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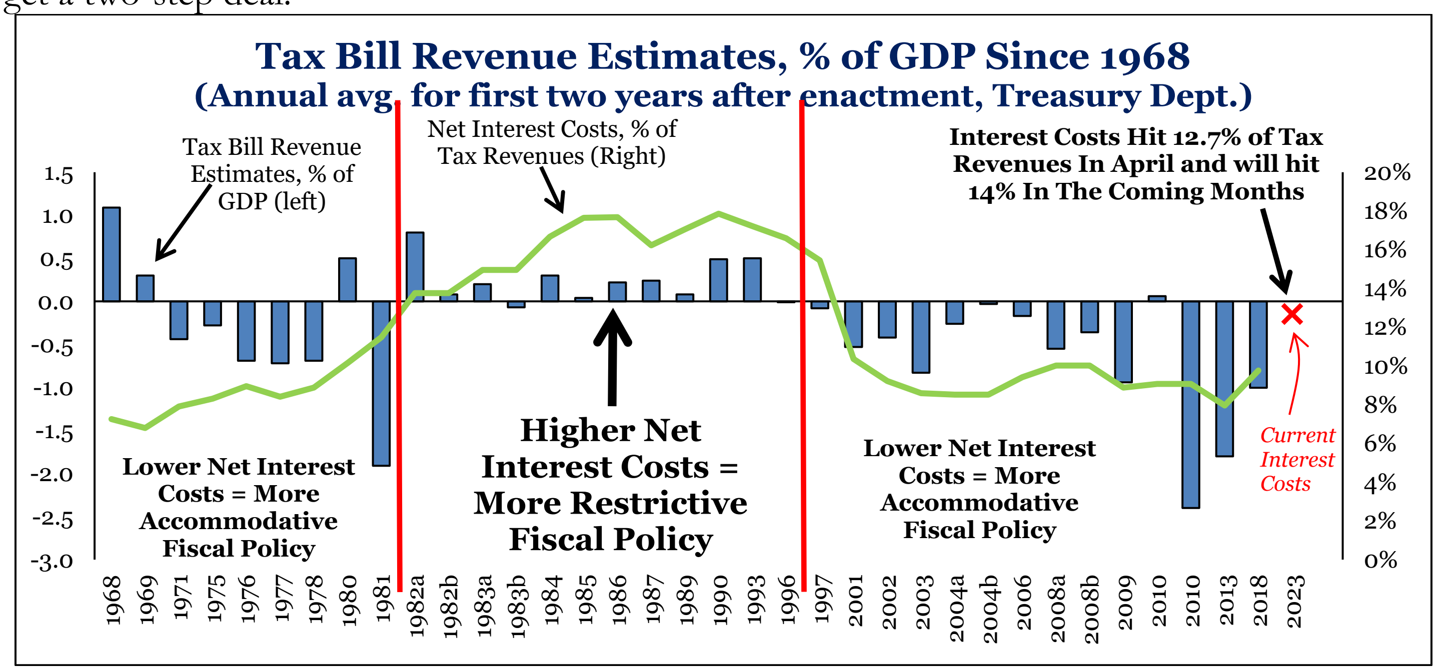
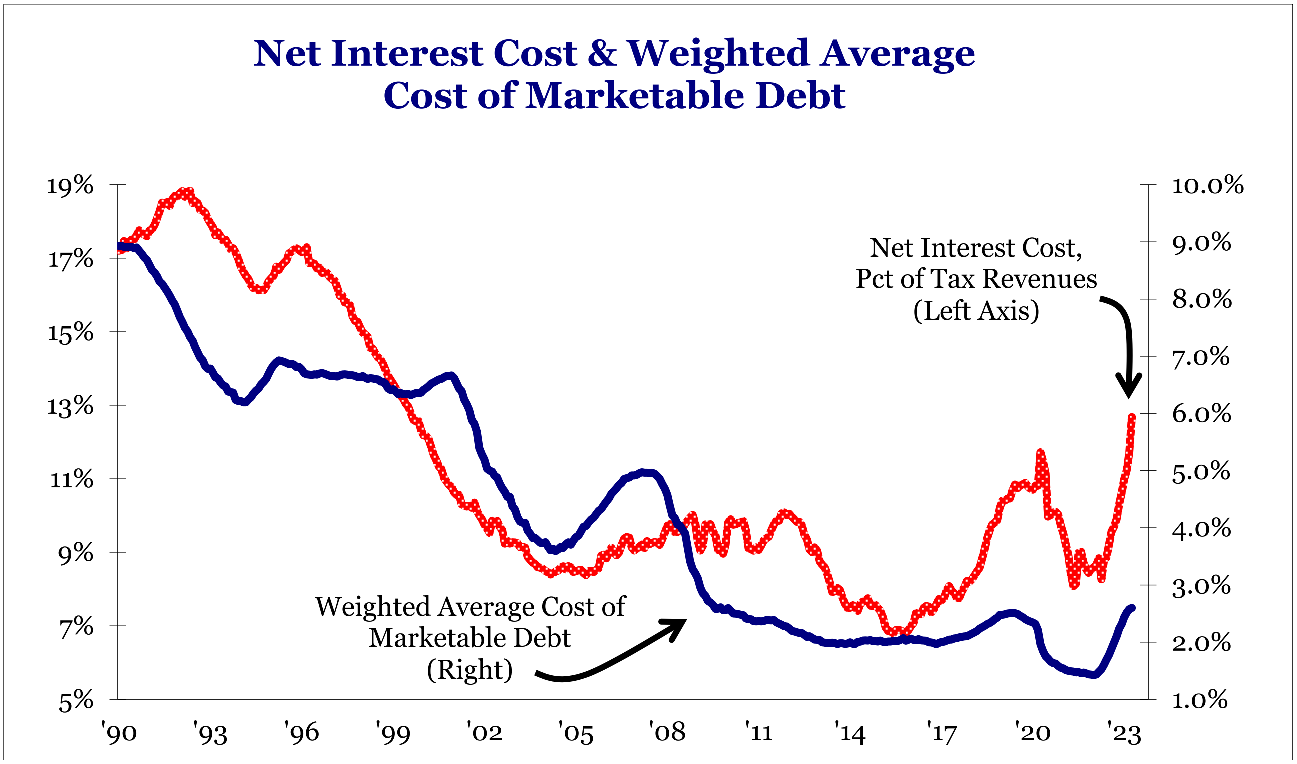
US DEBT SERVICING COST IS EXPLODING JUST AS THE DEBT CEILING X DATE APPROACHES

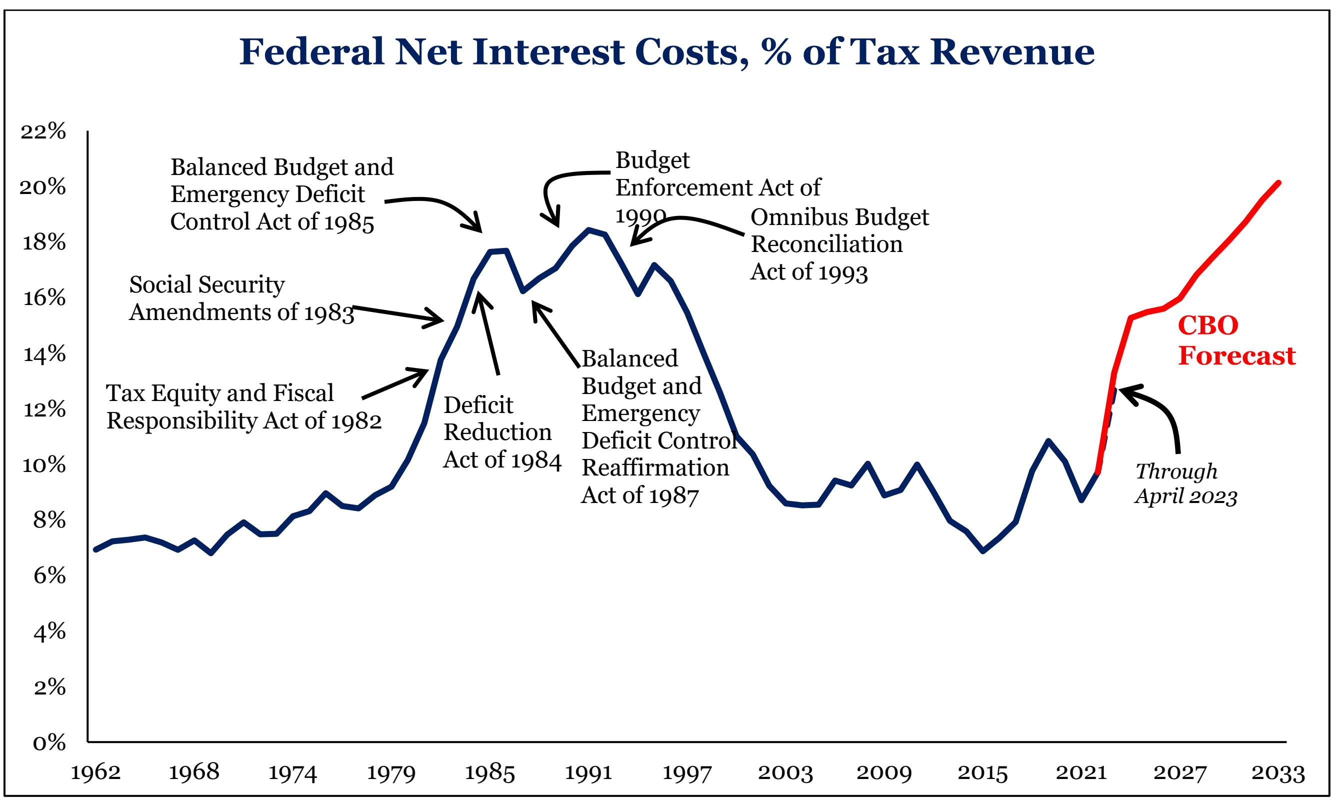
Later today, President Biden and House Speaker McCarthy will meet at the White House to discuss the debt ceiling. The starting point of discussions should focus on the just released April budget data, which illustrates an exploding US debt servicing cost that now sits at its highest level since August 1999. This may sound arcane, but the debt servicing cost is the key indicator for fiscal policy. The current 30-year trend of accommodative fiscal policy is ending. Historically, once the US government's net interest cost hits 14 percent of tax revenues, financial markets impose austerity on policymakers. Net interest costs as a percentage of tax revenues surged a full percentage point in April, from 11.7 to 12.7 percent. There is a complacency in Washington that rising debt is a political issue, not an economic or financial one. Most policymakers have only served in office with a declining debt servicing cost due to low inflation and interest rates. Congress was able to cut taxes and increase spending with no increase in the debt servicing cost. The free lunch is over. For the first time in 40 years, the US has a rising debt servicing cost, which is squeezing out the other parts of the budget. It's only a matter of time before the vigilantes arrive and the debt ceiling is just the opening act. The implication of this is that it is hard to see how a debt ceiling deal comes together that does not reduce spending. Energy permitting reform alone won't be enough. Moreover, we will likely need to be pretty far along in the negotiations to get a two-step deal.



US DEBT SERVICING COST AT ITS HIGHEST LEVEL SINCE AUGUST 1999 & RISING QUICKLY

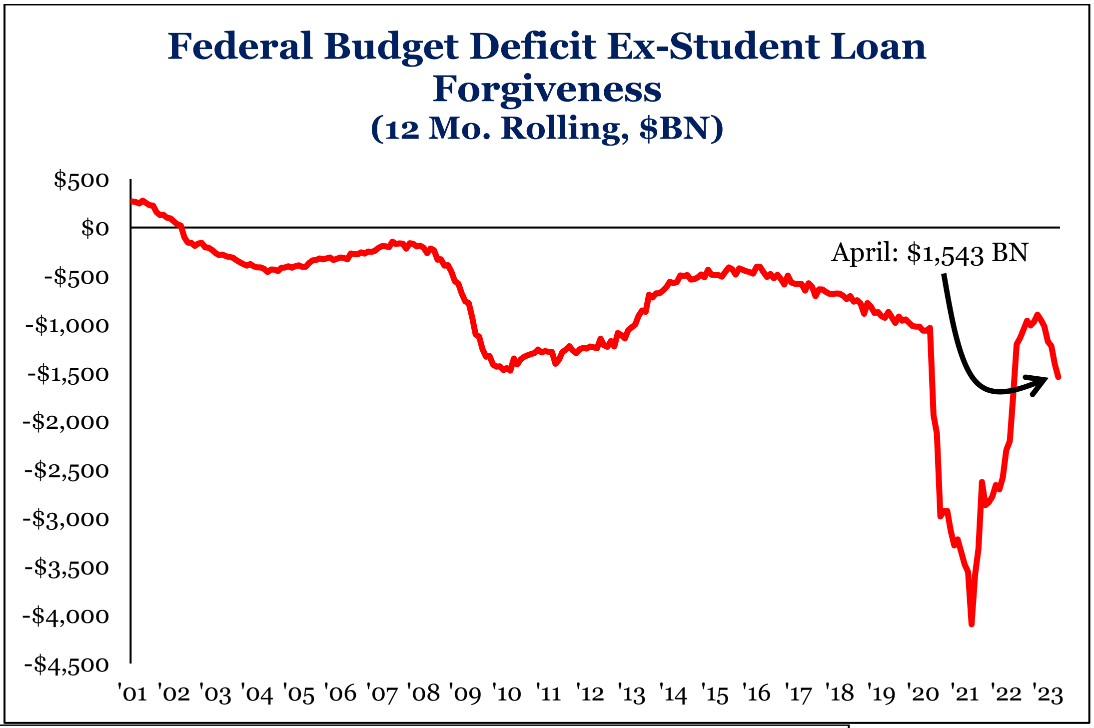


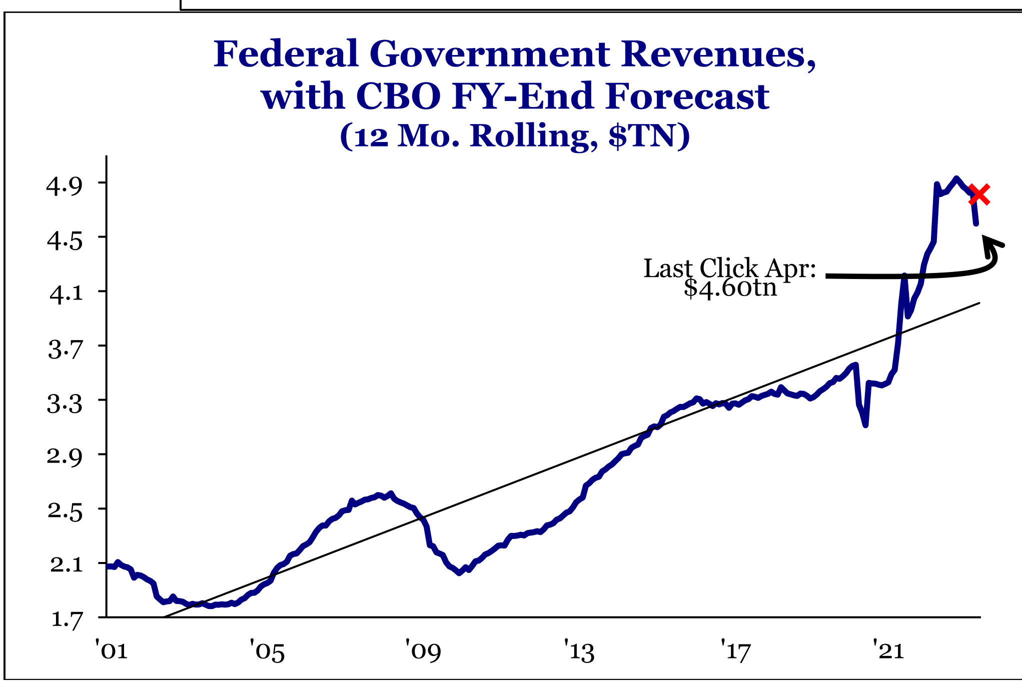
POLICYMAKERS HAVE YET TO REALIZE FISCAL ACCOMMODATION ENDS WITH RISING INTEREST COSTS



FISCAL SITUATION HAS DETERIORATED FAR MORE THAN CBO'S FEBRUARY FORECAST

The US budget deficit has already surpassed the deficit forecast expected for September. This forecast from the Congressional Budget Office was issued three months ago. The main driver of the worse-than-expected fiscal outcome was April tax revenues coming in $200bn below CBO's end-of-fiscal-year forecast. The budget deficit forecast is a bit confusing because of last year's student loan forgiveness credit charge of $400bn, which runs off in September. We run an ex-student loan deficit number to control for this. CBO expects a $1.4tn deficit in September and it is currently at $1.5tn (12 month rolling).

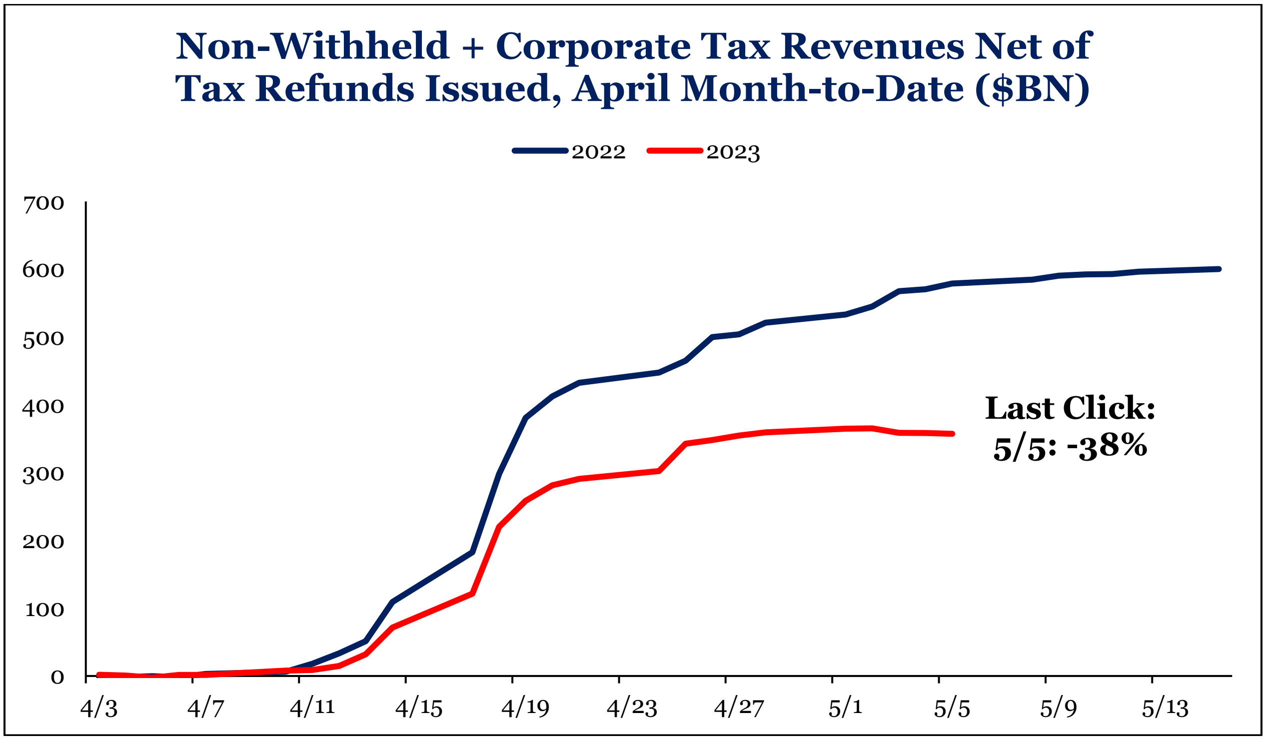


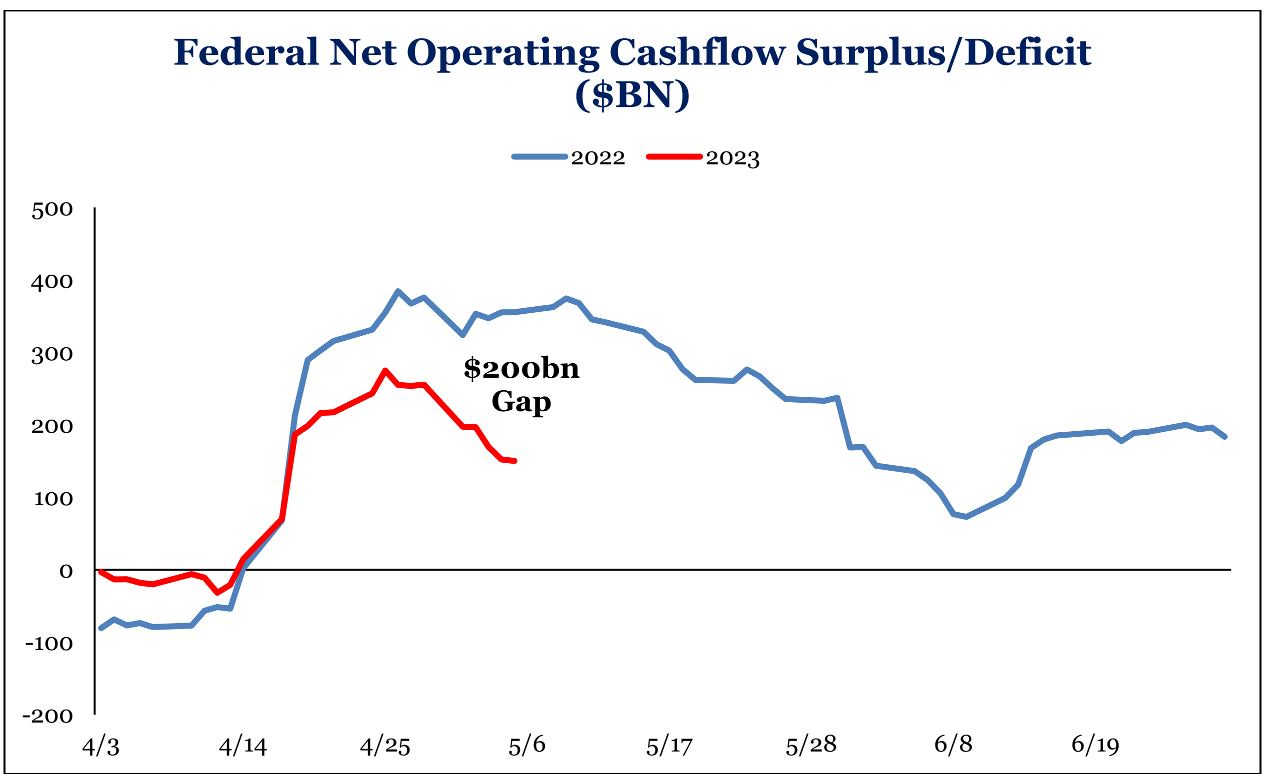


After April tax collections, the US budget is $200bn below its year-end tax revenue target. This number is not likely to get better over the next couple of months.

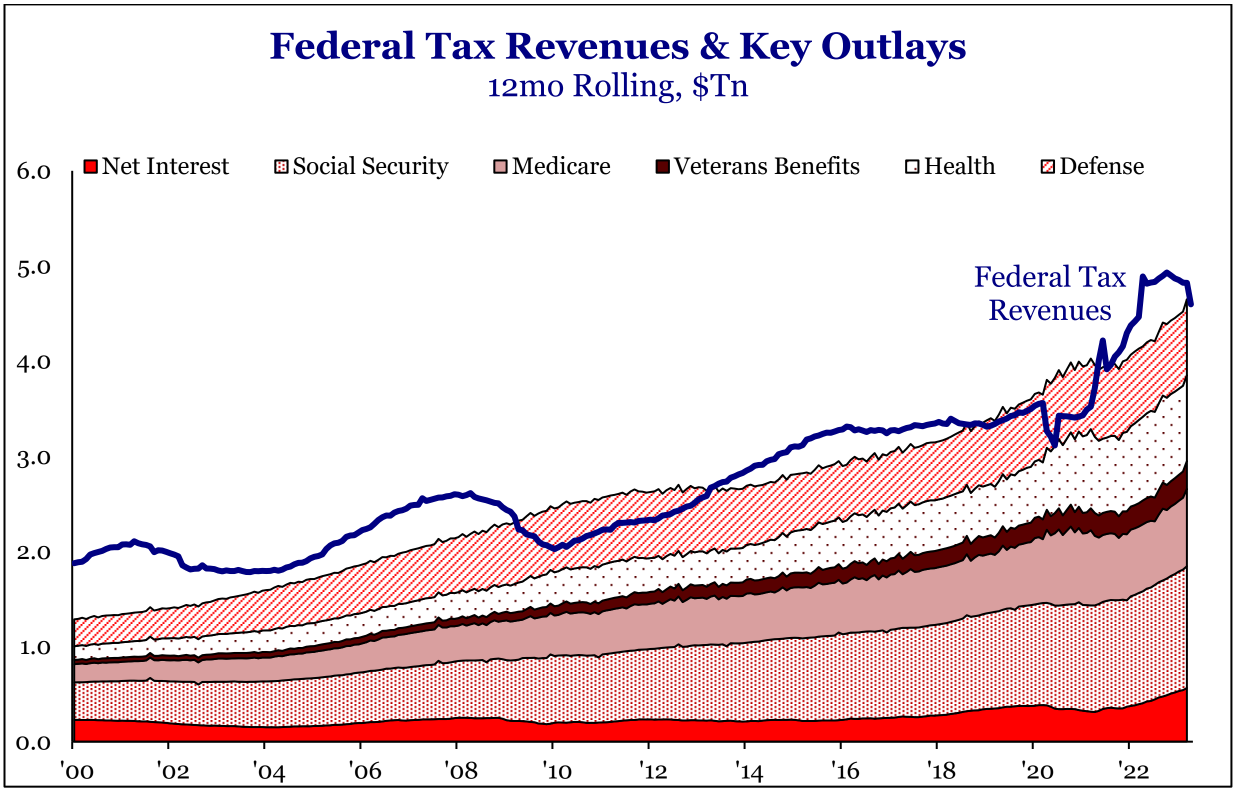
MAY TAX REVENUES ARE COMING IN WORSE THAN APRIL'S DISMAL TAX COLLECTIONS

Over the course of the next couple of days we are likely to see some forecasts of the X date with a bit more wiggle room than Treasury is giving. But the May data has been atrocious, and we believe a June 1 X date is appropriate.

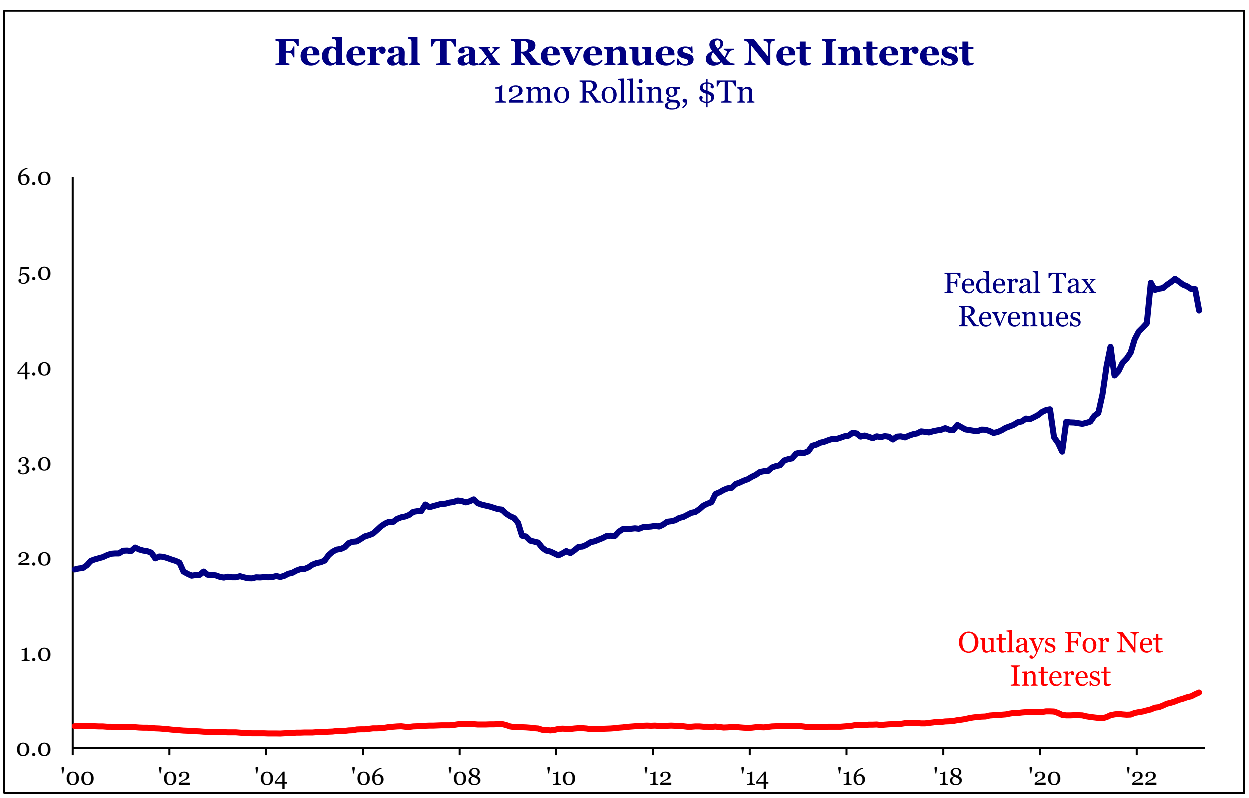




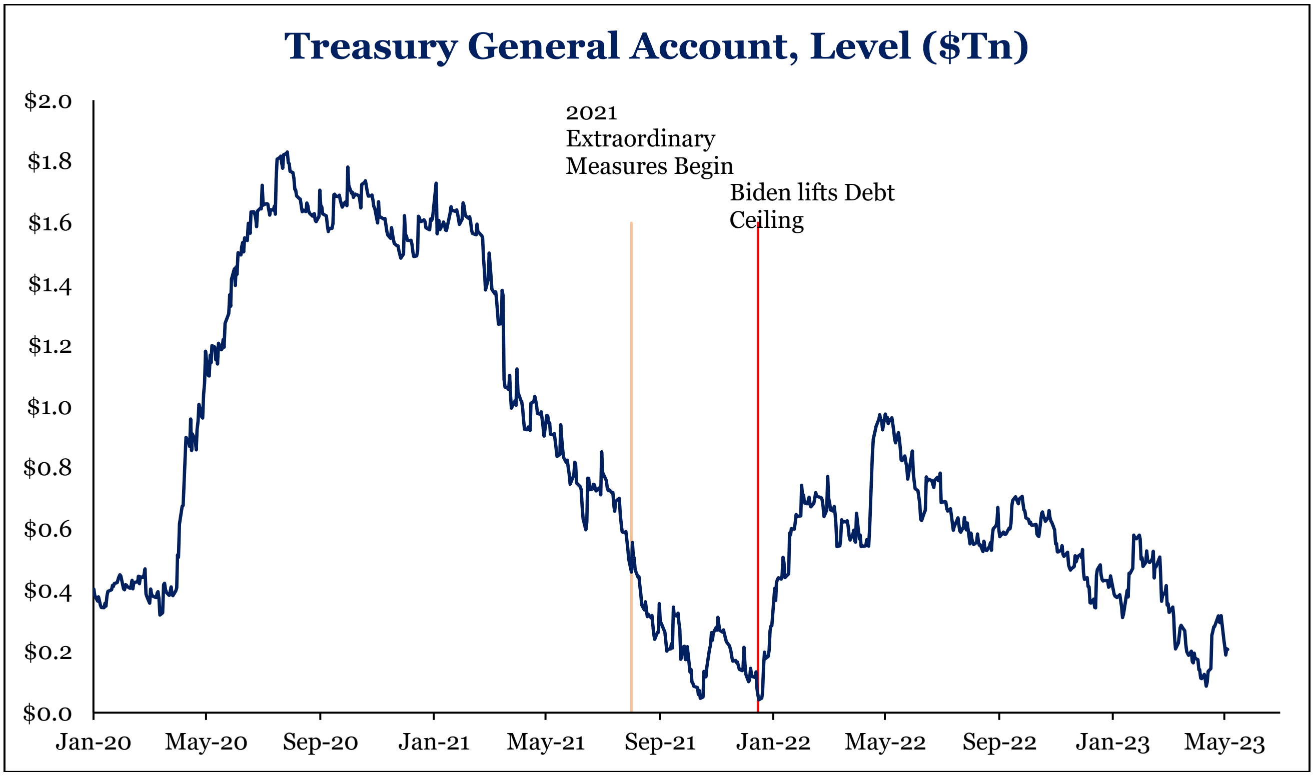
DETERIORATING FISCAL SITUATION MEANS LESS WIGGLE ROOM TO PRIORITIZE GOVERNMENT SPENDING

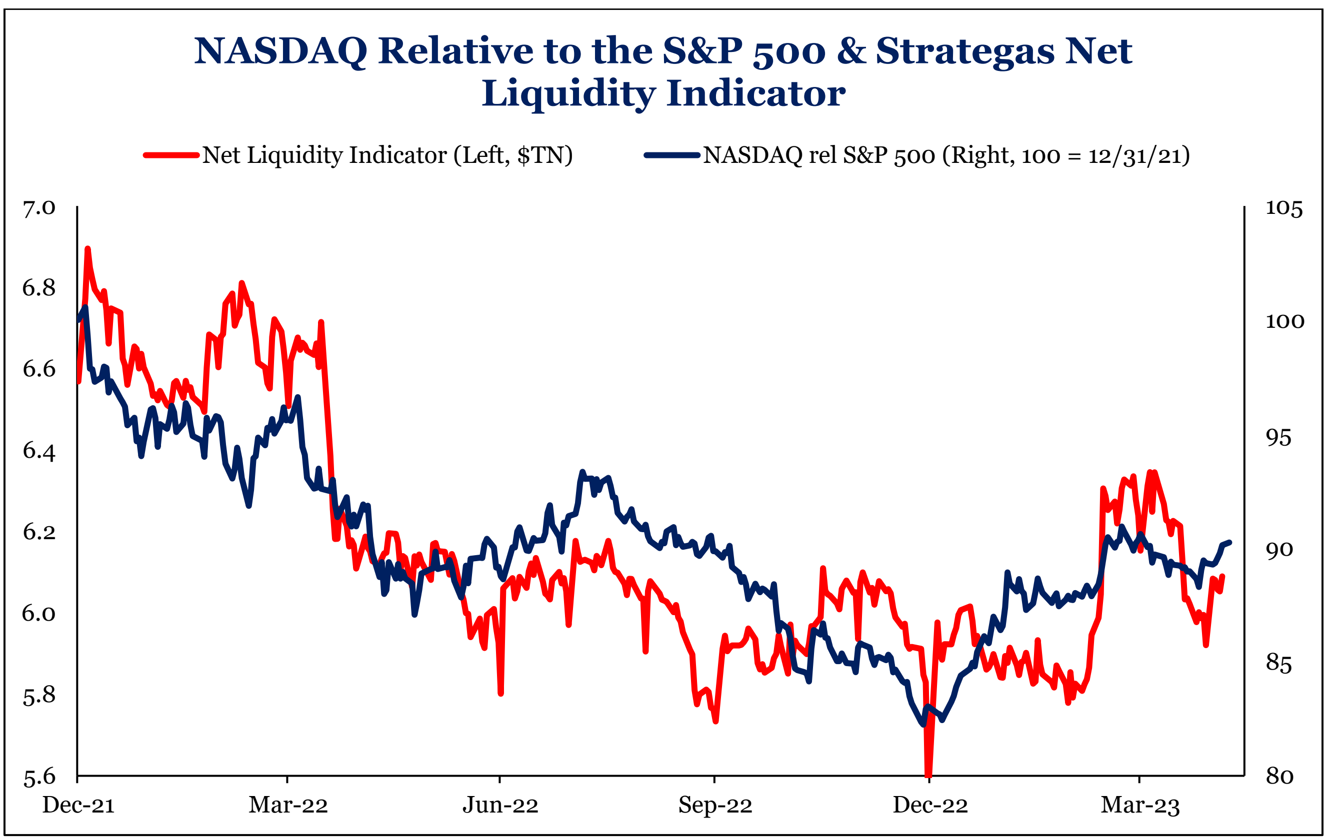


BUT MORE THAN ENOUGH CASH FLOW TO MAKE SURE INTEREST PAYMENTS CONTINUE POST-X DATE



LARGER DEFICIT IN MAY MEANS YELLEN IS INJECTING MORE LIQUIDITY AHEAD OF THE X DATE





BOTH SIDES STILL DIGGING IN ON DEBT CEILING

McConnell Warns He Won't Back Debt-Ceiling Increase Without 'Substantive' Reforms

Senate Minority Leader Mitch McConnell (R-Ky.) has signed onto a letter stating he and more than 40 members of the Senate GOP conference will not back "any bill that raises the debt ceiling without substantive spending and budget reforms," according to sources. "The Senate Republican conference is united behind the House Republican conference in support of spending cuts and structural budget reform as a starting point for negotiations on the debt ceiling," the letter states.

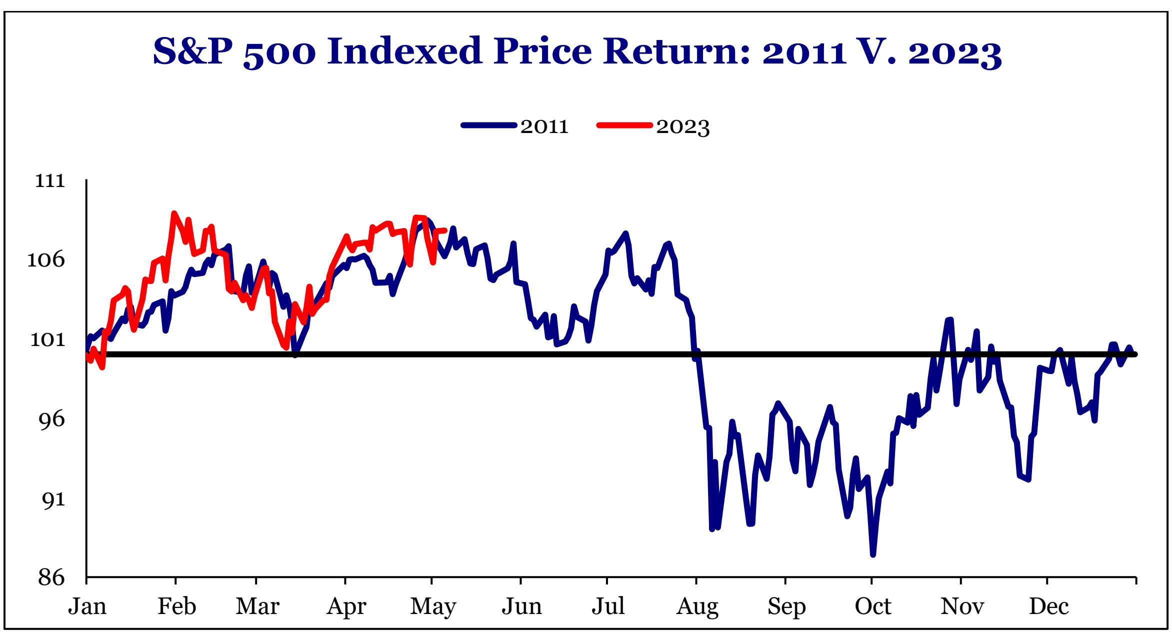
The Hill, **5/6/2023**

Biden Prepares To Take Debt Ceiling Battle To Vulnerable GOP Lawmakers

As President Joe Biden meets with the top Republican leaders in Congress this week to discuss the debt ceiling in an effort to avoid a catastrophic default on the nation's debt, he's also preparing to take the fight directly to some of the rank-and-file GOP lawmakers whose votes could become crucial. Biden's planned campaign-style trip to suburban New York on Wednesday — a day after he meets with congressional leaders — is the latest move in a White House strategy to pressure House Speaker Kevin McCarthy, R-Calif., in the spending battle in the soft underbelly of his fragile majority: GOP House members in competitive districts Biden carried in November.

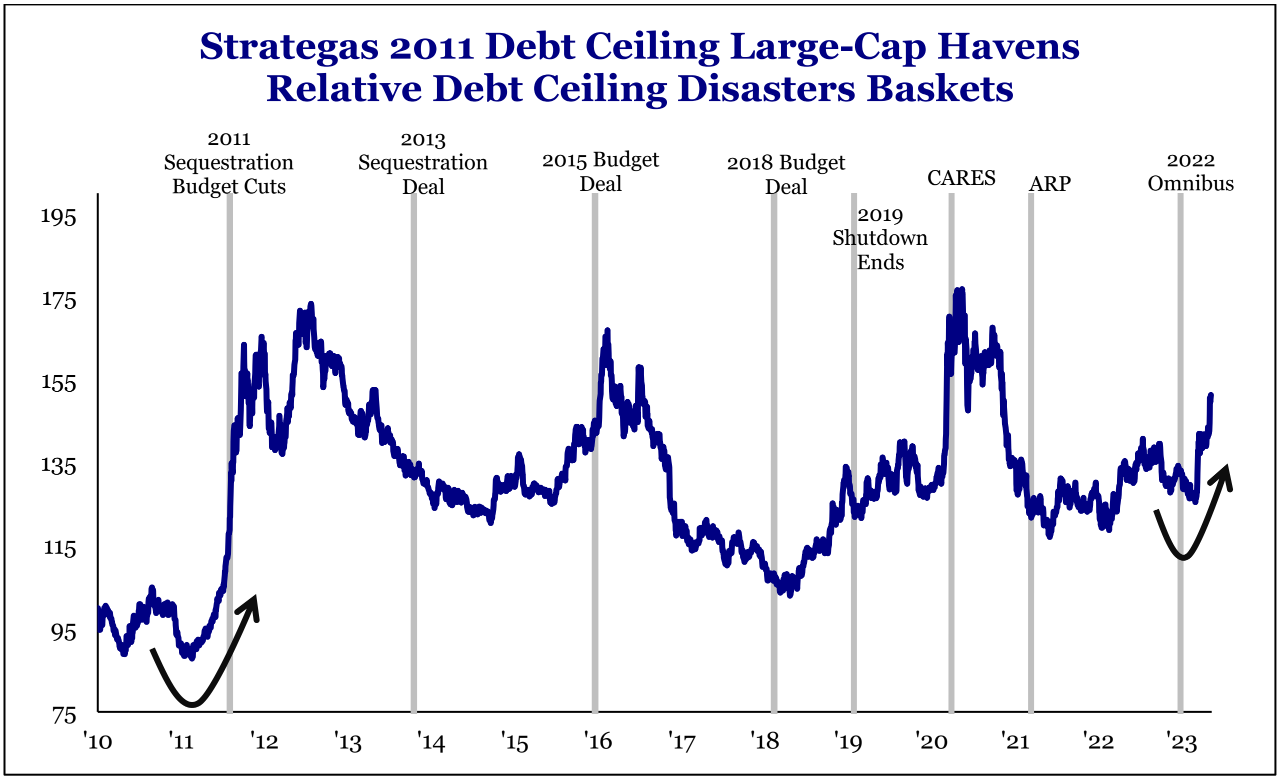
NBC, **5/8/2023**

Once the House passed a bill to raise the debt ceiling, the negotiating dynamics shifted. Senate Republicans unified and are standing behind the House. This means there are not the votes in the House or Senate for a clean debt ceiling increase. President Biden wants to apply pressure on vulnerable members to get these members to fold once the X date nears. But our sense is that Republicans think Biden is on the wrong side of the debt issue and has sagging approval ratings. Both sides are going to test each other, but our sense is that some deal will need to come together in the final two weeks of May given the legislative reality of both chambers.

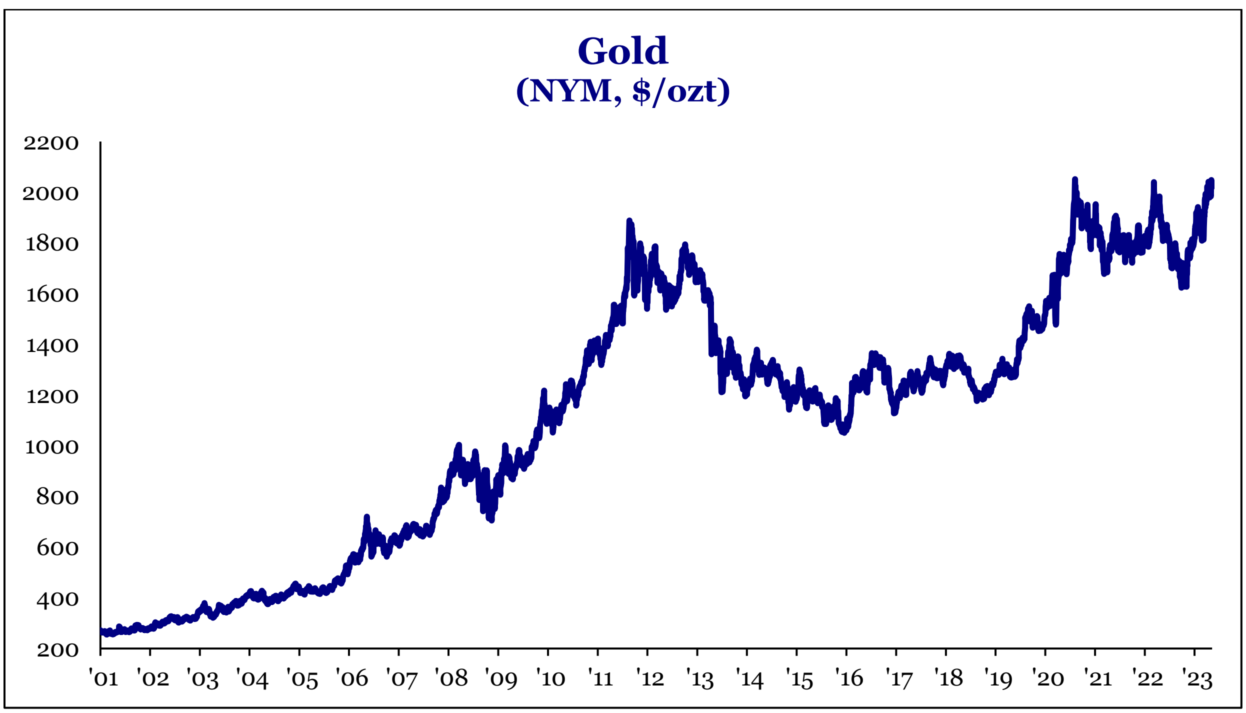


EQUITY MARKET IS TRADING LIKE THE SUMMER OF 2011…

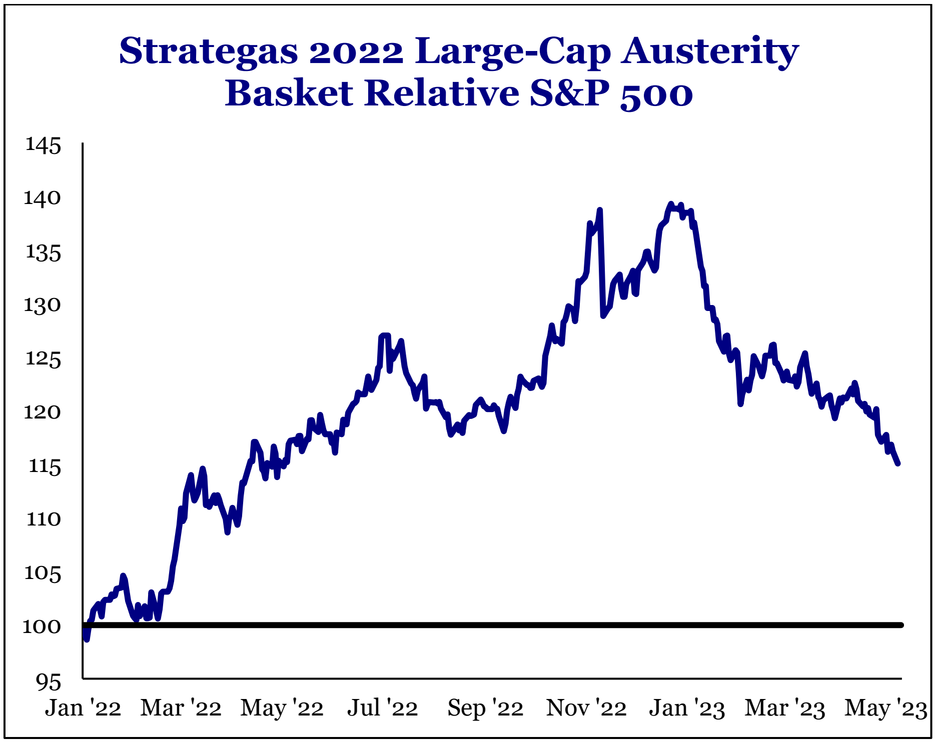
In February, Courtney Rosenberger outlined the debt ceiling investment playbook for investors and she nailed it. The relative winners of the 2011 debt ceiling fight (the last time we did fiscal austerity) are outperforming the relative losers, and quite significantly.



…AND SO IS GOLD

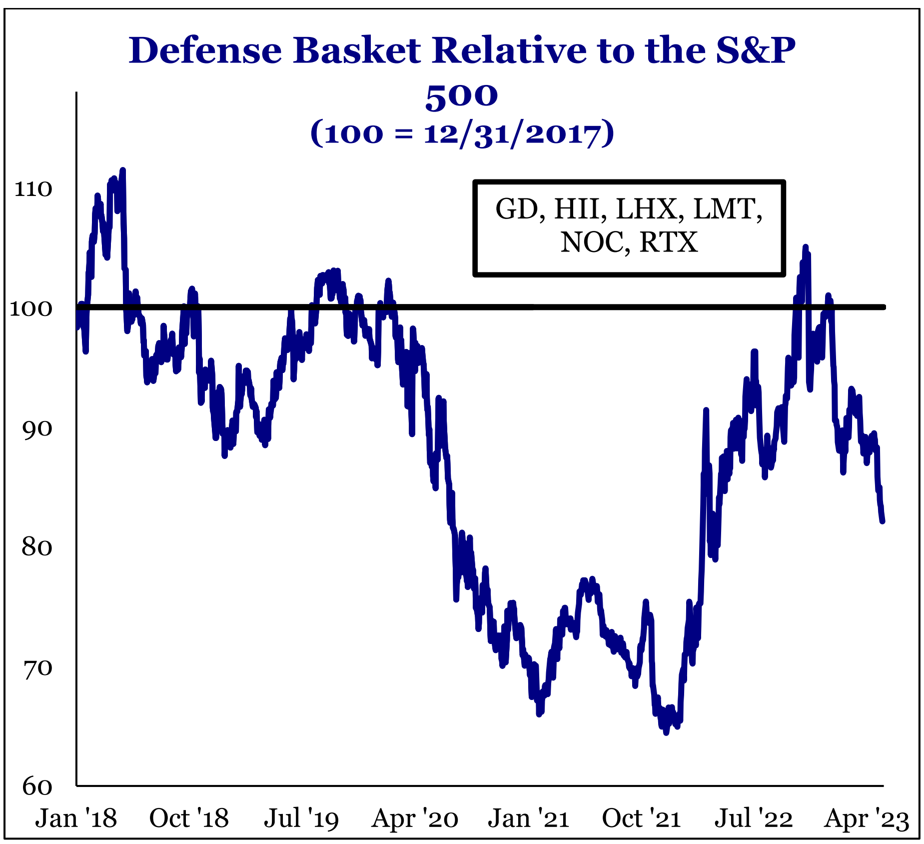


COMPANIES LEVERED UP TO FEDERAL SPENDING CONTINUE TO UNDERPERFORM



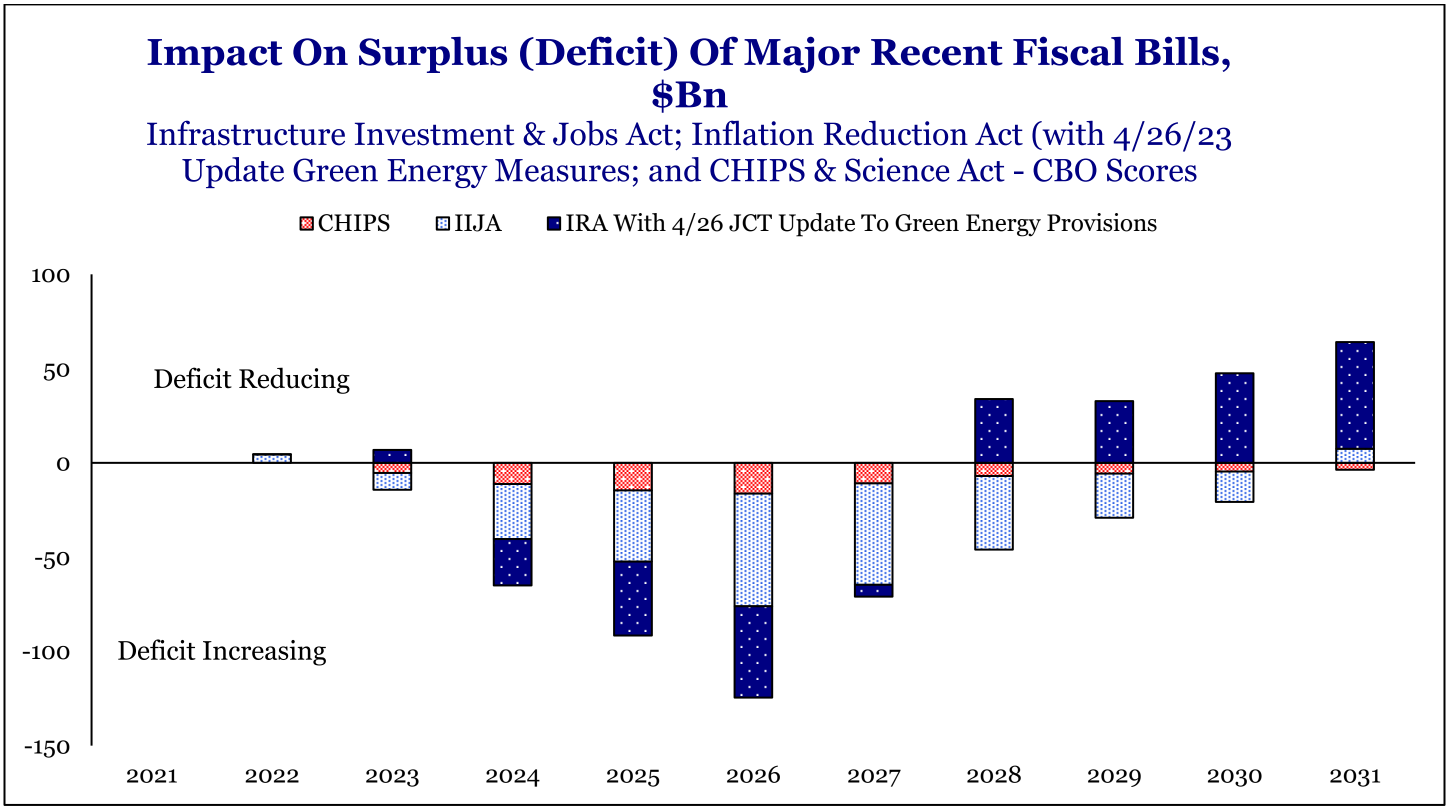
Starting on January 6th, the companies that generate the most revenue from the federal government as a percentage of their total sales started to underperform the S&P 500 as it became clear that Republicans would push for spending cuts.

DEFENSE STOCKS ARE TAKING IT ON THE CHIN

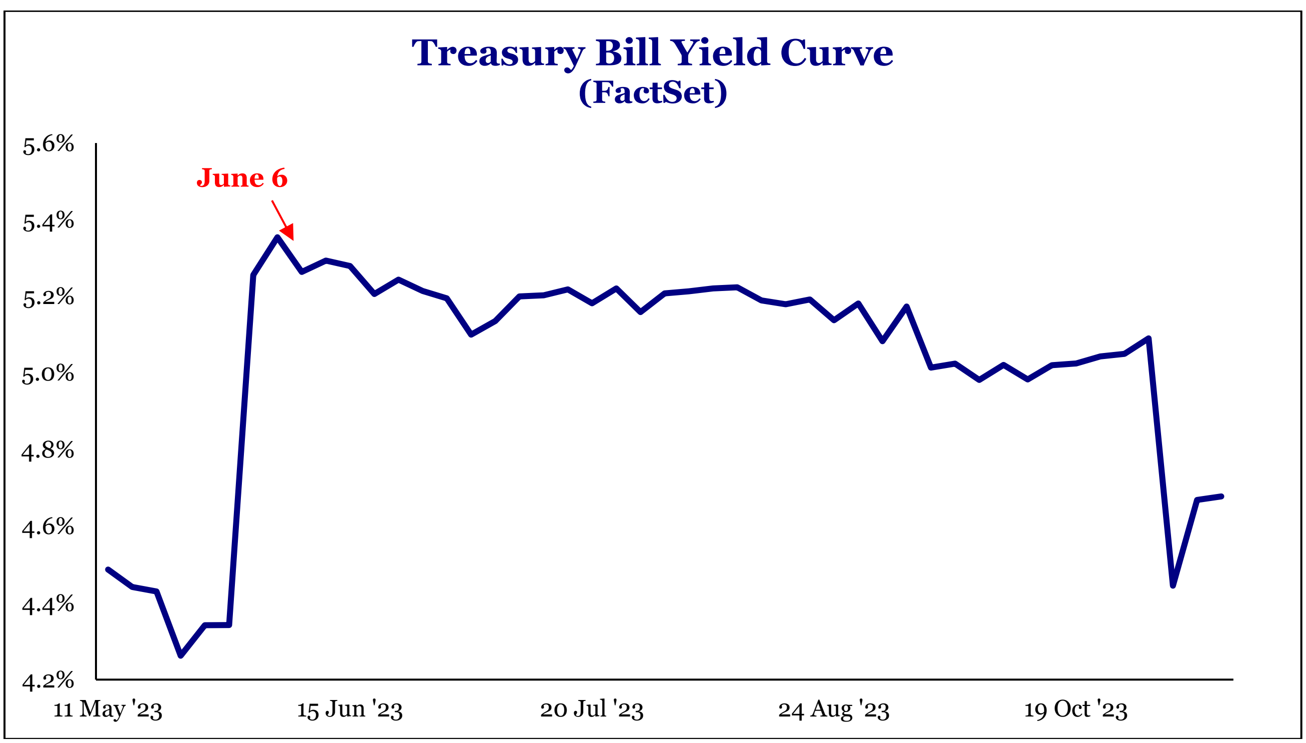


Defense has three headwinds in front of the industry: 1) Potential debt ceiling breach leads to reimbursement risk; 2) Likely slowdown in the growth rate of discretionary spending as part of a debt ceiling deal; and 3) Increasing discussion of an end to hostilities in Ukraine in 2024.

INFRASTRUCTURE, CLEAN ENERGY & CHIPS FUNDING IS LIKELY SAFE FROM CUTS, BUT TAKE YEARS TO SPEND



ONE-MONTH TREASURIES ARE PRICING IN SOME EXPECTED BRINKSMANSHIP LEADING INTO THE X DATE



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