U.S. BOND STRATEGY

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Monitoring The Fiscal Tailwind For Growth

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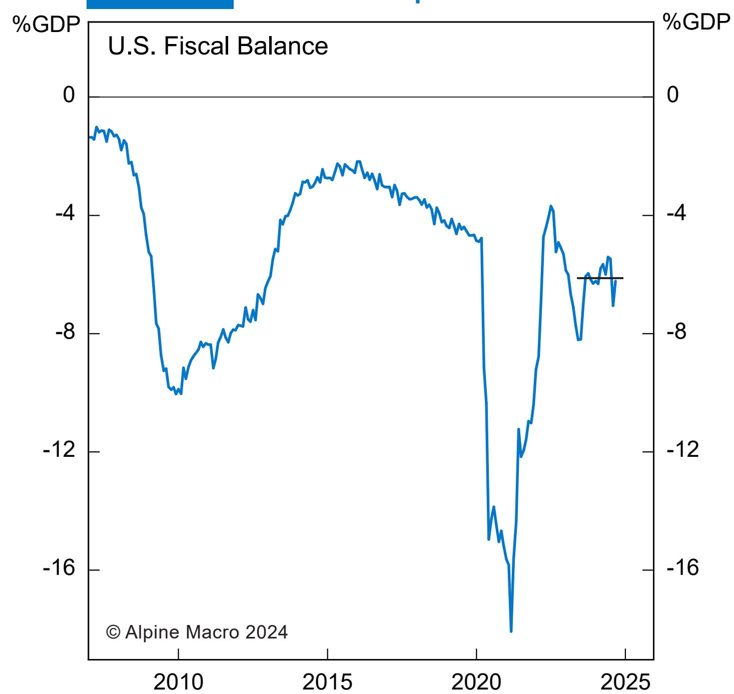
Fiscal policy has been a key tailwind since the pandemic that helps to explain the economy's resilience to higher interest rates. However, many analysts erroneously viewed the fiscal boost as a one-off factor driven mainly by new legislation such as the Inflation Reduction Act and CHIPS Act. Following the passage of the Fiscal Responsibility Act last summer, the Congressional Budget Office (CBO) estimated that federal fiscal policy would become a drag of ~1.5% of GDP in fiscal year 2024. The prospect of a fiscal drag contributed to recession fears among many investors heading into this year.

We began warning over a year ago that investors should not expect a large fiscal drag in FY2024 (Chart 1).[1] Most of the budget deficit increase in 2022 and 2023 was due to surging mandatory spending and poor tax collection rather than spending bills. Our analysis of actual expenditures by department revealed that most of the major spending increases occurred in areas that had nothing to do with recent spending bills (Chart 2). These three acts, including the IIJA, IRA, and CHIPS Act, added only $50 billion, or less than 0.2% of GDP, to net spending for 2024.

Chart 1 The Fiscal Impact Has Stabilized

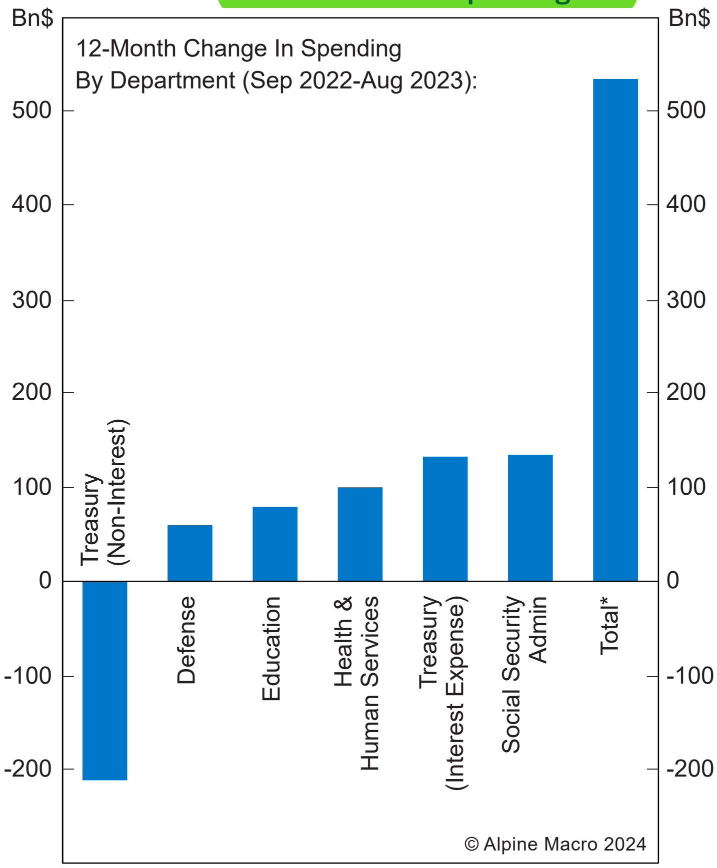


We suspected that there may be structural factors that bias the federal budget toward larger deficits. As a result, we projected only a marginal fiscal drag at worst for this year.

With FY2024 ending in September, fiscal policy indeed surprised the consensus on the stimulative

1 Alpine Macro *U.S. Bond Strategy Special Reports* "Pro-Cyclical Fiscal Policy: How Long Will It Last?" (September 28, 2023) and "U.S. Fiscal Policy And The 2024 Growth Outlook" (March 28, 2024).

Chart 2 The Boost In FY2023 Had Little To Do With Biden Spending Bills



*Includes other departments not listed

side once again. The budget deficit for FY2024 was 0.5% of GDP larger than in FY2023. The primary deficit (i.e., net of interest payments) declined by only 0.2% of GDP. This represents a negligible drag on real GDP growth.

This report clarifies the fiscal landscape for investors. We explore the key factors behind last year's larger-than-expected fiscal deficit and examine why fiscal policy may have a structural bias toward stimulus. Additionally, we provide our outlook for next year's federal and state & local government finances. The longer-term fiscal outlook will be discussed in a report to be published after the election.

Box 1: A Word On Methodology

Our approach focuses on changes in the primary budget balance (i.e., excluding interest payments) to assess the government's budget impact on aggregate demand. Economists usually focus on cyclically-adjusted primary balances that remove the effect of the business cycle on revenues and spending. However, these cyclical adjustments have been much more difficult to estimate since the pandemic, making them unreliable at best when gauging fiscal thrust or drag (see **Appendix** for more details on terminology and methodology).

A Larger-Than-Expected Deficit, Again

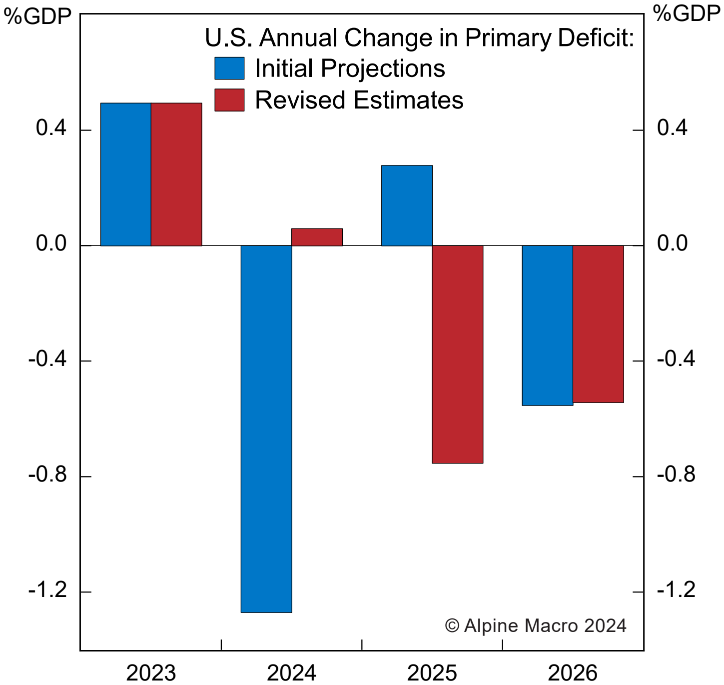
The unexpected lack of fiscal drag over the past 12 months surprised both investors and the CBO, a key benchmark for fiscal observers. The FY2024 primary deficit came in at 3.6% of GDP versus 3.8% in FY2023 and an initial estimate of 2.5% by the CBO (**Chart 3**). We think there may be methodological biases towards under-projecting spending.

The main sources of unexpected outlays and receipts are as follows[2]:

- Higher-than-expected costs for student loans totaled $145 billion. While the administration's student loan forgiveness plan was struck down by the Supreme Court, it retains significant discretion in managing existing student loan policies. We believe these administrative changes are driving the increased spending.

2 The breakdown is based on the CBO's June estimate. Aggregate outlays for FY2024 came in $50 billion lower than the June estimate, although the breakdown is unavailable.

Chart 3 Many Overestimated The Drag In FY2024



- New legislation increased discretionary outlays by $60 billion. Emergency military aid for Ukraine, Israel, and countries in the Indo-Pacific region was a major contributor.
- Outlays for Medicaid came in $50 billion higher than expected.
- A slower receipt of FDIC premium increases and asset liquidation from resolving the bank failures of 2023 and 2024 added another $70 billion.

Most of the higher-than-expected deficit is due to technical factors, rather than economic or legislative factors. *Economic* factors pertain to changes in the expected path of the economy while *legislative* factors reflect the effects of new laws governing spending.

Technical factors increased the deficit by $419 billion versus initial expectations, accounting for the bulk of the update. These changes reflect "revisions to CBO's budget projection models, new information or data from federal agencies, and changes in how programs are administered that affect federal spending and revenues."

The large technical revision indicates that the CBO's methodology may be biased toward underestimating the fiscal deficit. This aligns with the pattern that the technical component of CBO revisions has consistently increased the projected deficit over the past two years. Investors who use the CBO's estimates as a benchmark have been led to underestimate spending.

Structural Bias To Underestimating Fiscal Deficit

We believe the budget deficit may continue to exceed expectations in the coming years, driven by active political preferences and biases in model estimates:

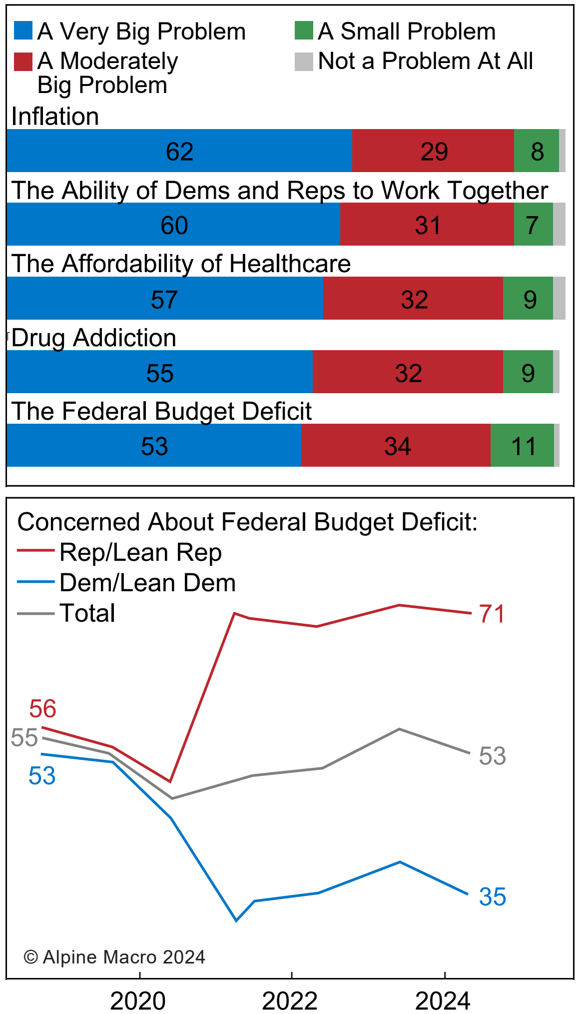
(1) **No Fiscal Hawks and Pro-Cyclical Policy Bias**

There are virtually no fiscal hawks left in Washington, as neither the Republican nor Democratic parties view a larger deficit as problematic. Reducing the deficit is not a priority for either candidate in the upcoming election.

This reflects voter sentiment. A recent Pew poll shows the fiscal deficit ranks fifth among key voter issues, with 71% of Republicans concerned

Lmao so military aid to ukr and isr is not legislative factors it seems

Chart 4 **Limited Political Support For Deficit Reduction**

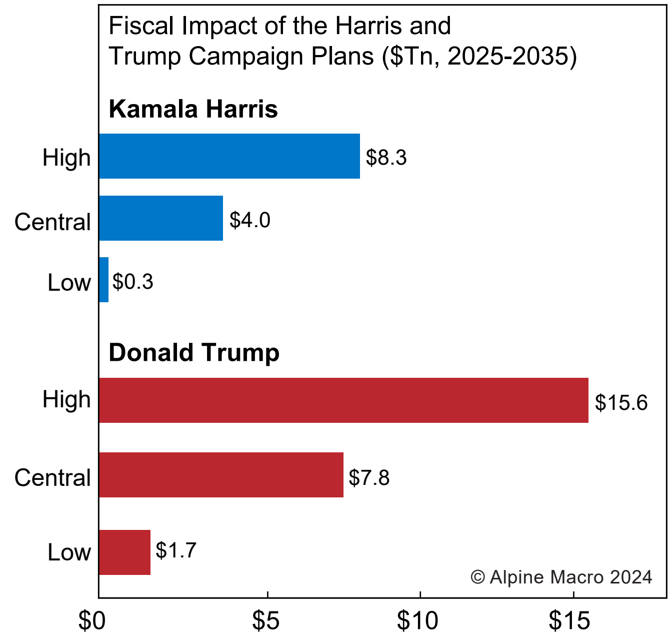


Note: No answer responses not shown
Source: Survey of U.S. adults conducted by PEW Research Center

compared to only 35% of Democrats – a gap that emerged after the current administration took office (**Chart 4**).

Both candidates' policy proposals are expected to increase the deficit significantly, if passed in full. The Penn Wharton model estimates Trump's plans would raise primary deficits by $5.8 trillion over the next 10 years, or $4.1 trillion with economic feedback. Harris' proposals are projected to add $1.2 trillion, or $2.0 trillion when including feedback.

Chart 5 **Both Presidential Candidates Are Spenders**



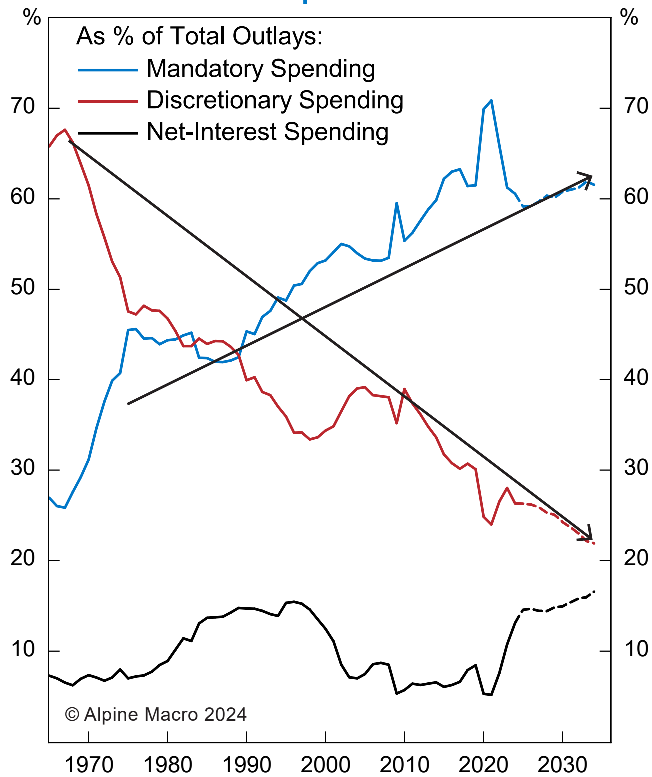
Source: CRFB

The Committee for a Responsible Federal Budget predicts increased total debt levels of $4 trillion and $7.5 trillion under Trump's and Harris' plans, respectively (**Chart 5**).

These figures are likely to be significantly watered down, depending on the makeup of the new Congress. Nonetheless, neither candidate appears predisposed to counter-cyclical fiscal measures, even when the economy is growing robustly.

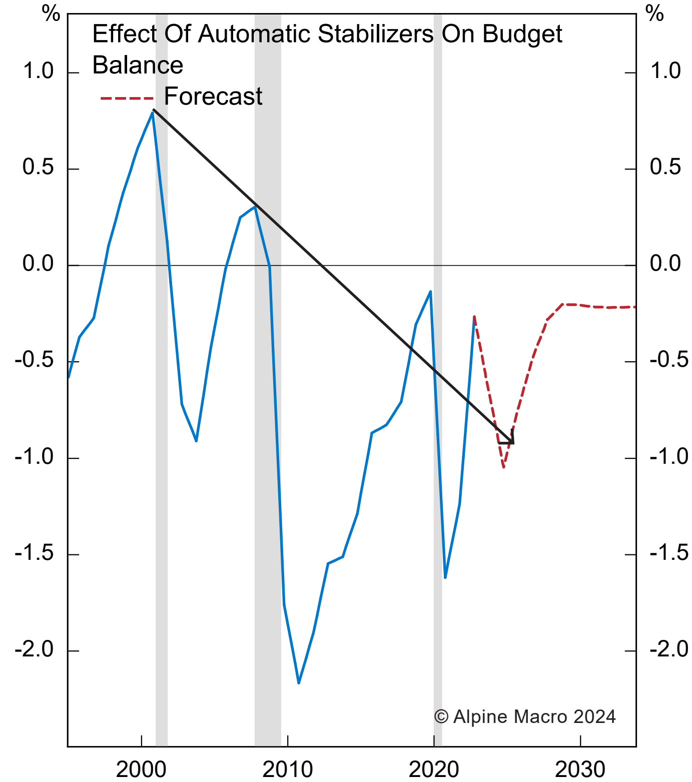
Both the 2016-2020 Trump administration and the current Biden administration followed this approach. Trump enacted tax cuts in 2017 when the economy was solid, but also supported massive fiscal stimulus at the onset of the pandemic. Similarly, Biden continued to support the economy during the economic reopening, and fiscal policy did not turn contractionary even when the economy overheated in 2022-2023.

Chart 6 Mandatory Spending Continues To Creep



Note: Dotted lines denote forecast period; source: CBO estimate

Chart 7 Biased Automatic Stabilizers



Note: Shown as a % of potential GDP, shaded area denotes U.S. recessions; source: CBO

(2) **Not-So-Automatic Stabilizers**

We suspect budget models fail to account for a structural bias toward fiscal stimulus, particularly from automatic stabilizers.

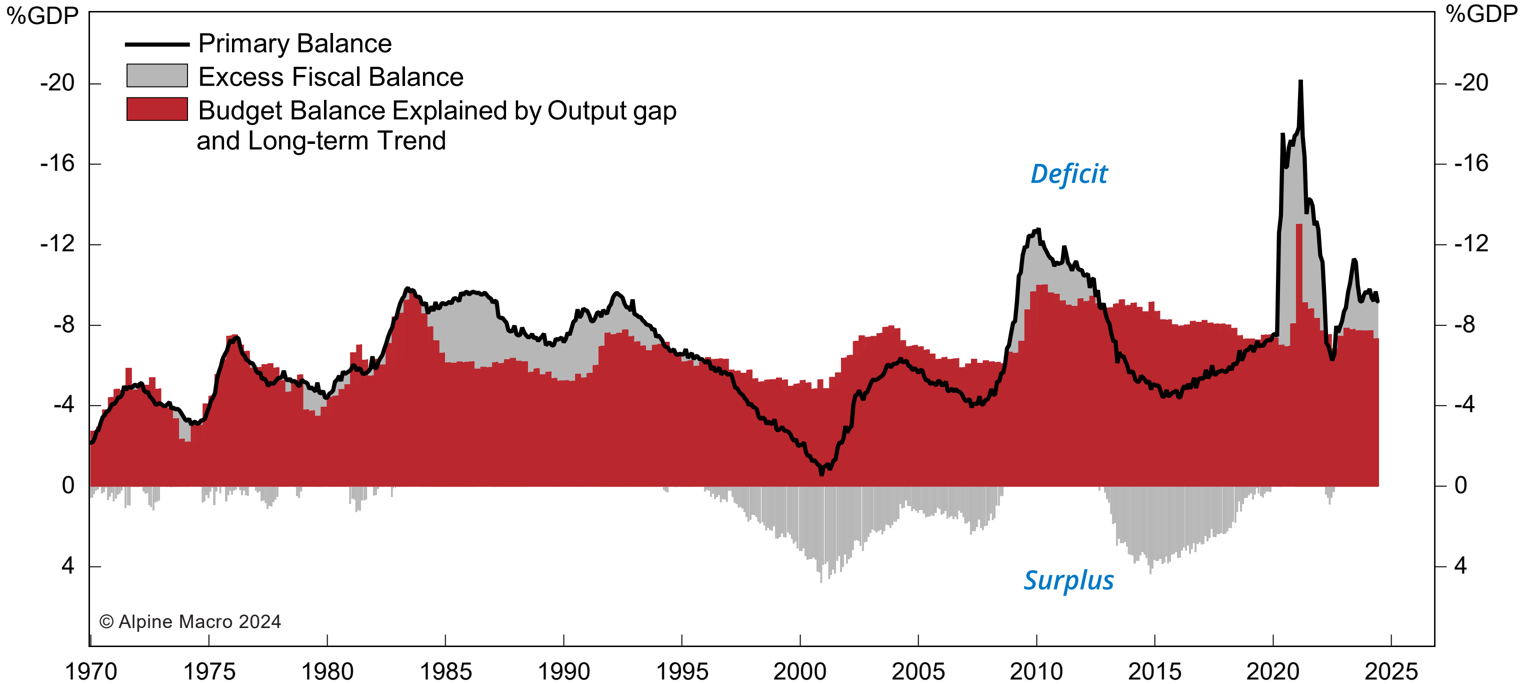
Historically, automatic stabilizers worked primarily through tax collections, which rose during booms and fell during recessions. However, the growing share of mandatory spending may have dampened this effect. Mandatory outlays have increased from 31% of government spending in 1970 to 61% in 2024 (**Chart 6**).

Much of this mandatory spending, including Social Security and healthcare, is indexed to inflation. When the economy runs hot, these expenses grow faster, offsetting the counter-cyclical effects on the budget balance of a rising tax take. However, during downturns, mandatory spending merely grows more slowly, while tax revenues are hit harder.

In theory, automatic stabilizers should have a neutral impact on the economy over the course of a business cycle. In reality, these stabilizers have consistently leaned towards the stimulative side (**Chart 7**). Except for a brief period before the GFC, automatic stabilizers have not been contractionary since the turn of the millennium. Even as the economy came roaring back after the pandemic, the stabilizers did not turn contractionary.

We ran a simple calculation to examine the stance of fiscal policy in relation to economic growth. We

Chart 8 Fiscal Policy Is Unusually Stimulative



regressed the primary budget balance against the output gap and a time trend.[3] The portion of the budget balance attributable to our explanatory variables is considered "normal". The portion of the budget balance not explained by the independent variables can be considered a measure of policy adjustment relative to the norm.

The latter includes both active policy changes and biases from automatic stabilizers. These two factors have clearly erred on the side of stimulus in recent times, as shown in **Chart 8**.

Outlook For Fiscal Policy

We expect a small increase in the federal budget deficit in the first half of FY2025, driven mainly by rising mandatory spending (the new fiscal year started in October). Discretionary spending will remain capped by the Fiscal Responsibility Act of 2023, which limits spending for FY2024 and FY2025.

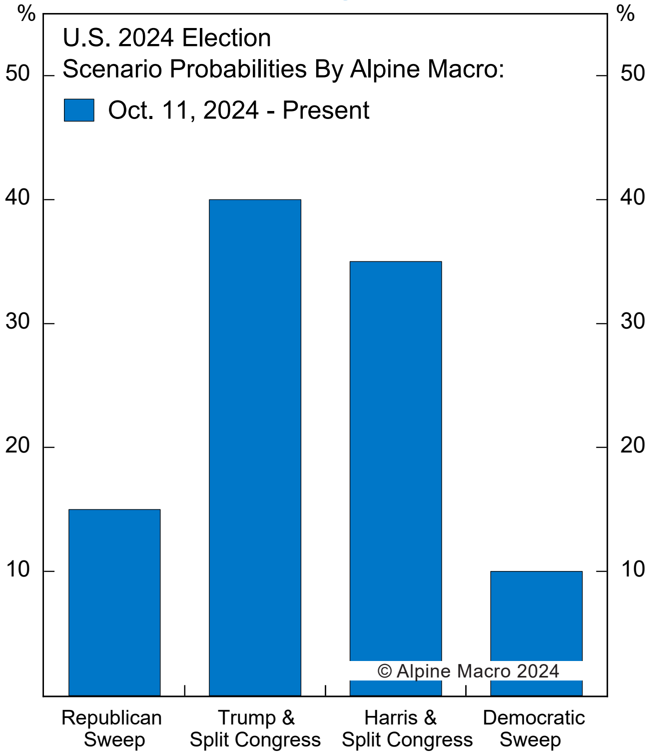
We think the CBO's 3% revenue growth estimate for FY2025 is reasonable. Taken together, we see fiscal thrust as roughly neutral for FY2025. This is in contrast to the CBO's estimate of a 0.5% drag.

The CBO projects no increase in mandatory spending from FY2024 to FY2025. However, this likely represents another underestimate that will eventually be revised up. Mandatory spending is driven by formulas that do not require new legislation.

Significant discretionary spending adjustments are unlikely until the second half of FY2025, after the new Congress convenes and has time to write, pass, and enact legislation. A split congress would be the most fiscally conservative election

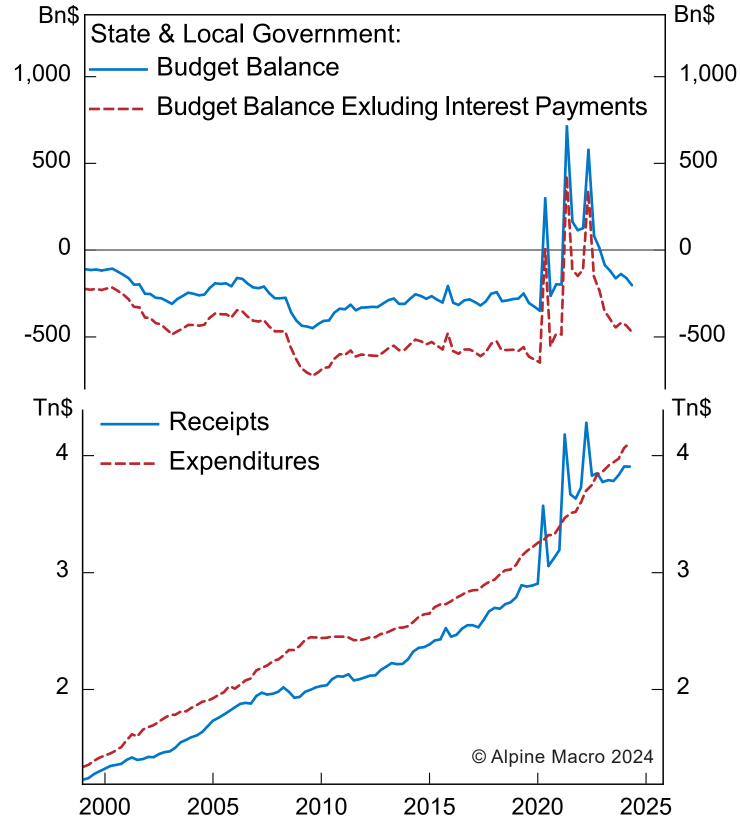
3 For methodology, see "*Recent and Near-Term Fiscal Policy: Headwind or Tailwind?*", Federal Reserve Bank of San Francisco, November 13, 2023.

Chart 9 A Split Congress Will Rein In Spending



Note: Split Congress assumes that the opposition party has a majority in at least one chamber of Congress, and possibly both

Chart 10 S&L Spending Is Renormalizing



outcome, sporting a 75% probability according to our Geopolitical Strategy service (**Chart 9**). Deficit reduction is unlikely, but at least gridlock would limit spending. In a split government, legislation will involve compromise, making large partisan spending bills unlikely.

State And Local Finances

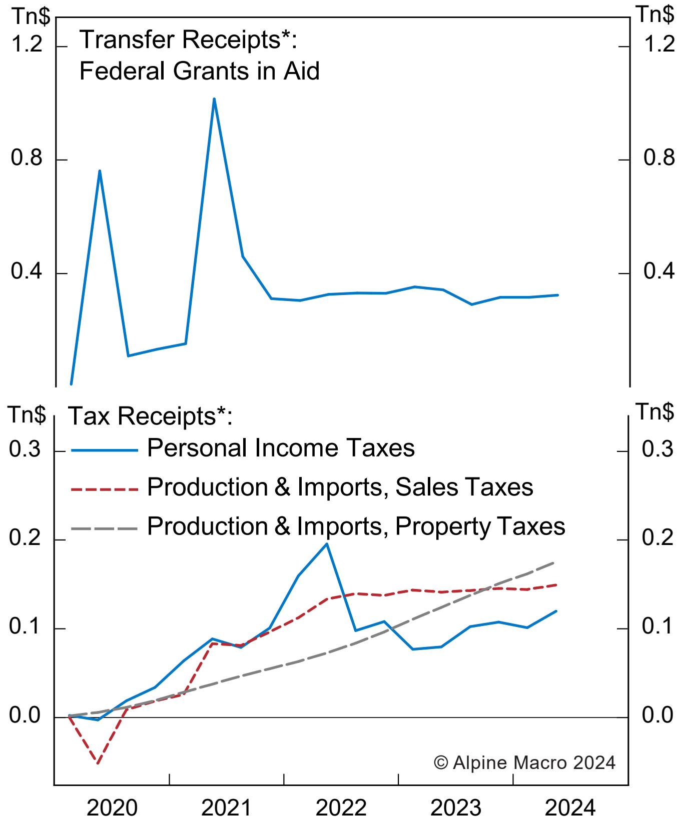
Recent data indicate that state & local government net spending is slowing. Revenues surged in 2021 and 2022, enabling significant spending increases in 2023 (**Chart 10**). However, this momentum has diminished in recent quarters (**Chart 11**).

- Fiscal transfers from the federal government have flatlined in recent months.
- Sales tax receipts are expected to grow in line with overall consumption.
- Slower wage growth and the rise in unemployment from post-pandemic lows will weigh on income taxes.
- Only property taxes continue to grow at a solid pace, owing to elevated home prices.

Not only will slowing revenue growth limit spending, but higher interest cost on outstanding debt means that the share of S&L expenditure going to debt servicing will also rise. This will further curtail non-interest spending.

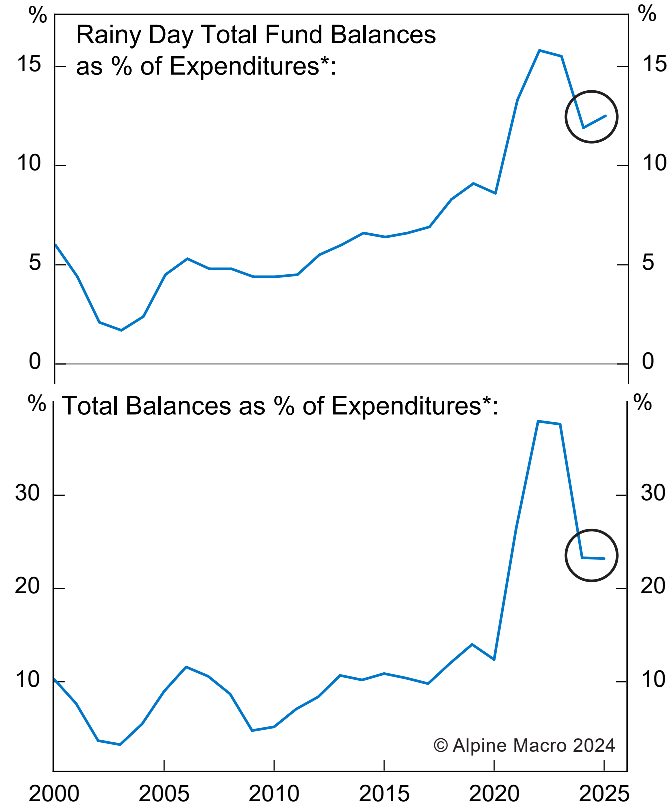
One offset is that general fund balances swelled after the pandemic and remain 2-3 times higher than

Chart 11 S&L Revenue Growth Is Slowing...



*Series calculated as performance change since 2020Q1

Chart 12 ...But Large Fund Balances Will Act As A Shock Absorber



*Figures for fiscal year 2024 and 2025 are projections based on governors' recommended budgets

historical levels. State and local finances remain in strong shape, meaning S&L spending growth may slow or slightly contract but will not experience a sharp decline (Chart 12). States have ample reserves in their rainy-day funds to cushion the impact.

Conclusions

Fiscal policy was more stimulative than expected in both 2023 and 2024, and we anticipate this trend toward larger deficits will continue. This is driven by both a lack of political will for fiscal restraint and structural biases.

Investors should expect fiscal policy to be somewhat more stimulative than the CBO baseline of a small drag for the coming two quarters. Our best guess is a neutral impact on growth based on previous CBO misestimates. The implication is that investors should not expect fiscal policy to become a major economic headwind that forces the Fed to ease more quickly than is currently discounted.

Fiscal policy beyond the next two quarters remains highly contingent on electoral outcomes. We will review the longer-term fiscal outlook after the election.

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Head of Quantitative Research

Appendix
Terminology And Concepts

The gold standard for analyzing fiscal policy is the cyclically-adjusted budget balance (CABB). The CABB aims to remove the effects of the business cycle from both the spending and tax sides of the equation, providing a clearer representation of discretionary changes in tax and spending laws that affect the economy. The change in the CABB, as a percentage of GDP, is a standard measure of fiscal thrust. Fiscal thrust estimates the initial impetus on GDP growth, excluding the impact of multiplier effects that play out over time.

However, estimating the CABB is challenging, even under the best of circumstances. This difficulty is exacerbated by new spending programs, high inflation, and post-pandemic structural economic shifts. Some estimates of the CABB, like the widely followed Hutchins Center Fiscal Impact Measure, suggest that policy has been a drag on growth. However, this conflicts with the surge in government spending and its contribution to GDP growth over the past few years.

We simplify matters by focusing solely on the direct contribution of net government spending to GDP, without cyclical adjustments. This approach serves as a good starting point for understanding what has transpired over the past year and how government spending's contribution to GDP may evolve.

Fiscal spending typically falls into two categories: mandatory and discretionary spending. According to the Treasury Department:

- The difference between mandatory and discretionary spending relates to whether spending is dictated by prior law or voted on in the annual appropriations.

- Mandatory spending, also known as direct spending, is mandated by existing laws. This type of spending includes funding for entitlement programs like Medicare and Social Security and other payments to people, businesses, and state and local governments.

- Discretionary spending is money formally approved by Congress and the President during the appropriations process each year. Generally, Congress allocates over half of the discretionary budget towards national defense and the rest to fund the administration of other agencies and programs.

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A Unique Mind On The Markets

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