2/15/2024

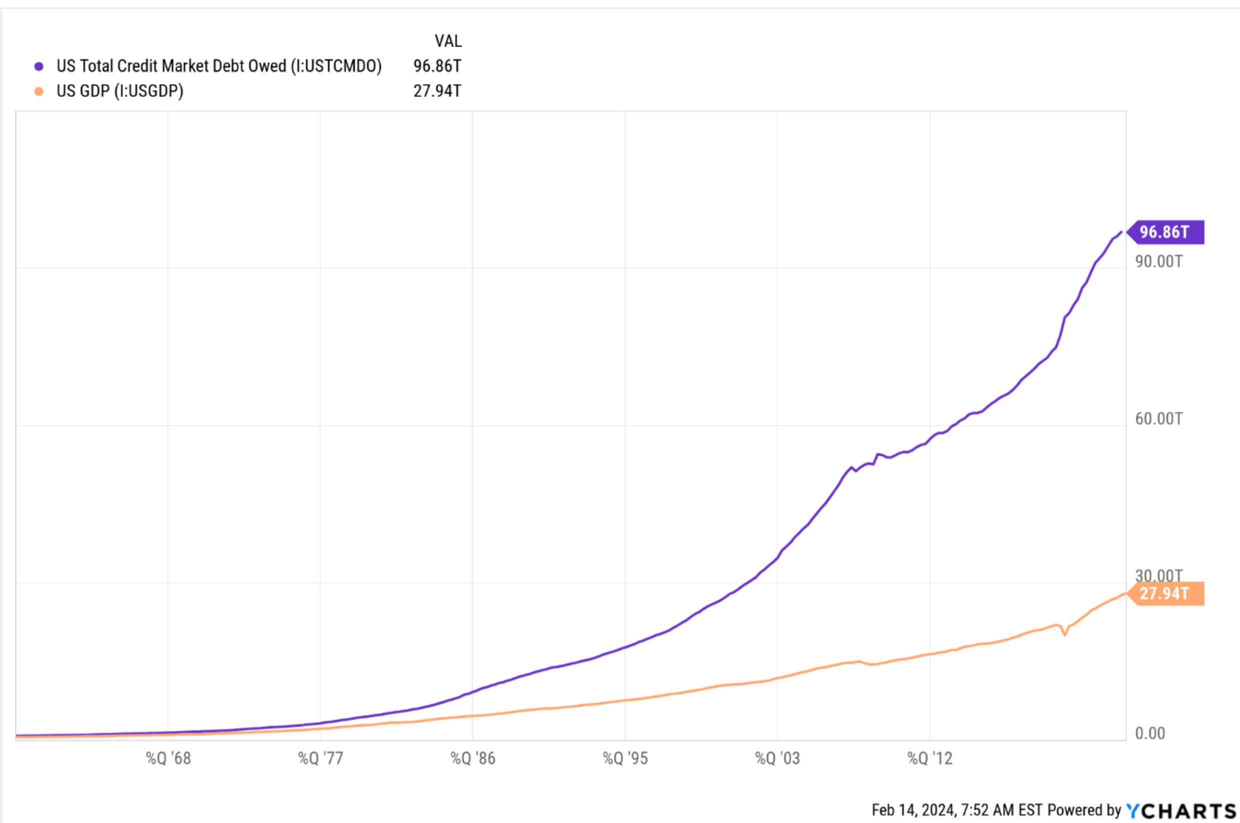
Debt, Inflation, Employment, and the Equity Risk Premium

Robert G. Kahl, CFA, CPA, MBA
https://SabinoIM.com

A Debt-Fueled Economy

Total US credit market debt (government, corporate, and consumer) has been growing at a faster rate than gross domestic product for several decades now. While total credit market debt in the US was nearly the same as GDP during the 1970s, the current ratio of US total credit market debt to GDP is 347%. The US economy and financial markets have benefited from the expansion of debt, but there are limits to how much debt can be issued without negative consequences. As debt/GDP rises, the probability of default rises and investors eventually become reluctant to lend more money.

The US government now has $34.2 trillion of debt outstanding, and the Treasury Department expects to increase it by nearly $1 trillion during the first half of this year. US Treasury debt that is maturing in 2024 will be refinanced at higher interest rates.



According to Moody's Investors Service, outstanding US household debt increased to $17.5 trillion at the end of 2023. Credit card debt was the fastest growing sector of consumer debt with a 14.5% increase in 4Q/2023 compared to the prior year's quarter. Auto loans and residential mortgage debt grew at lower rates of 3.5% and 2.8% respectively. The rate of new delinquencies on credit card debt was 8.5% in 4Q/2023, up from 5.9% in the prior year's quarter. Auto loans and residential mortgage delinquencies were also higher with default rates of 7.7% and 3.0% respectively.

Nonfinancial corporate debt stood at $13.7 trillion as of Q3/2023 according to the St. Louis Fed. Corporate bankruptcies remain at a low historical level. However, like the US Government, many corporations will have to refinance maturing debt at higher interest rates.

Inflation

On February 13, the US Bureau of Labor Statistics (BLS) released its inflation report. The consumer price index (CPI) for all urban consumers increased by 3.1% in January compared to the prior year. This was slightly higher than the consensus forecast of 2.9%. Most items were higher in price, but energy prices and used cars and trucks had price declines. The higher-than-expected inflation rate quickly changed expectations that the Federal Reserve will lower the fed funds rate during the first half of this calendar year. Interest rates on US Treasury securities rose and the stock market declined, with the S&P 500 Index down by 1.4% for the day.

Employment

On February 2, the BLS reported that January payrolls increased by 353,000, nearly twice as high as forecast. Trey Reik at the Bristol Gold Group and other analysts have highlighted the unusually large divergence between the BLS establishment survey (of businesses) and the BLS household survey. The establishment survey showed payroll growth of 353,000 and 333,000 in December and January in contrast to the household survey which had declines of 683,000 and 31,000 for the same two months.

Two aspects of the household survey are troubling. During the last 12 months, part-time jobs increased by 870,000 while full-time jobs declined by 97,000. Also, since March 2022, employment of American-born workers declined by 126,000 while employment of foreign-born workers increased by 2.1 million jobs.

2/15/2024

Equity Risk Premium

One measure of risk compensation for US equities is the equity risk premium. Normally, the equity risk premium is positive because stock investors expect to get higher returns with higher volatility compared to a "risk-free" investment such as a 3-month US Treasury bill. The most common measure of the equity risk premium is the S&P 500 earnings yield (trailing earnings/price) less the rate on the 3-month US T-bill.

According to Multpl.com, the S&P 500 Index currently sells at 27.2X trailing earnings. The inverse of this ratio (1/27.2) is the earnings yield and equals 3.67%. The current rate on a 3-month US Treasury bill is 5.38%. So, the equity risk premium is currently negative at -1.71%. The equity risk premium turned negative in early 2023, but prior to that, it had been positive since early 2001. For the equity risk premium to return to zero, the S&P 500 would have to decline by 32%, based upon the last 12 months of earnings.

Given the dynamics of the US economy, monetary policy, and high equity valuation levels, there is a strong argument for a conservative asset allocation at this time.

If you have any questions or comments, please contact me.

Sincerely,
Robert G. Kahl
CFA, CPA, MBA