First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*
Nate Gerze, CFA – *Economic Analyst*

630-517-7756 • www.ftportfolios.com

December 9, 2024

Irresponsible and Addictive Deficits

Why hasn't tighter monetary policy caused a recession? One reason: federal budget deficits have been huge. Don't get us wrong, we don't believe government spending is good for the economy in the long-run. But, in the short-run, it certainly can make things look and feel, better. Just ask Amazon, which basically doubled its workforce during COVID as people spent their pandemic payments buying stuff, instead of paying off student loans.

The budget deficit soared to 14.7% of GDP in Fiscal Year 2020 and was followed in 2021 by a deficit of 12.1% of GDP. They were the two largest deficits as a share of the economy since World War II, larger than in the 1981-82 recession and the Great Recession and Financial Panic of 2008-09.

Meanwhile, the M2 measure of the money supply soared. M2 rose a massive 41% in the twenty-five months during COVID. As a result, CPI inflation took off – peaking at 9 %.

However, after peaking in March 2022, M2 declined 5% by October 2023 and has since grown only 3% in the past year. Normally that kind of slowdown in M2 would be followed by a recession, but the economy grew a hardy 3.2% in 2023 (Q4/Q4) and appears headed for growth of about 2.6% in 2024, which is above the 2.1% trend of the past twenty years.

We think one of the reasons for continued growth in the face of tighter monetary policy is that the federal budget blowout never really stopped.

The federal budget deficit was 6.2% of GDP in FY 2023 and 6.4% in FY 2024, which ended on September 30. Let's put these in historical perspective. During the 1980s, President Reagan was consistently criticized for running overly large budget deficits. He was criticized by the Democrats, the opposition party at the time; he was criticized by the media (Sam Donaldson comes to mind); he was even criticized by many of his fellow Republicans. And yet the largest deficit ever run under Reagan was 5.9% of GDP in FY 1983.

But Reagan had two pretty good excuses for that deficit. First, he was fully funding the Pentagon at the height of the Cold War. Second, and more important, the unemployment rate that year was 10%, meaning spending on unemployment and welfare were elevated.

There are no similar excuses for the past two years. In the past two fiscal years the unemployment rate averaged less than 4% and we aren't at war. We get that Keynesians want stimulative budget deficits when the unemployment rate is high; but no serious Keynesian, much less a supply-sider, can intellectually support current deficits.

We think the enormity of these deficits, relative to economic conditions, have temporarily masked or hidden some of the pain we will eventually feel from the tightening of monetary policy in the past couple of years. In turn, this means the US is not yet out of the woods on recession risk in spite of the great optimism now embedded in US equity prices.

Also notice how little extra bang for the buck the US is getting out of these deficits. Keynesian theory suggests extra government spending should generate multipliers that can make growth soar. Yes, the economy is still OK so far, but soaring it is not.

The big question for the next few years is how quickly the federal government can wean itself from an addiction to big budget deficits and whether it can successfully implement pro-growth policies at the same time. In other words, will the loss of deficit stimulus (if DOGE is successful at cutting spending) be offset by a productivity boost from less regulation and more certainty on tax rates in the future?

If government spending really is cut, and the government becomes a smaller burden on the private sector, that will boost growth – *in the long-run*. However, roughly 50% of new jobs in the past year were in government and healthcare (which is dominated by government). That boost to growth will recede when spending is cut in the short-term.

If the Fed tries to offset the short-term hit to growth with easier money, then inflation could easily flare up again. Quitting any addiction is painful in the short-term, but positive in the long-term. The next few years will be interesting for sure.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-11 / 7:30 am	CPI – Nov	+0.3%	**+0.3%**		+0.2%
7:30 am	"Core" CPI – Nov	+0.3%	**+0.3%**		+0.3%
12-12 / 7:30 am	Initial Claims – Dec 7	220K	**221K**		224K
7:30 am	PPI – Nov	+0.2%	**+0.2%**		+0.2%
7:30 am	"Core" PPI – Nov	+0.2%	**+0.2%**		+0.3%
12-13 / 7:30 am	Import Prices – Nov	-0.2%	**+0.3%**		+0.3%
7:30 am	Export Prices – Nov	-0.2%	**+0.2%**		+0.8%