labor compensation, which are poised to slow as we enter phase two of the recovery process. Whether Congress is able to cobble together a stimulus package in coming weeks will determine how much momentum will be lost as we head into the fourth quarter.