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US Budget Deficits, The Falling US$ And Growth Stocks

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It is a core Gavekal belief that good money management is more about "avoiding losers" than "picking winners". Yet sell-side research focuses almost entirely on identifying winners. This leaves an avenue for a small, independent firm like ours to lean the other way and help clients identify "losers".

Now, there is no single way to be a "loser". It can be a country or industry facing bad fundamentals, a richly valued and overbought sector, a thematic exposure caught in the crosshairs of a political shift, or a firm left on the wrong side of capitalism's creative-destruction dynamic. This is the third instalment of a new research series that aims to identify areas that investors should avoid, whether countries, sectors, themes or asset classes.

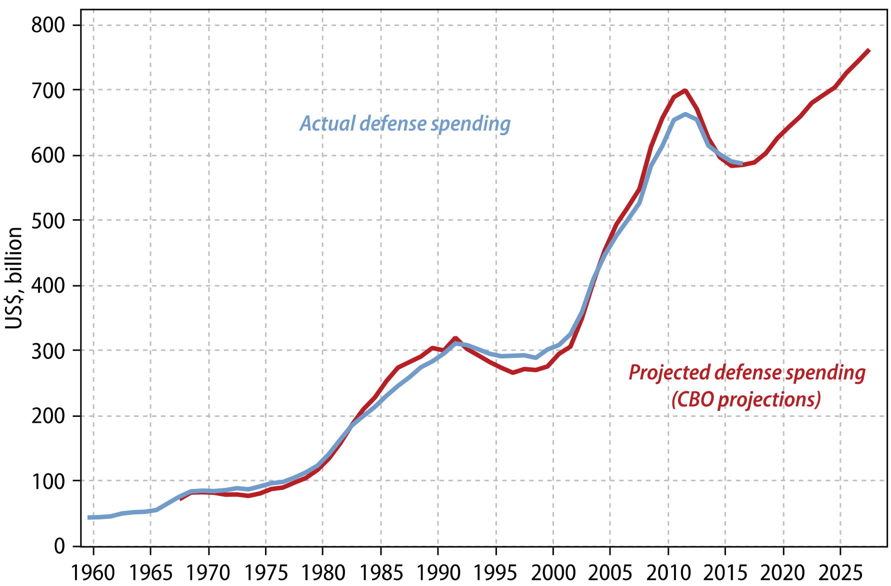
The recent US government shutdown demonstrated (once again) the truth of P.J. O'Rourke's observation: "It is a popular delusion that the government wastes vast amounts of money through inefficiency and sloth. Enormous effort and elaborate planning are required to waste this much money." Over the last year, all that effort and planning have thrown up a couple of interesting new developments when it comes to money wasting.

Warbucks is back

The Obama-era decline in US defense spending is set to go into reverse

Firstly, after five years of contraction, military spending in the US is now set to rebound. And nothing says "wasting money" quite like buying a bunch of new tanks, battleships and nuclear missiles, especially when the future of warfare will be in cyber-space, and outer-space (on a positive note though, the Pentagon is having to go through its first audit).

Onwards and upwards: US military spending marches on



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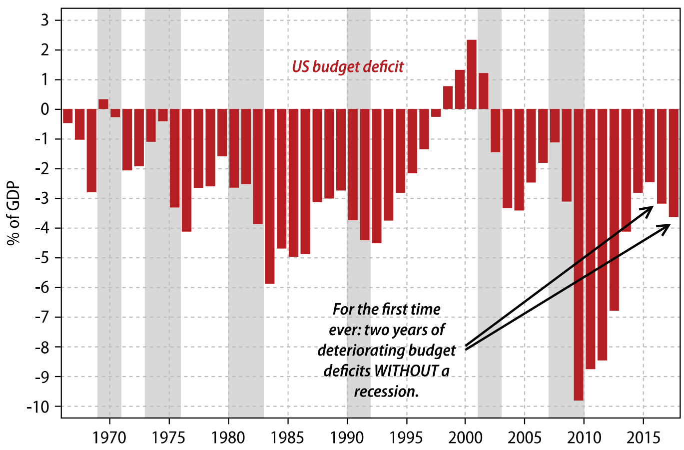
Secondly, and for the first time ever, we have just witnessed back to back deteriorations in the US budget deficit as a proportion of GDP without the contributing factor of a recession. In fact, 2017 turned out to be a much better year for GDP growth, employment, and capital gains than almost anyone had anticipated. And yet, in spite of this very benign growth environment, the budget deficit still widened.

Despite solid GDP growth, the US budget deficit is widening again...



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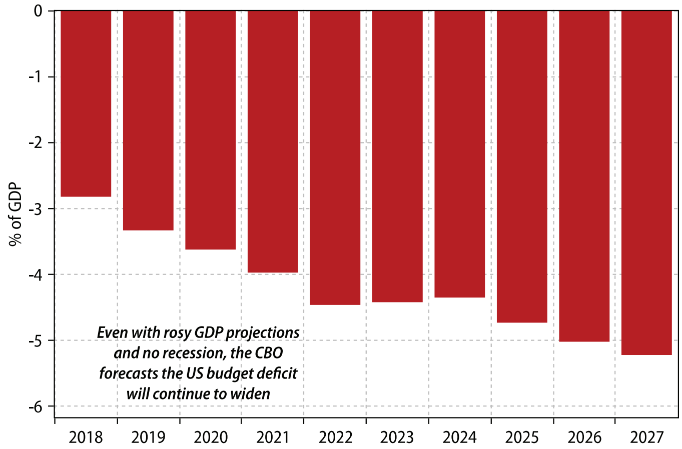
...and the deficit is set to continue growing over the next 10 years



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Needless to say, these two developments are not independent: all else equal, a pick-up in military spending entails a wider budget deficit. And the effect is especially pronounced when out of every US$1 the federal government spends, US$0.95 goes on either a) interest, b) entitlement spending or c) the military. This tough math helps to explain why, even before going into potential increases in infrastructure spending, student loan write-offs, or increases in social housing, the Congressional Budget Office is already projecting the US deficit to deteriorate steadily over the next decade to more than -5% of GDP.

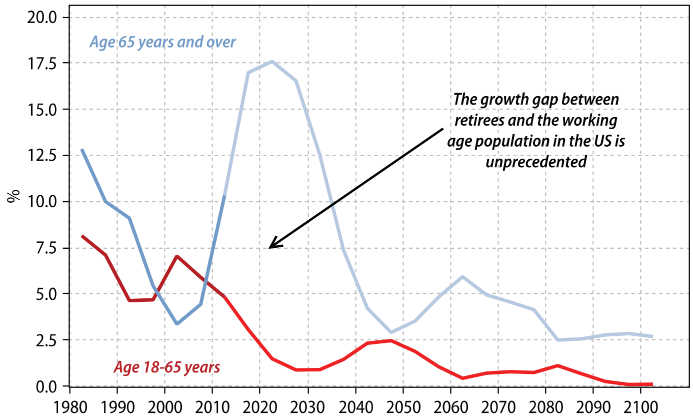
Even without spending increases, the US budget deficit is expected to widen

Note that this deterioration in the US budget deficit does not assume any additional outlays, for example on infrastructure. Instead, the CBO assumes that the US economy will grow by 3% a year for the next 10 years (meaning that by 2027, the US economy will have gone through almost two decades without a recession). This is not impossible (although the US economy failed to grow at an average 3% rate in the 10 years following the 2008 crisis). However, the important point is that even under this rosy scenario, the budget deficit continues to expand tumescently (as a family publication, we will forbear from showing what the budget deficit would look like if the US were somehow to stumble into recession).

Of the three big spending poles of the US government—interest costs, defense, and entitlement spending—it seems that all three are heading higher, hence the bigger deficit projections. As a result, in the coming year the US treasury is set to issue a net US$1.3trn in additional debt, in the first step of many more to come. And of the three big budget items, the one that is really slated to go through the roof (if there is no reform) is entitlement spending. This is for a very simple reason: over the coming years, the US is set to age rapidly.

The US population is getting older faster than ever before...

Annual growth rate of 18-65 years and 65+ years population cohorts



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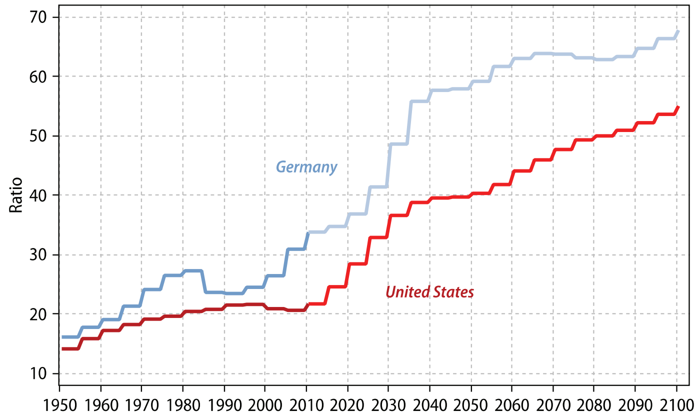
...with the US approaching European levels of old-age dependency

Old-age dependency ratios (number of people aged 65+ per 100 people aged 20-64)



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Baby boomers are now retiring in droves, while the growth of the working age population aged 18-65 years has fallen to low single digit rates and is set to fall further to lows never seen before in US history. This means that the US is fast approaching the demographic tipping point reached by Western Europe a couple of decades ago at which the old-age dependency ratio—the ratio of retired people to the working age population—starts shooting up at an accelerated rate.

With a fast-aging population, US spending on health care is only likely to rise over the coming decades

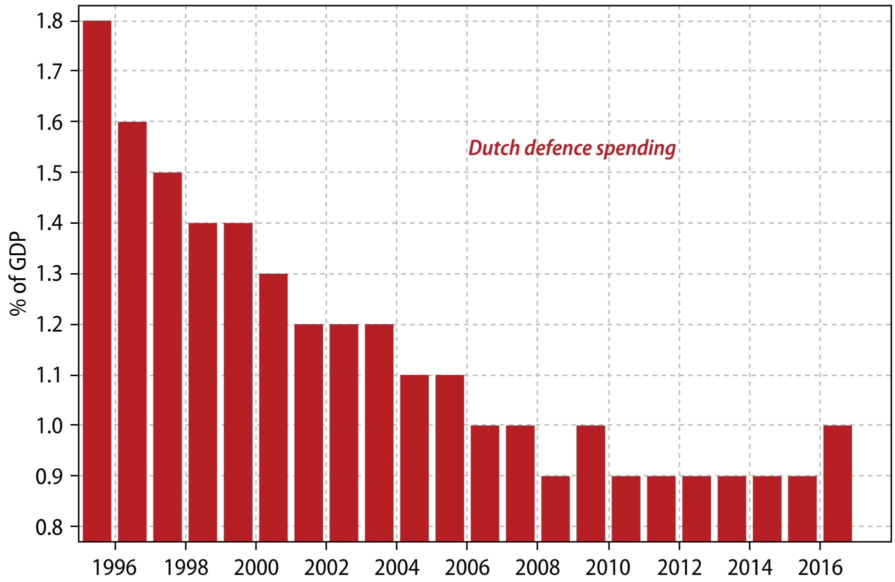
There is of course one important difference between Europe 20 years ago and the US today: the US already spends a whole lot more on health care as a proportion of GDP than Europe did back then, or even does today. And the US is only just starting to go grey.

One country stands out

Health care spending ranked as a proportion of GDP

	Health care spending per capita (US$)		CAGR	2014 spending (% GDP)
	1995	2014		
USA	3,788	9,403	7.8%	17.1%
Sweden	2,292	6,808	10.4%	11.9%
France	2,745	4,959	4.3%	11.5%
Brazil	314	947	10.6%	11.5%
Germany	3,129	5,411	3.8%	11.3%
Canada	1,831	5,292	10%	10.4%
Japan	2,845	3,703	1.6%	10.2%
Australia	1,591	6,031	14.7%	9.4%
Italy	1,462	3,258	6.5%	9.2%
UK	1,364	3,935	10%	9.1%
Russia	113	893	36.3%	7.1%
China	21	420	100%	5.5%
Singapore	741	2,752	14.3%	4.9%
India	16	75	19.4%	4.7%

Fewer tanks, planes and ships in Europe



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Facing a similar budgetary dynamic 20 years ago, Europe made a simple choice: sacrifice its armies and keep the entitlement spending. Here is the Netherlands as an example (we don't mean to pick on the Dutch; every European country looks pretty much the same).

An aging Europe cut defense budgets; the market expects a different response from the US

Interestingly, today the market seems to be expecting an entirely different policy choice when it looks at the US. With defense stocks trading close to record highs in valuation terms, investors appear to be saying that the projected rebound in US defense spending traced in this report's first chart is a done deal (and given that almost every other member of the current US cabinet is a retired general, they may very well be right).

Valuations for US defense stocks are close to all-time time highs

Price to book ratio

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So investors keen to project themselves into the future (beyond the end of the next month), and wondering how the US will square the circle of rising entitlement spending (driven by demography) and rising military spending (propelled by political promises), are left with three possible conclusions:

To balance the books, the US could opt to restrain its defense spending...

- **US military spending will not accelerate.** This is the whole objective of the Pentagon audit and the message that Donald Trump is sending to US allies when he says that NATO countries (along with Japan, South Korea, India, Australia etc...) need to increase their defense spending. One scenario that could see US defense spending stall would be if the Democrats took back the House in the fall, and returned to the Obama policies of getting military spending under control.

  Personally speaking, I struggle to see how the GOP could lose the House when prosperity is blooming and the Democrats suffer badly from a lack of young, charismatic leaders. But then again, as the late UK prime minister Harold Wilson said, "a week is a long time in politics", and there are still 10 months to go to the November mid-terms. In the meantime, one thing is clear: defense stocks are definitely pricing in a re-acceleration of US military spending. **So maybe anyone who believes that 2018-19 will see a political shift in the US back to the left should look to sell defense stocks in the second half of the year?**

...Washington could trim entitlements...

- **The US will reform entitlement spending.** After the debacle of Obamacare reform, it seems unlikely that Trump will be burning to return to entitlement spending matters. Meanwhile, both the GOP and the Democrats are so inherently divided on what to do about runaway medical costs that the fallback position of both parties seems to be to let sleeping dogmas lie, and allow widening budget deficits to take care of the resulting increase in social costs.

...or it could just let deficits blow out

- This brings me to the third possible conclusion: that **US budget deficits will continue to grow** (as the CBO forecasts). This, by a long way, seems the path of least resistance, and the scenario that the market is increasingly pricing in through the continued collapse in the US dollar. In this respect, **the US is increasingly displaying characteristics usually confined to emerging markets: the odd combination of rising bond yields and a falling currency**.

In the emerging economies, the combination of rising yields and a falling currency is a sure sign that the market is starting to question the fiscal policy of the country in question. And of course, rising yields and a falling exchange rate typically put the afflicted emerging market under pressure, as its import bill rises just as its ability to borrow becomes constrained. Of course, for the US things are different, because the US settles its import bill in its own currency. In that respect, a falling US dollar, and even rising yields, are not the constraints on the US economy that a falling currency and rising yields might be on, say, the Indian or South African economy.

Nonetheless, it is too much of a stretch to think that the continued expansion of US budget deficits, along with the consequent collapse of the US dollar and rise in US bond yields, will not be met by some kind of policy response. In this respect, imagine that you are the incoming Fed Chairman; here is how the landscape has changed since your late November nomination hearing:

1) Congress has passed a tax reform bill, which is proving very stimulative to the US economy, but which will also likely widen the budget deficit.
2) Yields on 10-year treasuries have risen 35bp and have broken through an important resistance level at 2.6%.
3) The US dollar has gone down roughly -5%, more or less in a straight line.

At this rate the new Fed chair could find himself facing a near-crisis

It is Wall Street lore that most incoming Fed chairs are handed a crisis shortly upon their arrival; it is almost as if the market is testing their mettle. Paul Volcker was given the Iran crisis and the consequent spike in oil prices. Alan Greenspan was handed the 1987 crash. And Ben Bernanke inherited the housing crisis. Maybe Jerome Powell will be as lucky as Janet Yellen and cruise through his term with few hiccups. Or perhaps the market is already telling us that **Jerome Powell, on day one in his new job, may have to confront the question of what monetary policy is appropriate in an age of runaway government spending and a rapidly collapsing US dollar?**

The US dollar dynamic

This brings me to my overall conclusion: **the US dollar is now very clearly in a bear market**. And, unless we see a sharp shift in US monetary policy under incoming Fed chair Powell (which is possible), or a sharp shift in US fiscal policy (which seems far less likely), the US dollar bear market looks set to continue.

Interestingly, financial markets have so far welcomed this fall in the US dollar in a near-uniform way: **everything has risen strongly.** Yet, the fall in the US dollar is not equally good news for everyone. Specifically, **the US dollar bear market should be bad news for US growth stocks**.

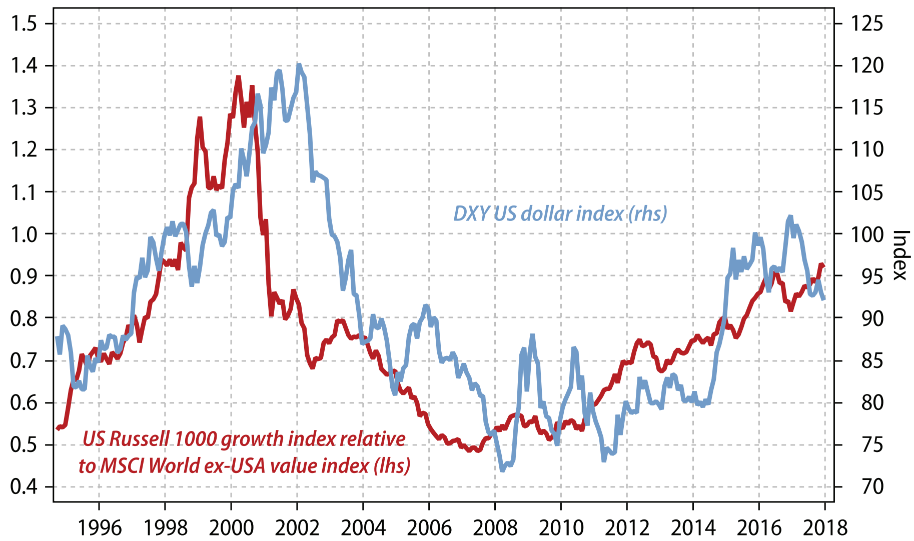
Growth stocks tend to do better in a strong US dollar environment

When the US dollar is very strong, US growth stocks tend to benefit for two reasons. The first is that foreigners will move their excess savings into the US (to benefit from the strong dollar tailwind). And this foreign capital typically goes into “growth-type” names (technology, healthcare, staples, consumer cyclicals...) as this is where the US comparative advantage tends to be the greatest.

The second reason growth stocks benefit is that when the US dollar is strong, the Fed does not need to tighten monetary policy aggressively. This is especially good news for growth stocks, whose prospective returns tend to be far off in the future.

A weakening US dollar is bad news for US growth stocks

DXY US dollar index, and performance of US growth relative to global value stocks (in US$)



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With the US dollar weakening and the Fed tightening, investors may balk at heady growth stock valuations

But now, as the US dollar continues to fall, non-US investors may well start to feel that they no longer need to pay P/E ratios of 40 or more to get exposure to US tech stocks whose returns, for them, will look a lot more pedestrian when adjusted for the weaker US dollar. This will be all the more true if they can now get decent returns on European or Asian financial stocks, or on consumer stocks in their local markets (which will benefit from the rising disposable income that an appreciating currency brings).

Combine that with the Damocles Sword of a Fed that may well need to tighten its monetary policy more aggressively than the market anticipates, and the idea of extending your exposure ever further into the future by owning companies that make little or no money, but are nonetheless richly rewarded in the market for their profligate ways (Tesla? Netflix? Uber?), may soon begin to seem as outdated as bell-bottomed jeans.