WEEKLY COMMENTARY

A Year Out from the Presidential Election, America's Fiscal House Is Not in Order

By Francis Généreux, Principal Economist

US bond yields have surged recently, and there are a number of reasons why. Investors are looking to offset their inflation-induced losses, and soaring key interest rates and rate expectations have affected the future path of monetary policy. But these two factors alone don't explain the spike in bond yields over the past few months. The answer lies in the rising term premium—the compensation for the risk of future interest rate fluctuations. We discussed this in a recent Weekly Commentary.

One of the risk factors a higher term premium offsets is the supply of public debt on the market. While part of this supply is from the Federal Reserve's quantitative tightening, some is the result of public finances. The size of the federal debt and deficit has been under increased scrutiny of late. For a long time, it seemed as though deficits didn't matter anymore. But times have changed, and bond investors are now being more cautious. This caution is warranted, as federal government finances have deteriorated further in the past year. And we don't have the pandemic to blame anymore.

Finances Are Moving in the Wrong Direction

The US ended fiscal year 2023 (FY2023) on September 30 with a deficit of US$1.695 trillion. That's an improvement over the pandemic deficits of US$3.132 trillion in FY2020 and US$2.776 trillion in FY2021, but it's higher than the FY2022 deficit of US$1.375 trillion.

And it could have been much worse, as the Biden administration's student loan forgiveness program was blocked by the Supreme Court before it took effect. The US Treasury added US$379B to the deficit in FY2022 for the program before having to reverse most of the accounting and reduce the FY2023 shortfall by US$333B. Without student loan forgiveness, the deficit would have topped US$2 trillion in FY2023, twice the nearly US$1 trillion deficit that would have been recorded in FY2022.

Why the Slide?

The United States has both a spending problem and a revenue problem. At first blush, spending appears to be down 2.2%. But take away the impact of the reversal of student loan forgiveness, and spending is up 4.1%, or US$242B, year-over-year. That's a big jump, though it's not surprising given today's high inflation—which also drives up government spending—and higher debt servicing costs, which were up 23%, or US$162B. That said, in 2023 there was virtually none of the pandemic-related spending we saw in 2022. In other words, spending is still high. It accounted for 24.0% of GDP in 2023 versus 20.4% on average between 2014 and 2019.

Looking at revenue, the change over the last fiscal year was even more stark. Revenue fell 9.3%, or US$457B, in FY2023. Personal income tax receipts excluding payroll deductions were down sharply. There was also a US$106B drop in revenue from the Federal Reserve compared to FY2022. As a percentage of GDP, revenue fell from 19.3% in 2022 to just 16.5% in 2023. That's in line with the 16.2% rate seen in 2018 and 2019 after the Trump tax cuts. The average over the four years prior to the cuts was 17.4%.

With spending up and revenue down, the shortfall widened in 2023 despite fairly strong economic growth. As of September 30, 2023, the national debt stood at US$33.167 trillion, up US$2.238 trillion year-over-year. Looking just at the debt held by the public (including what is held by the Federal Reserve), the debt totalled US$26.330 trillion (98.0% of GDP) at the end of FY2023 compared to US$24.299 trillion at the end of FY2022 (96.9% of GDP). Unfortunately, there's no easy way—or even

CONTENT

Desjardins Economic Studies: 514-281-2336 or 1-866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

the political will—to balance the budget and get the debt under control. And therein lies the risk for investors: the debt is rising and appears to be going nowhere but up. According to the Congressional Budget Office's June outlook, the public debt will increase to 100.2% of GDP in 2024 and an astounding 115.0% by 2033.

Political Gridlock a Year Out from Election Day

The political divide in Washington and across the US makes it hard to find a long-term solution. The Republican speaker of the House paid dearly for cutting bipartisan deals to end the debt ceiling standoff in May and avert a government shutdown in September. That left the House speakerless for three weeks, giving it precious little time to pass a new funding bill by mid-November. This underscores not just the Republican–Democrat divide, but also the rifts within the Republican party itself. There are differences between the centrists and the left flank of the Democratic party as well.

Gridlock always results in some pullback in spending, and we might well see that. But that's not a long-term fix, and it could short-change some near-term priorities. What's more, the White House recently requested US$105B in funding for the wars in Ukraine and Israel. That's on top of requests for things like border security and humanitarian aid that went unanswered during the House speaker fight. We'll have to see what the new House speaker, Republican Mike Johnson, can get done.

If Congress remains divided or gridlocked, a solution could be hard to come by. Republicans will likely never agree to raise taxes, which would boost revenues. And Democrats are opposed to cutting spending, especially on social programs—a major driver of long-term spending growth. There's talk of a bipartisan commission on public finances, but getting one off the ground wouldn't be easy. And the leaders of both parties would need to formally commit to implementing the commission's recommendations, which would be challenging in today's political climate.

But while investors are increasingly alarmed by the state of the nation's finances, it doesn't seem to be a major concern for voters. In a recent Economist/YouGov poll, just 6% of respondents said taxes and government spending was the most important issue for them. It came in 6th, well behind inflation and prices at 24%.

A lot can happen in a year. But right now, it's hard to see public finances becoming a major issue in the next presidential election. As in 2020, the election may well be a referendum on Donald Trump—if he clinches the Republican nomination. Geopolitics, national security, the environment, energy prices and President Biden's fitness could also be on voters' minds as they head to the polls on November 5. And the economy, which can be the deciding factor in presidential elections, continues to be an issue as well. Our latest forecast calls for a soft landing that brings down inflation without crushing the labour market. That would help Biden's re-election chances. The investments made in some communities through the Inflation Reduction Act and infrastructure spending may also help him. If the lagged effects of interest rate hikes hit the economy harder, however, it could help the Republican nominee. It remains to be seen whether public finances re-emerge as a leading issue not just for investors, but also for politicians and the public. But barring a dramatic turn of events, interest rates could remain elevated and throw a wrench in the works.

What to Watch For

By Randall Bartlett, Senior Director of Canadian Economics, Tiago Figueiredo, Associate – Macro Strategy, Marc Desormeaux, Principal Economist, Marc-Antoine Dumont, Economist, and Francis Généreux, Principal Economist

UNITED STATES

TUESDAY October 31 - 9:00	
August	**y/y**
Consensus	n/a
Desjardins	1.6%
July	**0.1%**

S&P/Case-Shiller index of existing home prices (August) – The upward trajectory in US home prices continued in July. The year-over-year change in the S&P/Case-Shiller index even returned to positive territory for the first time since February, reflecting the decline in mortgage rates earlier this year. However, rates have started to rise again to very high levels, which is likely to eventually impact home values. That said, the index probably gained another 0.3% in August, which should push the year-over-year change up to 1.6%.

TUESDAY October 31 - 10:00	
October	**Index**
Consensus	100.0
Desjardins	101.0
September	**103.0**

Conference Board consumer confidence index (October) – The Conference Board consumer confidence index plummeted by 5.7 points in September, its biggest monthly contraction since August 2021. October's negative prints for the University of Michigan and TIPP indexes don't bode well for Tuesday's release. The headwinds faced by the major stock markets combined with rising interest rates—including mortgages—also aren't a good sign for confidence. The only silver lining is the labour market, which still appears to be advancing, and falling gasoline prices. We expect the Conference Board index to drop to 101.0.

WEDNESDAY November 1 - 10:00	
October	
Consensus	49.1
Desjardins	49.0
September	**49.0**

ISM Manufacturing index (October) – The ISM Manufacturing index hit its highest level since November 2022 in September, at 49.0. But after gaining 1.4 points last month, we expect a flat print in October—at 49.0 again—based on regional manufacturing indexes, which have had rather mixed performances.

WEDNESDAY November 1 - 14:00	
November	
Consensus	5.50%
Desjardins	5.50%
September 20	**5.50%**

Federal Reserve meeting (November) – Things aren't easy for Fed officials. Based on much of the messaging over the last few weeks, some of them will be inclined to extend the pause they began in September. Generally, they see the recent rise in market rates as a form of monetary tightening allowing them to maintain the status quo. Past rate hikes are also expected to continue impacting the US economy. However, some Fed officials would probably prefer another rate hike. Strong real GDP and employment growth make it hard to believe that the economy has slowed enough to reduce inflationary pressure. And the Fed's September dot plot indicated the possibility of another 25bp hike by the end of the year. However, we believe the more dovish arguments will prevail and the Fed will continue its pause.

FRIDAY November 3 - 8:30	
October	
Consensus	180,000
Desjardins	170,000
September	**336,000**

Job creation according to the establishment survey (October) – September's hiring strength came as quite a shock. The 336,000 jobs added was the strongest print since January. Based on the low level of weekly unemployment claims at mid-month, we could be in for another stellar month in October. On the other hand, after September's blowout print, a pullback is also plausible. We must also consider the job losses caused by the automotive industry strike, which began after the September survey. We think 170,000 jobs will be added, although this forecast is rather uncertain. We expect the unemployment rate to stay put at 3.8%.

FRIDAY November 3 - 10:00	
October	
Consensus	53.2
Desjardins	52.5
September	**53.6**

ISM Services index (October) – While the ISM Manufacturing index rose in September, the ISM Services index fell from 54.5 to 53.6. Based on the falling confidence indicators and most regional non-manufacturing indexes, we're expecting a further decline in the ISM Services index in October to 52.5.

CANADA

TUESDAY October 31 - 8:30	
August	
Consensus	0.1%
Desjardins	0.1%
July	**0.0%**

Real GDP by industry (August) – Monthly real GDP growth is expected to have accelerated in August, advancing by a healthy 0.1% after flatlining in July. Economic activity was probably especially strong in goods-producing sectors. Construction and mining and oil and gas extraction look poised to post notable moves higher. Services-producing sectors should also have gained ground on a mixed bag of industry-specific developments, likely led higher by a solid wholesale trade print. While our outlook is in line with Statistics Canada's flash estimate, we think the risks to the outlook are tilted to the upside. This reflects historical revisions to key input series, which point to a possible upward revision to July's real GDP outturn as well. Looking ahead, September real GDP by industry is tracking a soft +0.1%.

FRIDAY November 3 - 8:30	
October	
Consensus	25,000
Desjardins	10,000
September	**63,800**

Labour Force Survey (October) – With the seasonal anomalies from the start of the school year likely finished, expect employment growth in October to have been around 10K. The population probably continued to grow rapidly, suggesting that the pace of employment gains once again is lagging that implied by the rise in the labour force. As such, we expect the unemployment rate to have risen by 1 tick to 5.6%. The latest data from the SEPH suggest that job vacancies continue to fall and the imbalance of supply and demand in the labour market is gradually normalizing, which should eventually translate to lower wage pressures. Wage growth on an annual basis should moderate as the bar for acceleration remains high.

OVERSEAS

MONDAY October 30	
October	
Consensus	-0.10%
Desjardins	0.00%
September	**-0.10%**

Japan: Bank of Japan meeting (October) – We've been thinking for a while that it may be time for the Bank of Japan (BoJ) to raise its key rate slightly, but the BoJ doesn't want to get burned again. Although inflation is above the BoJ's target and has even surpassed 4% excluding food and energy, Japan has a long history of struggling to keep inflation above zero. Once the dust settles, the BoJ's concern is that inflation expectations won't have increased enough, which would push inflation toward an excessively low level. That said, based on comments from officials, the BoJ doesn't seem to have completely closed the door on the idea of shifting its monetary policy. Reducing its monetary policy stimulus could also help the exchange rate. The yen is trading at close to 150/US$ again, as it was when the authorities intervened to prop up the currency in the fall of 2022. However, this type of intervention will have little impact if the BoJ maintains a negative key interest rate and an asset purchasing policy to limit the rise in its 10-year bond yield.

MONDAY October 30 - 21:30	
October	
Consensus	n/a
September	**52.0**

China: Composite PMI (October) – China's composite PMI rose for the second month in a row in September after a five-month slide. However, the gains were uneven, with both the services and non-manufacturing indexes declining. Still, the situation appears to be improving in China as third-quarter real GDP and last month's retail sales exceeded forecasters' expectations. That said, China isn't out of the woods yet, with virtually non-existent inflation a sign of weak domestic demand. October's data will give us more insight into the state of the Chinese economy.

TUESDAY October 31 - 6:00	
Q3 2023	**q/q**
Consensus	0.0%
Q2 2023	**0.1%**

Eurozone: Real GDP (third quarter – preliminary) – Eurozone economic growth has been weak since the fall of 2022. It's not as disastrous as we could have expected when the war in Ukraine broke out, but it's certainly sluggish, amid the rising cost of living, higher interest rates and tighter credit conditions. Quarterly real GDP growth is forecast to be rather weak again in the third quarter. PMI levels suggest a contraction is possible, particularly in Germany.

TUESDAY October 31 - 6:00	
October	**y/y**
Consensus	3.1%
September	**4.3%**

Eurozone: Consumer Price Index (October – preliminary) – Inflation continues to ease in the eurozone. The year-over-year change in the consumer price index was 4.3% in September, a vast improvement over the 10% prints we were seeing a year ago. Core inflation has also fallen recently, from 5.3% in August to 4.5% in September. This is still some way from the European Central Bank's 2% target, but it's clearly a step in the right direction. We'll have to wait and see whether the trend continues with October's print.

THURSDAY November 2 - 8:00	
November	
Consensus	5.25%
Desjardins	5.50%
September 21	**5.25%**

United Kingdom: Bank of England meeting (November) – The Bank of England (BoE) hit pause at its last monetary policy meeting, but the vote was very close. Looking at the situation objectively, although inflation has come down, it remains very high and well above the other major advanced economies. While the UK economy has slowed, it's not yet in a recession, and the labour market remains too tight. Wage growth is still high and is a significant inflationary risk. We think it's more likely that the BoE will hike again. It will also publish its latest monetary policy report after the meeting.

Economic Indicators

Week of October 30 to November 3, 2023

Date	Time	Indicator	Period	Consensus	Desjardins	Previous reading
UNITED STATES						
MONDAY 30	---	---				
TUESDAY 31	8:30	Employment cost index (q/q)	Q3	1.0%	1.0%	1.0%
	9:00	S&P/Case-Shiller home price index (y/y)	Aug.	n/a	1.60%	0.13%
	9:45	Chicago PMI	Oct.	45.0	45.0	44.1
	10:00	Consumer confidence	Oct.	100.0	101.0	103.0
WEDNESDAY 1	---	Total vehicle sales (ann. rate)	Oct.	15,200,000	15,700,000	15,670,000
	10:00	Construction spending (m/m)	Sept.	0.4%	0.6%	0.5%
	10:00	ISM Manufacturing index	Oct.	49.1	49.0	49.0
	14:00	Federal Reserve meeting	Nov. 1	5.50%	5.50%	5.50%
	14:30	Speech by Federal Reserve Chair J. Powell				
THURSDAY 2	8:30	Initial unemployment claims	Oct. 23–27	210,000	214,000	210,000
	8:30	Nonfarm productivity – preliminary (ann. rate)	Q3	4.0%	4.3%	3.5%
	8:30	Unit labor costs – preliminary (ann. rate)	Q3	0.7%	0.6%	2.2%
	10:00	Factory orders (m/m)	Sept.	1.7%	2.3%	1.2%
FRIDAY 3	8:30	Change in nonfarm payrolls	Oct.	180,000	170,000	336,000
	8:30	Unemployment rate	Oct.	3.8%	3.8%	3.8%
	8:30	Average hourly earnings (m/m)	Oct.	0.3%	0.2%	0.2%
	8:30	Average weekly hours	Oct.	34.4	34.4	34.4
	10:00	ISM Services index	Oct.	53.2	52.5	53.6
CANADA						
MONDAY 30	---	---				
TUESDAY 31	8:30	Real GDP by industry (m/m)	Aug.	0.1%	0.1%	0.0%
WEDNESDAY 1	---	---				
THURSDAY 2	---	---				
FRIDAY 3	8:30	Net change in employment	Oct.	25,000	10,000	63,800
	8:30	Unemployment rate	Oct.	5.6%	5.6%	5.5%

NOTE: Each week, Desjardins Economic Studies takes part in the Bloomberg survey for Canada and the United States. Approximately 15 economists are consulted for the Canadian survey and a hundred or so for the United States. The abbreviations m/m, q/q and y/y correspond to month-over-month, quarter-over-quarter and year-over-year change respectively. Following the quarter, the abbreviations f, s and t correspond to first estimate, second estimate and third estimate respectively. Times shown are Eastern Daylight Time (GMT - 4 hours). Desjardins Economic Studies forecast.

Economic Indicators

Week of October 30 to November 3, 2023

Country	Time	Indicator	Period	Consensus m/m (q/q)	Consensus y/y	Previous reading m/m (q/q)	Previous reading y/y
OVERSEAS							
MONDAY 30							
Japan	---	Bank of Japan meeting	Oct.	-0.10%		-0.10%	
Germany	5:00	Real GDP – preliminary	Q3	-0.2%	-0.7%	0.0%	-0.2%
Eurozone	6:00	Consumer confidence – final	Oct.	-17.9		-17.9	
Eurozone	6:00	Economic confidence	Oct.	93.0		93.3	
Germany	9:00	Consumer price index – preliminary	Oct.	0.2%	4.0%	0.3%	4.5%
Japan	19:30	Unemployment rate	Sept.	2.6%		2.7%	
Japan	19:50	Retail sales	Sept.	0.2%	6.0%	0.2%	7.1%
Japan	19:50	Industrial production – preliminary	Sept.	2.5%	-2.3%	-0.7%	-4.4%
China	21:30	Composite PMI	Oct.	n/a		52.0	
China	21:30	Manufacturing PMI	Oct.	50.2		50.2	
China	21:30	Non-manufacturing PMI	Oct.	51.8		51.7	
TUESDAY 31							
Japan	1:00	Consumer confidence	Oct.	35.0		35.2	
Japan	1:00	Housing starts	Sept.		-6.4%		-9.4%
France	2:30	Real GDP – preliminary	Q3	0.1%	0.6%	0.5%	1.0%
France	2:30	Personal consumption expenditures	Sept.	0.4%	-2.8%	-0.5%	-1.9%
France	2:30	Consumer price index – preliminary	Oct.	0.2%	4.0%	-0.5%	4.9%
Germany	3:00	Retail sales	Sept.	0.5%	-3.4%	-1.2%	-1.9%
Italy	5:00	Real GDP – preliminary	Q3	0.1%	0.1%	-0.4%	0.4%
Italy	6:00	Consumer price index – preliminary	Oct.	0.4%	2.4%	0.2%	5.3%
Eurozone	6:00	Real GDP – preliminary	Q3	0.0%	0.2%	0.1%	0.5%
Eurozone	6:00	Consumer price index – preliminary	Oct.	0.3%	3.1%	0.3%	4.3%
WEDNESDAY 1							
United Kingdom	5:30	Manufacturing PMI – final	Oct.	45.2		45.2	
Brazil	17:30	Central Bank of Brazil meeting	Nov.	n/a		12.75%	
THURSDAY 2							
Italy	4:45	Manufacturing PMI	Oct.	46.5		46.8	
France	4:50	Manufacturing PMI – final	Oct.	42.6		42.6	
Germany	4:55	Manufacturing PMI – final	Oct.	40.7		40.7	
Norway	5:00	Bank of Norway meeting	Nov.	4.25%		4.25%	
Eurozone	5:00	Manufacturing PMI – final	Oct.	43.0		43.0	
United Kingdom	8:00	Bank of England meeting	Nov.	5.25%		5.25%	
FRIDAY 3							
Germany	3:00	Trade balance (€B)	Sept.	16.3		16.5	
France	3:45	Industrial production	Sept.	0.0%	0.1%	-0.3%	0.5%
United Kingdom	5:30	Composite PMI – final	Oct.	48.6		48.6	
United Kingdom	5:30	Services PMI – final	Oct.	49.2		49.2	
Eurozone	6:00	Unemployment rate	Sept.	6.4%		6.4%	

NOTE: Unlike release times for US and Canadian economic data, release times for overseas economic data are approximate. Publication dates are provided for information only. The abbreviations m/m, q/q and y/y correspond to month-over-month, quarter-over-quarter and year-over-year change respectively. Times shown are Eastern Daylight Time (GMT - 4 hours).