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RICHARDSON Wealth

Market Ethos

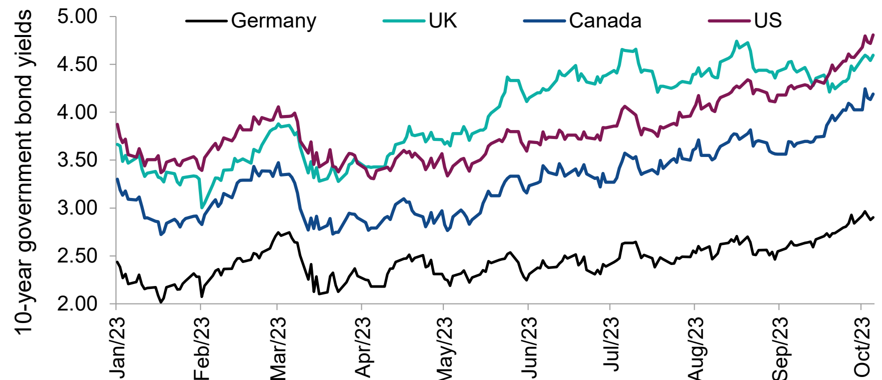
The latest market insights from Richardson Wealth

Craig Basinger

The crowding out effect

Now that was a blockbuster jobs report! The U.S. economy added 336k jobs in September, based on the nonfarm payroll report, much stronger than expected. Plus, the last two months were revised higher by 119k. This was a strong labour report (or labor as they like to spell it in America). Almost 100k jobs in leisure / hospitality and education / health +70k were the big contributors, as was government at +73k, bringing total government employees above pre-pandemic levels. We will touch on deficits below. Canada too, enjoyed strong labour gains at +64k. Jobs for everyone it seems is still on.

n response, bond yields have jumped higher yet again. At time of writing the U.S. 10-year Treasury is now yielding 4.8%, up a full percentage point since mid-July on what appears to be a relentless climb to who knows where. It is not just America, yields have been climbing in Canada, Europe, the list goes on. The yield gains are larger in North America, but in the past few weeks the other major markets are hopping on the trend.



Source: Bloomberg, Purpose Investments

So, you are telling me I can lock in a 10-year annualized return of 4.8% by owning a U.S. Treasury or 4.2% for a Canada Govie? That certainly makes for a more constructive financial plan if my portfolio target is somewhere in the 6-7% range. Of course, it wouldn't be a straight line, but if it's more end point focused it certainly has an appeal, as does 5% yields on money market or shorter-term vehicles. Clearly appealing yields, looking at investor behaviour this year as money has piled into money market vehicles. Based on ICI data from the U.S., money market assets have increased from $4.7 to $5.7 trillion so far this year, following a similar trend in Canada, albeit of smaller magnitude.

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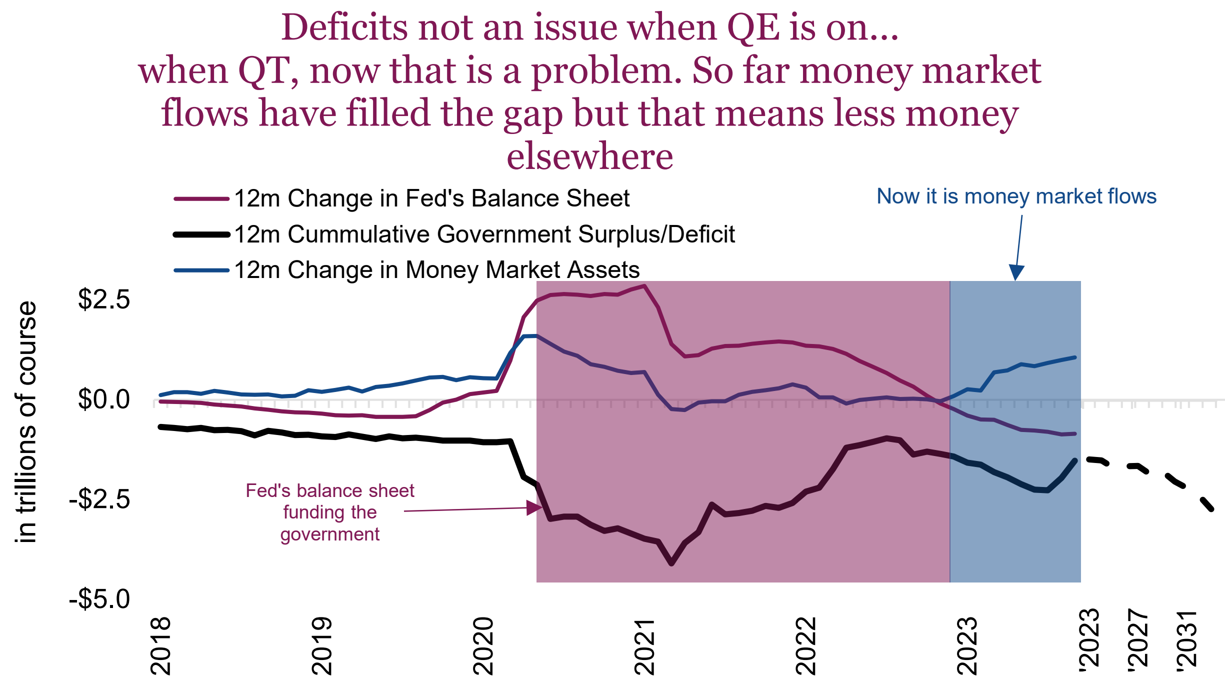
Here lies the problem

The U.S. government is expected to be running a $1.5 trillion deficit in 2023 which is forecast to rise to $2.8 trillion over the next decade. During the pandemic, when the deficit was an astonishing $3.1 trillion, it was largely funded by the central bank buying bonds and expanding its balance sheet. One hand helping the other. But that is no longer the case as QE has become QT, meaning the balance sheet is shrinking. International Treasury buying is also on the decline as other central banks such as China and Japan are simply less enthusiastic buyers compared to years past.



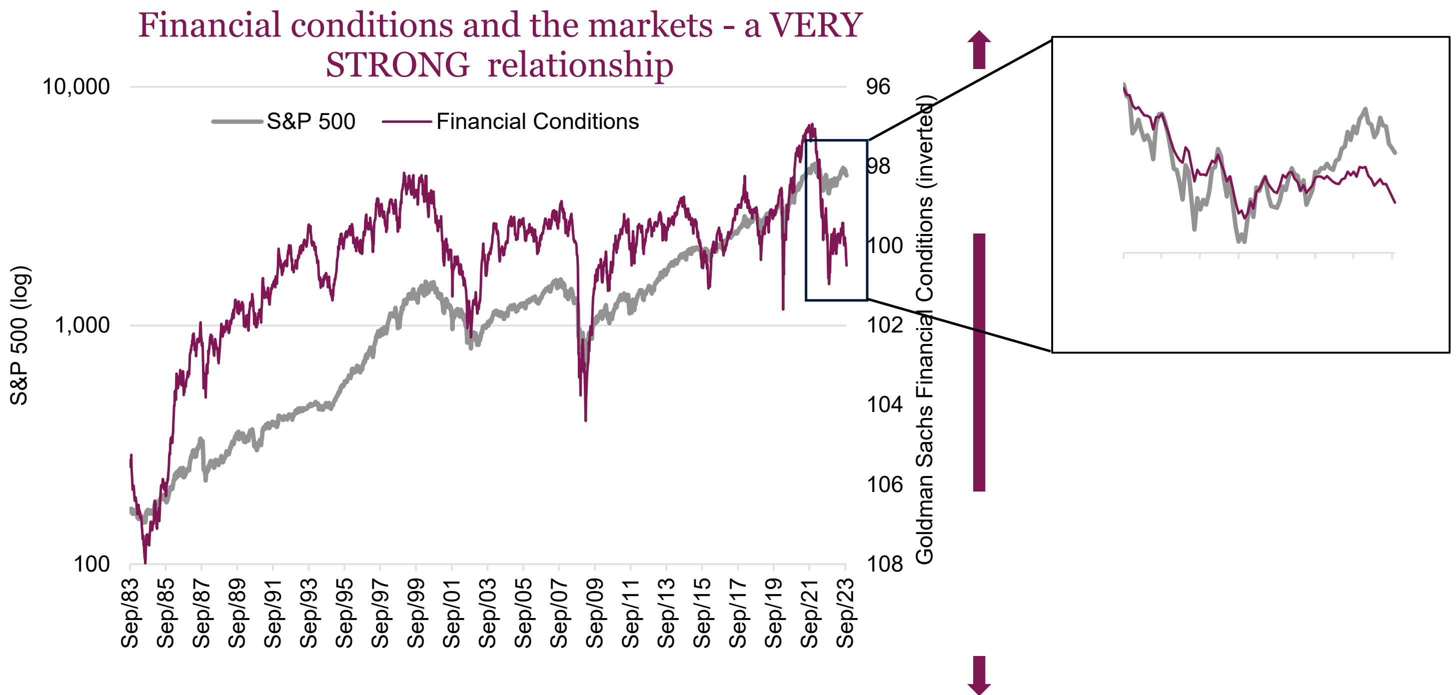
Source: Bloomberg, Purpose Investments

And then there are the banks. U.S. banks have been buyers of Treasuries in years past. But with short rates so high and unrealized losses on their existing bond holdings (expect to hear more about that in the upcoming earnings season), let's just say they too are not enthusiastic about buying more Treasuries, especially with such a low carry. So, it's up to the private sector which so far has been a willing buyer given money flows lured by the higher yields. But if you and I are the new buyers of government debt to fund deficits, that means our capital is not going into corporate investments as much. This is what crowding out of private investment looks like. And while it is no surprise to anyone, a dollar given to the government does not have the same economic benefit as a dollar given to a corporation.

Taken all together, money supply has been shrinking, yields have moved higher and now credit spreads are rising. That means financial conditions are tightening at an increasing pace. Monetary policy is a blunt instrument that works on a delay, it is starting to bite more and more. It's also worth pointing out that a sudden move like this in financial conditions is unsettling.

Final thoughts

The cost of capital is real again and it is a lot higher than it has been in years. It's also not as plentiful, exacerbated by more private capital going to government spending. It isn't all doom and gloom though; in fact it is probably healthier. Unfortunately, after so many years of a low cost of capital and tons of excess liquidity sloshing about the world, the adjustment is likely a long process. This means we will continue to see big market moves, like down in 2022 and up in the first half of 2023. We remain cautious on the second half of 2023.



Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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