



Debt, Deficits & the Fed's Next Move

LIZ ANN SONDEERS: I'm Liz Ann Sonders.

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LIZ ANN: And this is *On Investing*, an original podcast from Charles Schwab. Every week we analyze what's happening in the markets and discuss how it might affect your investments.

COLLIN: Hi, Liz Ann. We're recording this one a little bit earlier in the week due to a lot of travel. We're on the road a decent amount talking with Schwab clients and meeting with our financial consultants. So we're trying to sneak this conversation in a little bit earlier. But let me tie that in with our discussion. When we hit the road a lot, we're meeting with a lot of clients, prospects, different business colleagues. So let me ask you about the kind of questions that you're hearing. Are there questions you get all the time? Are you hearing some new worries and concerns lately?

LIZ ANN: Well, maybe, Collin, I'll state the obvious. In the last seven weeks, it's been war, war, war, oil prices, oil prices, oil prices. "What does an end of this look like?" That sometimes veers into, even though we have our brilliant colleague Mike Townsend that deals with all things Washington, inevitably there's going to be a question or two about politics, and especially now in the lead into the midterm election, I'm sure we'll be getting more of those. You know, prior to the start of the war, I would say for me, the topic about which I was asked most was AI, especially when we were in the throes of that, you know, heady disruption part of the phase where software stocks were getting absolutely hammered. That, of course, was happening at the same time, elevated concerns about strains in the private credit markets, which when I'm done rambling here, I'll turn it back to you because I'm sure you get probably even more questions on that than I do.

I would say the number one, two, or three question that I get at every single client event is something to do with the deficit and debt. That is one of those perennial favorites, and you know, it's an interesting topic because, number one, it's always interesting how people ask the question. Sometimes it's just a general, "What do you think about the deficit and debt?" or "This can't possibly be sustainable, is it?" Sometimes the questions are a little bit more granular. They'll ask it in the context of "Is there a tipping point?" And they might fill in the blank there. Could it be the dollar losing its reserve currency status? Is China going to dump all its Treasuries one day? Are we going to default on our debt?

I'd say a number of years ago, I would also get the question, "Is U.S. debt going to be downgraded by a rating agency?" Well, that ship sailed because all three rating agencies have already done that. So in that way, I'm able to answer the question with a little bit more specificity. And as you well know, because I know it's always been the answer on the fixed income side of things too, that we don't believe that the dollar will lose its reserve currency status. There's simply no replacement for it. There will continue to be more diversification in terms of transactions that happen in global trade, more of them being done in local currency terms. There are some blocs forming. That means you may see the dollar on one side or the other of transactions globally may continue to diminish a little bit, but there's really no replacement for the dollar as the world's reserve currency. We're not going to default on our debt. At least we don't think we are.

In terms of things like, you know, China, literally or figuratively waking up one day and deciding to just stomp all their Treasuries, they would do a lot of damage to themselves economically. And as you know, Collin, they've been diversifying away from such a heavy holding of Treasuries anyway. And then just a little bit more micro-level questions. Now this was prior to the war, but more maybe people who don't know that I don't cover individual stocks. So you know, "What's your single best idea?" or "What are your favorite stocks?" or "How do I best pick stocks?" "Should I be trading a little bit more?"

So for a while there, most of the questions I was getting for a really long time, really sort of the post-pandemic world, was one where macro tended to be the theme of most questions. And then it got in the last year or so it got a little bit more "What can I do in the market right now? Where are opportunities for me? How can I trade this kind of market or what investments would you specifically recommend?" So that's the theme. I'm going on the road this week. I think I've got actually four client events just in Boston alone. So stay tuned for what is top of mind this week. How about you?

COLLIN: Well, I'm going to be following you because next week, the following week, I'll be in Boston, too. So maybe, maybe we'll meet up with some of the same clients.

But a lot of the key points and questions you made are similar to the ones that I get. And I'll ... let me follow up on the fiscal concerns. No surprise, that's one that we always get. But we get it as it relates to Treasuries all the time. You kind of touched on the dollar and the reserve currency status. But we get it on the Treasury side of the equation, that there's a concern that there's not going to be enough buyers out there for Treasuries. And if those buyers step away, what's it going to do for Treasury yields?

And before I get into it, Liz Ann, I'm not endorsing our fiscal policies. I agree that we're probably on an unsustainable path, but we haven't found a relationship between our debt levels, our deficit levels, and what that means for long-term Treasury yields. And you hit on this point before about a potential tipping point. Maybe there will be one. But without a relationship, without a statistical relationship over time, we don't know what that is. And I think that's difficult for a lot of people to understand. And it almost seems like it's a cop-out answer if someone says, "Well, what about our debt and deficits?" and I say, "Well, we can't point to a relationship," but we mean that.

Now, there are still a lot of buyers out there. And one thing that makes a lot of headlines are China, for example, or a big country, selling our Treasuries. We haven't really seen that happen over the years. In fact, if we look at foreign official holdings of U.S. Treasuries—so when I say official holdings, that's generally central banks—foreign official holdings of U.S. Treasuries has been around \$4 trillion for about 13 years or so now, very steady. It's gone up and down, but it's pretty steady. But it hasn't kept pace with the amount of Treasuries that have been issued. But private investors have kind of stepped up to the plate and purchased them instead.

But I think if you have private investors who, if that's just individuals across the globe, they may be more focused on actual valuations, on yield opportunities. That might be more temporary capital as opposed to a central bank who has a lot of reasons to hold Treasuries. So something to consider, but we're not worried that the more debt we issue that suddenly we're going to have failed auctions where there's just not enough buyers or that yields are going to surge significantly higher from here. We think maybe it keeps yields kind of in the range they're at, but we're not worried that it's going to send them much higher. Maybe at some point a relationship presents itself, but again, we haven't been there just yet.

And we keep getting questions ... we always get questions on the Federal Reserve, but it's become more front-and-center lately because this week in Washington, Kevin Warsh, the nominee to be the next Federal Reserve chair, he's heading to Washington for his congressional hearings. So we're getting a lot of questions on that. So I think it's important to kind of explain the situation a little bit right now. But first and foremost, I want to point out that Kevin Warsh is not replacing Jay

Powell as a governor. The seat that Kevin Warsh will be taking is a different governor, Stephen Miran, and Jay Powell, his term as chair ends in May, but his term as governor doesn't end till 2028. So he's not necessarily replacing Powell. He might be replacing him as the chair, but not as a voter.

There's a handful of things that we're going to be looking to during the congressional hearing about Warsh's views on monetary policy in the here and now. Because if we go back to his comments before his nomination, which it's been a few months now, and we haven't really heard his views since the conflict began.

LIZ ANN: Yeah, he's been pretty quiet.

COLLIN: Yeah. So it'll be interesting to see how he frames the rise in oil prices and inflationary pressures, because if we go back a handful of months, he was making the case for lower interest rates. That's probably a reason why he got the nomination, because we know the administration is looking for someone who will lower interest rates. But it'll really be interesting to see how he squares that in an environment where inflation is still elevated.

We're going to be interested to see how he talks about Fed independence, because if we actually go back to 2010, he gave a speech that was titled "An Ode to Independence." So he values Fed independence, but clearly we're in this environment where there's a lot of concerns about that. So I expect questions there. And then finally, he's talked for years, I mean, since he was a governor back during the financial crisis, about the Federal Reserve's balance sheet and that it's too big. And that's a challenge right now because, if he were to shrink the balance sheet, I'd say he risks seeing long-term yields rise a little bit from here, which is what we know the administration doesn't want.

So it's going to be interesting to see how he kind of threads that needle that he wants a smaller balance sheet, but how he can do that in practice without impacting the bond markets too much and sending yields significantly higher. So it's going to be very, very interesting. One thing I'll finish with this, Liz Ann, I think it's funny because the Fed has become, it's made so many headlines lately. And when I do client events, just like you're doing this week, I kind of ask for a raise of hands if you know the name or who Jay Powell is. And most people raise their hands these days. If we went back 10 years ago or so, and I said, "Can you name the chair of the Federal Open Market Committee?" a lot of people, would know who that was ...

LIZ ANN: In our business maybe, yeah, in the investor class, yeah, but not man on the street, yeah.

COLLIN: Most, exactly, most individual investors, yeah, there'd be a lot that do, but plenty that don't. But nowadays, Jay Powell's a household name. So it's funny how that's changed.

One final thing, Liz Ann, that we get a lot, and I'm sure you get this also, so let me pass it back to you, is the 60-40 question. And I know that's not for everybody. 60-40 might work for some people. It's a starting point. It's a way to start a discussion and then figure out what works best for you. But I get that all the time. So what are your thoughts on that?

LIZ ANN: Yeah, so let me answer it in a slightly longer-term context. And it's something that I've been writing about for many, many years, and Kevin and I have been writing about more recently. And I think we've definitively exited the so-called "Great Moderation Era." So that was the era, I think the label was given by Ben Bernanke, and it kind of stuck. It really represents the period from the mid-to-late 1990s up until, I don't know, about two years into the pandemic, up until the 2022 pandemic-related spike in inflation.

And there were a lot of facets to why it was great moderation, inflation, volatility was very low and was generally a disinflationary period of time. You had massive globalization. You had not a lot of monetary policy, uncertainty, at least not relative to say times like today, and one of the implications of that backdrop was that bond yields and stock prices moved in the same direction, which meant bond prices and stock prices moved in the opposite direction.

So that "classic 60-40," you know, I'm doing air quotes, we don't go on camera here, but so everybody knows, our listeners know I'm doing air quotes. That was "classic 60-40." And the reason why that was largely the case for almost an entire period, save for the 2008 period where you saw an exception, is that yields were moving generally based more on what was happening in the growth side of the equation, not on the inflation side of the equation, so higher yields, because of higher growth without the attendant grave concern about inflation, that's sort of nirvana for equities and vice versa.

Well, go back to the 30 years prior to the Great Moderation, what I've been calling the temperamental era from the mid-60s to the mid-90s. Very different backdrop, obviously, relative to the Great Moderation. And by the way, I don't think we're going back into a '60s to '90s, but what was different about that period relative to Great Moderation is that relationship between bonds and stocks was the complete opposite, almost the entirety of that 30-year period. Bond yields and stock prices moved in the opposite direction, which means bond yields and bond prices moved in the same direction. So it meant it was not as simple, again, air quotes, a backdrop

for diversification because bond yields, more often than not, when they moved up or down, it was keying off of what was going on in inflation.

So higher inflation without necessarily higher growth, not great for equities, and vice versa. So that's how I think about the stocks-bonds relationship. I also think that, if indeed, we are in some sort of longer-term phase where, on paper anyway, you don't see that same beneficial diversification with those two simple asset classes, we still think it's appropriate to have exposure to both the equity side and the fixed income side, and there's strategies you can employ, not to mention the fact that those are not the only two asset classes out there. There's never been more access to other asset classes. So you know, the 60-40 frame sort of is a little bit too simplistic, but I wanted to answer it in the context of sort of these two big secular eras.

COLLIN: Yeah, I'd frame it the same way. And I'd always stress that when it comes to bond investing, and when you're looking at performance, you need to hold bonds for a long enough period of time to earn that income. I mean, that's really where you get a return from a bond, barring a default, of course. Over the short run, you can see prices change and fluctuate based on fluctuating market conditions. But if you look at a long-term performance chart of what drives a bond's or bond index's return, it's income.

Just think if you buy a bond at par, we'll say, and you hold it for the duration of its maturity, five or 10 years, for example, and over that time frame, if yields move up and down, its price can move up and down, but then it matures back at its par value, your return is really just the income earned over time. And we got this question a few times in the early stages of the war when we saw Treasury yields rise because of the inflationary impulse, and that pulled the values of bonds down in an environment where stocks were falling.

So people were saying, "Uh oh, is diversification dead?" And I would respond, "Well, we're only a few weeks into this. You need to hold bonds for a long period of time to earn that income, to offset some of those potential price declines." And over time, again, your return is going to come mostly from income payments. I think it's good to kind of take a step back, remember why you hold bonds. You hold them for income. You hold them for capital preservation, if you're focusing on very high-quality bonds. And generally speaking, but not all market environments, you hold them for diversification because I think, for the most part, the diversification properties still hold.

LIZ ANN: All right, so Collin in terms of looking ahead to next week, which is always how we start to bring these episodes to a close, we talked a little bit about the Fed, but in the context of the Fed's dual mandate of what is officially called price stability

and full employment, which basically we think of is just the labor market and inflation, so what types of data points that are coming out do you expect the Fed will be watching in terms of their dual mandate?

COLLIN: Well, we think the Fed will be focusing more on its inflation mandate, its price stability, than its maximum employment mandate, mainly because we know inflation is very much in the here and now and expected to rise. So next week, we do get a very important release. We get the March PCE, or Personal Consumption Expenditures, report. It's expected to increase relative to February.

We're going to focus more on those core readings. So a core inflation that excludes volatile food and energy prices. I think the Fed will likely do the same. But core is expected to rise also. So on a year-over-year basis in February, it was 3%. And consensus expectations are pointing to a 3.2% increase. So it's moving in the wrong direction. The Fed's not going to be happy about that. And that supports our case for the Fed to be on hold for several meetings. There is a Fed meeting next week. The next week's PCE report should not factor into their decision next week. They're likely on hold regardless of what inflation looks like over the next month or two. But again, we think they'll focus more on core versus headline, which includes the rise in oil prices.

But they're going to also look at inflation expectations. They want to make sure that inflation expectations don't become unanchored because then that can become sort of a self-fulfilling prophecy. On the labor market side of the equation, you know, they're still focusing there, but we think it'll take a backseat to inflation for now. The Fed's likely paying more attention to the unemployment rate than non-farm payroll gains, I think, for a few reasons. You know, non-farm payroll gains or payroll gains in general, they tend to slow as you get later in a cycle. And then we also have change in immigration policies that is taking a lot of supply out of the market.

So we see lot of headlines about how many jobs were added or lost in a given month. That matters, of course, but we think the Fed is focusing more on the unemployment rate as opposed to actual gains.

LIZ ANN: Yeah, not only that, but payrolls are so highly subject to revision. And I would say, sort of as a PSA more broadly, don't react to any initial read on payrolls. You get subsequent revisions for two months, and you get annual benchmark revisions, and you get even broader census-oriented revisions. So they don't tell an accurate in-the-moment story.

COLLIN: Maybe we need to shout that from a mountaintop, Liz Ann, because everybody pays attention to that monthly number, even though we've known over the past few years, there's been a ton of revisions. And I think, and I think you would

probably agree, that the revisions probably matter more, gives us more of a comprehensive look.

LIZ ANN: No question.

COLLIN: But that first or second Friday of every month, we see that headline number, and everyone reacts.

LIZ ANN: What's an interesting exercise to do for people who don't have enough fun in their lives is you go back and you look at periods like late 2007, and you look at what the initial readings were of payrolls in October, in November, even into December, and they look still very healthy. We look back now at what those postings were post- all the revisions, and they looked quite dire. We know that the recession began in December of '07, but at that time, the data that is seen as really sort of a proxy for recessions looked quite good.

So sometimes you have to go to the extremes of economic inflection points to understand that when you're at one of those inflection points at the start, the data looks pretty good. Ultimately with revisions, it's a very different picture.

COLLIN: Yeah, well, it'll be something important to pay attention to over the next few months. So what's on your radar, Liz Ann?

LIZ ANN: Yeah, so we get retail sales coming up, and that's probably up I think pre-when we release this episode. But we basically finished the big financials in terms of first quarter earnings season, and they had relatively good things to say about the consumers. So we'll have to see whether retail sales corroborates in that or not.

We get a lot of housing data that comes out in the next week or two. So keeping an eye there, we get S&P Global's version of what's called the Purchasing Managers' Index, PMIs. Not quite as widely followed as the ISM version of those, but see whether it is in line with what ISM has shown or not. What we have seen there is a pickup on the manufacturing side of the economy, but some ... not weakness in an absolute sense, but some relative deterioration on the services side of the economy. And then we get the final read from University of Michigan consumer sentiment. And there's lots of subcomponents to that. The overall consumer sentiment reading, which has been kind of plumbing historic lows, but also inflation expectations, shorter-term inflation expectations, longer-term inflation expectations.

And then the other version of that consumer sentiment is the Conference Board consumer confidence, and we'll have to see whether those two are aligned with one another. I'm just looking ... we actually have the Federal Open Market Committee meeting on April 29th, which we don't expect them to do anything, but these days the press conferences are way more interesting than the actual decision.

COLLIN: And it could be Powell's last press conference ...

LIZ ANN: It could be. That's right.

COLLIN: ... depending on the timing of the Warsh nomination.

Well, as always, thanks for listening. As a reminder, you can always keep up with us in real time on social media. I'm @CollinMartinCS on both X and LinkedIn. That's Collin with two L's and CS for Charles Schwab.

LIZ ANN: And I'm @LizAnnSonders on X and LinkedIn. Still have imposters, lots of them, so make sure you're following the real me. And you can always read all of our written reports, they typically include lots of charts and graphs for those of you that are more visually oriented. And those can be found at schwab.com/learn.

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