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AN UPDATE FROM PAUL DIETRICH

10/5/2023

IRRESPONSIBLE & UNSUSTAINABLE: CONGRESSIONAL DEFICIT SPENDING

STOCK MARKET UPDATE: The Suckers Stock Market Rally Is Ending

Over the past six months I have been warning investors about the risks of investing in bear market rallies, when the stock market goes up while the overall economy and corporate earnings are declining.

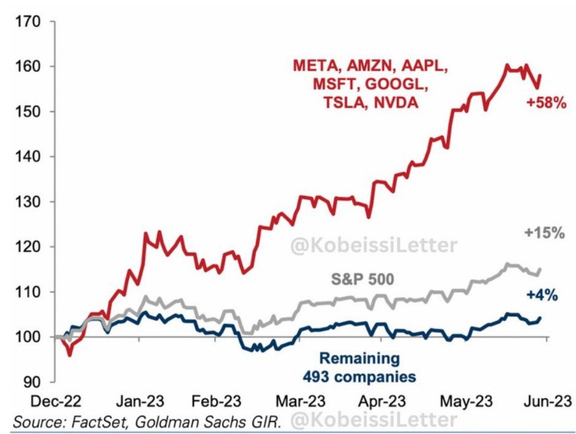
Historically, these bear market rallies have been referred to as "suckers rallies." This is when investors pile back into the stock market for fear of missing out on what could be the next new bull market.

In the 2008-2009 recession, when the S&P 500 Index went down from its peak to bottom -57%, there were five bear market "suckers rallies" and one of them lasted almost seven months.

Each time investors moved back into the stock market to "buy the dip" or thought it was the beginning of a new bull market they lost money because the market eventually dropped to lower lows than the last decline. This is why trying to "time the stock market" is a fool's errand.

The Stock Market Is Currently Overvalued, Unbalanced & Undiversified

Stock market gains this year have been led by seven megacap tech stocks, amplifying the performance of the tech-heavy Nasdaq and the S&P 500 Index. Here are two charts that show what has happened over the last seven months.



Note: This chart was created at the end of June 2023

Note: This chart was created September 23, 2023

The S&P 500, as a whole, is up +10.16% this year.

Never has the entire stock market been driven by so few stocks.

In other words, if you buy the S&P 500 today, your portfolio will be dominated by the performance of a small handful of companies that are currently overshadowing the vast majority of stocks that make up the index.

These top 7 stocks now make up ~34% of the entire S&P 500's market capitalization. Without these 7 stocks, the S&P 500 is now basically FLAT for this year.

What happens if the Artificial Intelligence-hype fades?

What happens if the S&P 7 mega-cap stocks turn lower?

Recently, one of those 7 stocks, Nvidia, had a price earnings ratio of 115. That means an investor was willing to pay 115 times Nvidia's current annual earnings for that stock. It could be a long time before any investor makes money at that price.

In 2008, the top 7 companies reflected ~14% of the S&P 500's market cap.

In 2000, which is widely considered one of the largest stock market bubbles of all time, the top 7 stocks reflected ~19% of the S&P 500 Index.

An equal-weighted measure of the S&P 500 Index, is now negative in performance for the year by -2.06%, while, the S&P 7 (Nvidia, Tesla, Alphabet, Apple, Meta, Microsoft, and Amazon), the seven largest mega-tech stocks in the S&P 500, are up +81%. This emphasizes the outsize role of a handful of these mega-tech stocks in overall index gains.

To put this disparity in context, this means that the top 20 stocks in the S&P 500 were responsible for ~85% of the index's gains.

Meanwhile, these 7 stocks also currently account for ~74% of the Nasdaq's gain this year.

Seven to 20 large cap stocks have become the backbone of this year's stock market.

S&P 500 Equal Weighted Index Now Negative -2.06% Year-To-Date

Dow Jones Industrial Index Now Negative -0.44% Year-To-Date

The Canary In The Coal Mine

Another important major benchmark for stocks is the Russell 2000 Index—the small cap index. This week it turned negative for the year by -1.94%.

When the Russell 2000 turns negative, this indicates a broader weakness occurring in the economy that's being masked by a few mega-cap tech stocks.

The Russell 2000's comparative weakness to the broader market indexes highlights Wall Street's concerns that the 2023 stock market rally has been too narrow and undiversified. By contrast, the Russell 2000 is often seen as a better indicator as to the state of the broader U.S. economy due to its focus on 2000 smaller businesses who are more connected to current macroeconomic conditions.

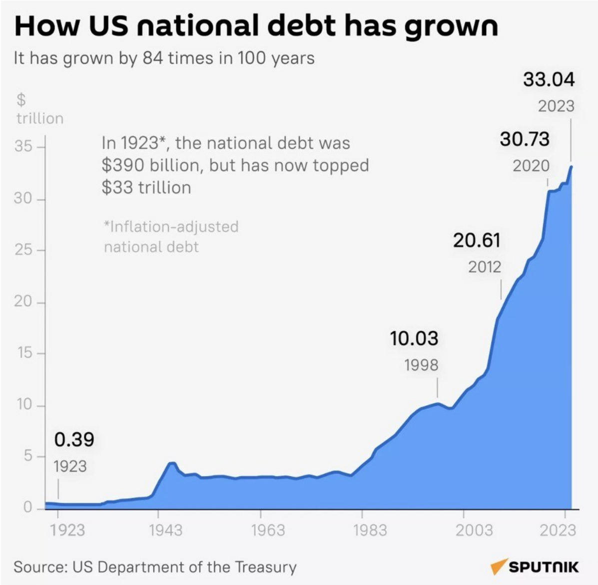
Russell 2000 Index Now Negative -1.94% Year-To-Date

BUDGET DEFICIT HEADLINES: Everything You Never Wanted To Know About U.S. Unfunded Deficit Spending*

- Current U.S. debt: $33.44 trillion
- Total U.S. debt is now up +$10 trillion in three years, since 2020.
- U.S. debt rose last week by $275 billion in ONE DAY.
- The U.S. has added $32 billion in debt per day for the last 2 weeks.
- The U.S. is on track to pay over $1 trillion+ in annual interest by late next year.
- Decades of near-zero Fed rate policies have ended—we are now paying the price.
- Over $1.5 trillion has been added to the unfunded debt balance since the "debt ceiling crisis" four months ago. The U.S. has been borrowing ~$14 billion PER DAY to cover deficit spending.
- U.S. government total spending is up +40% more in 2023 over pre-Covid 2019.
- Congressional Budget Office (CBO) projects debt-to -GDP ratio to rise to 225% by 2050.
- Total U.S. budgeted spending is now 44% of GDP per year—the same levels as World War II.
- Unfunded deficit spending alone is a massive 6% of GDP per year, now at the highest level outside of a war or recession.
- By 2033, Bloomberg projects annual unfunded deficit spending will be ~7% of GDP. This means that after ~8 years, the U.S. deficit will grow to about HALF of U.S. GDP.
- The CBO projects U.S. Debt as a percentage of GDP will climb from 100% now to 107% in 2029 (topping the WWII 1946 peak of 106%), and will hit 181% by 2053.
- The U.S. is spending like we are in a recession or war, while calling for a "soft landing." How does this make any sense?
- The CBO also projects that U.S. Debt could climb to $50 trillion by 2030 (but at the current pace, it could happen well before that).
- U.S. net interest payments as a percentage of government receipts (i.e. tax revenues) has risen to 15%.This percentage has doubled over the last 2 years and now is at its highest since 1998.
- At the same time, U.S. federal tax receipts are now down -8.4% on a 12-month basis.
- We have rapidly rising unfunded debt levels with rising interest rates and falling government revenues.
- The "debt ceiling crisis" deal four months ago agreed to by then-Speaker Kevin McCarthy and President Biden UNCAPPED the unfunded debt ceiling until January 2025. What is the incentive to cut spending if there are no limits on how many trillions of dollars in treasury bonds we can print?
- Nearly one-third of all outstanding U.S. debt is set to mature over the next 12 months. 52% is set to mature over the next 36 months, meaning this U.S. debt needs to be refinanced at much higher interest rates than before.
- Headlines of U.S. interest expense hitting $1 trillion will be gone soon. $2 trillion in annual interest expense is coming quickly.
- For nearly 20 years, U.S. debt service was effectively free for the U.S. to issue debt as annual debt service costs were ~1.5%. The annual cost of U.S. borrowing hit 4.6% during the past fiscal year--highest since 2007. To put this in perspective, 5% on $33 trillion is ~$1.7 trillion PER YEAR just on interest expense.
- This means that maintaining past debt is now 2.7x as expensive and it will soon be 3x as expensive as rates rise.
- As deficit spending rises, interest rates are also rising as the U.S. issues trillions in treasury bonds to cover new deficit spending.
- Treasury bond yields have risen dramatically over the past few weeks as investors are demanding higher yields (higher interest payments) on U.S. treasury bonds.

It's a never ending cycle of borrowing to spend which is driving rates higher and leading to interest expense eventually being 20% of U.S. tax revenue.

Republicans say federal spending programs championed by the Biden administration are too expensive, and Democrats say GOP-backed tax cuts have squashed revenue. There is no long-term plan.



** Sources: Congressional Budget Office, Tax Foundation, Peter G. Peterson Foundation, Kobeissi Letter, ZeroHedge, Committee for a Responsible Federal Budget.*

U.S. DEFICITS EXPLAINED: Congress Is Spending Like Drunken Sailors

The explosion in federal spending — and U.S. government debt — under both the Trump and Biden administrations is starting to take its toll.

Eventually the massive and growing deficits are going to slow U.S. economic growth for at least the next decade. Once the stimulus money and other deficit spending wears off, the economy could enter a zombie state of stagflation similar to the 1970s.

With stagflation, there is economic growth, but inflation continues to run at the same rate or higher. Everyone feels like they are going backwards.

Because of all the printing of money to fund the trillions of dollars in congressional Covid and recent stimulus spending, business and consumer strength has artificially kept U.S. growth going longer than most analysts expected.

Unfortunately, after Covid, consumers' excess savings peaked at $2.1 trillion in 2020. Most of those savings are gone and consumers are now continuing their current spending using credit cards rather than savings. But that credit card debt now comes with 30%+ annual interest rates. It is simply a matter of time before consumer spending starts to dramatically slow.

Consumer spending on goods and retail shopping have already slowed, but consumers are still enthusiasticly spending on services like airlines, travel, Taylor Swift concert tickets and restaurants.

Since Biden became President in 2021, there has been $8 trillion in new overall federal spending, with $6.5 trillion going to the U.S. military, entitlement programs like Social Security and Medicare, U.S. debt payments and subsidies to U.S. companies to help them compete against China.

This record $8 trillion being disseminated through the U.S. economy is a major reason the Federal Reserve (Fed) rate hikes have had trouble slowing the economy. It has also likely pushed off the upcoming recession by a few months.

U.S. debt hit an all-time high this week of over $33.4 trillion while the debt-to-GDP ratio is projected to reach a new record high of 107% later this decade.

This is all happening while the U.S. economy is still expanding and with the unemployment rate near a 54-year low at 3.6%.

What happens to the deficit when a recession actually hits?

Both Republicans & Democrats Are At Fault

If one listens to Biden's defense of Bidenomics, which has been funded by massive deficit spending, he is basically pledging more of the same in his second term as President.

If you listened to the recent Republican debates that have not included Trump, you hear almost nothing about fiscal responsibility, or how they will cut spending, grow the economy without government stimulus spending, encourage small business and free enterprise, keep taxes low, cut regulations, get rid of tariffs and reenact free trade policies unless they conflict with our national security.

The Republican candidates only seem focused on social issues, immigration and personal infighting. Republican candidates used to primarily talk about how they would help the economy and free enterprise. Now it is almost absent from most debates.

If you listen to Trump's recent campaign speeches, he is specifically saying he doesn't want to cut Medicare, he doesn't want to cut Social Security, he doesn't want to cut spending except for the Justice Department, the FBI and the IRS, and those agencies are a very small part of the U.S. Budget. When he talks about his 2024 proposals, he basically wants to increase spending, which he did in his first term—even before Covid.

Unfortunately, unless a politician is prepared to cut entitlements, like Social Security and Medicare, and the Defense Budget, they will never ever balance the budget or really cut spending.

Right now, over 65% of the U.S. budget is made up of mandatory spending for Social Security (23%), Medicare (13%), National Defense (13%), Interest paid on U.S. debt (11%), and Veterans Benefits & Services (5%).

Only about 18% of America's budget is left after the politicians set aside "all mandatory" spending, including public pensions and health care.

2024 Fiscal Challenges

The next President is going to face an enormous number of fiscal challenges—an expiring tax code, a trade war, and rapidly increasing debt burden and interest expense, to name just a few.

Trump Tax Cuts: The expiring tax code is the result of Trump's 2017 tax cuts. Among its many changes, the law cut average tax burdens for households across the income spectrum, it included a much larger standard deduction, a doubled Child Tax Credit, and lower tax rates. All of those tax cuts are scheduled to expire after the end of 2025, leaving Americans with across-the-board tax hikes come January 2026 if the cuts are not reauthorized.

Trade War: The trade war was the result of significant tariffs levied by Trump on U.S. businesses that purchase goods from foreign producers. These tariffs, a tax paid by U.S. businesses—not the Chinese—hurt U.S. manufacturers. According to the Tax Foundation, they have cost U.S. jobs and investments and raised prices for consumers.

Biden has maintained almost all of Trump's tariffs despite their failure to improve trade relations with China or strengthen U.S. manufacturing. The Trump tariffs have been strongly supported by U.S. labor unions. Since labor unions are the largest funder of the Democratic Party, that is the primary reason Biden has kept the tariffs.

According to the Tax Foundation, import tariffs are taxes that do generate revenue for the U.S. government—but at a very high cost. Studies of the tariffs implemented under Trump and maintained by Biden have found them to be a disasterous policy. They cost more U.S. manufacturing jobs than they saved, harmed U.S. farmers, raised prices for U.S. consumers, and alienated our allies — all without changing unfair trade policies or reviving protected domestic industries.

At a recent political rally, Trump proposed escalating the tariff war with a 10% universal basic tariff. Applying an across the board 10% tax on everything we purchase from businesses overseas would hike taxes by more than $2 trillion over the next decade. That would reduce government debt, but it would also compromise growth and invite retaliation, making Americans poorer as a result. It would also offset a significant amount of tax savings from the original Trump tax cuts.

Lastly—*and most importantly*—the rapidly increasing debt burden is forecasted to exceed the size of the entire U.S. economy by the time of the next presidential election.

Annual budget deficits are projected to grow substantially, reaching $2.7 trillion per year in 2033, or 6.4% of gross domestic product (GDP). The 2023 deficit looks like it will increase by $1.7-to-$2 trillion in unfunded spending.

According to a new report by the Congressional Budget Office, the federal government's net interest cost will exceed $1 trillion annually within the next few years, eclipsing the spending on the U.S. defense budget for the first time.

This fiscal irresponsibility is the direct result of Congress's unwillingness to exercise any kind of fiscal discipline.

There are plusses and minuses to every fiscal policy. Trump has stated if he wins the presidency next year, he will reenact and reauthorize his 2017 tax cuts.

While a wholesale extension would definitely boost growth and maintain a simpler tax code, it would also **add upwards of $3 trillion to the deficit over the next decade.**

Is There Anything That Can Be Done About These Runaway Deficits?

Let's make one thing clear, there are only THREE WAYS to deal with unfunded U.S. government budget deficits and debt:

1) **Politicians can raise taxes**. (that's not going to happen in an election year)
2) **Politicians can cut spending.** (that's not going to happen in an election year)
3) **Politicians can devalue the U.S. currency.** (this is more commonly called inflation)

Anytime politicians create another trillion dollars in unfunded federal spending the Fed has to issue new treasury bonds to pay for that spending. Those new treasury bonds pay for the newly increased U.S. government debt.

Since no one in Washington D.C. believes that politicians will raise taxes or cut spending in an election year, the only way this unfunded deficit can be paid off is by devaluing the U.S. currency. That is a nice way of saying they are going to let inflation devalue the newly created treasury bond dollars issued by the Fed. This is also commonly referred to as "printing money."

There is a major misconception, even by many stock market analysts, that the Fed can make inflation magically disappear by raising interest rates.

It is important to understand that all the Fed can do by raising interest rates is control how much time it takes to devalue the currency.

During the Covid period of Trump's presidency ($4 trillion deficit) and the first year of Biden's presidency ($2 trillion deficit) the government ran a deficit of about $6 trillion.

That new unfunded deficit added about 26% to the total U.S. money supply.

That means that eventually the U.S. government will have to devalue the U.S. dollar by 26%.

Last year in 2022, total inflation ran about 6% for the year. That means the government has to eventually devalue the U.S. dollar another 20% in order to devalue the dollar back to where it was before Covid.

The Fed can crudely control the rate of devaluation/inflation by raising rates—but, eventually we still need inflation or devaluation of another 20% to write off the $6 trillion in unfunded deficits.

We can live with 4% inflation for 5 years. That would devalue the currency by 20%.

Or we can live with 2% inflation a year for 10 years and that would devalue the currency for 20%. This is the Fed's goal to devalue the currency over a longer period of time.

The problem is we keep running up new trillion dollar unfunded budget deficits each year. As I mentioned before, for this 2023 fiscal year just ended, the deficit will be about $1.7 to $2 trillion. We now have to add that and the trillion dollar deficits from 2022 to what needs to be devalued in the future.

I believe the Fed can eventually raise rates high enough to get the inflation rate down to between 3% and 4% over the next 10-20 years and that may work if politicians can slow their deficit spending.

However, I wouldn't hold your breath!

Inflation is going to be a continuing problem for the U.S. economy for the foreseeable future. A higher Fed interest rate held higher longer is going to be our future until Congress can reel back their spending.

As I said, I wouldn't hold your breath!

What Are The Recession Signals Saying Right Now?

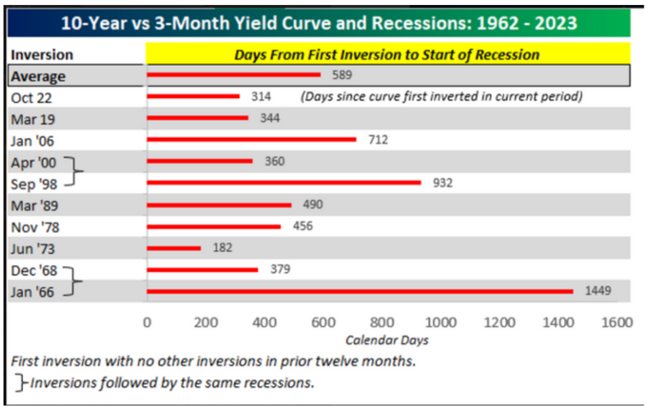
The Inverted Yield Curve

In October 2022, the 10 year-3 month Inverted Yield Curve, which is the preferred recession signal used by the Federal Reserve, started flashing a recession signal for the U.S. stock market when it declined below zero.

When inverted, the Yield Curve usually signals a recession 12 to 18 months before a recession begins. Like Leading Economic Indicators, it has a 100% record of accurately calling recession in advance, like an early warning system.

Analysts at *Bespoke Investment Group* think the next recession could start between October 2023 and early June 2024.

That's because past recessions took an average 589 days to materialize after the 10-year and 3-month yield curve first inverted, based on data since the early 1960s.



Past recessions took almost 600 days on average to start after a key recession gauge first flashed. Source: BESPOKE INVESTMENT GROUP

Their data also shows June 1973 was the only time in the past six decades when a recession arrived within 300 days of the 10-year and 3-month yield curve first inverting.

The Conference Board's Composite Index of Leading Economic Indicators

The *Conference Board's Leading Economic Index®* (LEI) is the other major recession signal.

The LEI tracks 10 forward-looking measures, including permits for future home construction; stocks, which anticipate future earnings; upcoming orders for manufactured goods; consumer expectations; and new unemployment applications.

Basically what it does is tell us where the economy is heading in the near term.

It is kind of like athlete rankings, the LEI crunches 10 different performance stats that hint at future economic activity.

The Leading Economic Indicators Are STILL Signaling A Recession

The LEI— which measures U.S. business cycles—again dropped to its lowest level since November 2020, consistent with worsening economic conditions ahead. Its 17th consecutive monthly decline is the longest since the 2007-2009 recession.

The LEI is a crucial barometer for the economy's health. It continues to flash a recession warning sign, indicating an economic downturn in the U.S. will start in the near future.

The importance of the LEI is that it has historically signaled a recession 9-12 months before a recession starts. This is an extremely valuable early warning system as to when a recession is about to begin.

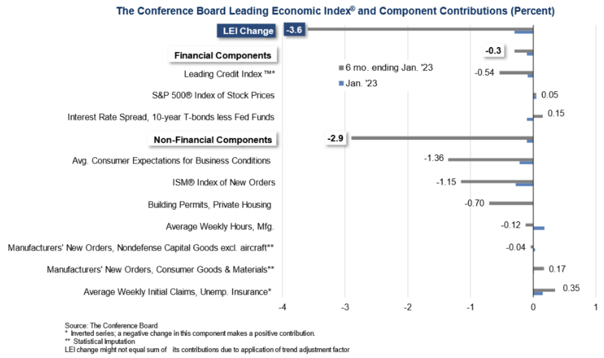
That would mean we should be able to expect the recession to start sometime in the fourth quarter of 2023.

Below is the *Conference Board's Leading Economic Index®*

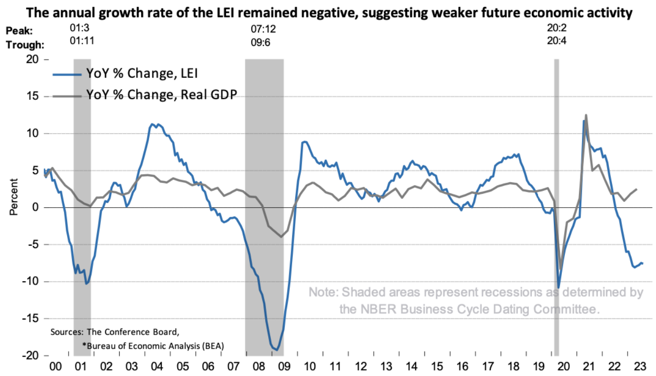
On average, this index signals a recession when it declines below the red bar about nine months to a year ahead of a recession, according to The Conference Board. They announced their recession signal in late September 2022.

"With August's decline, the US Leading Economic Index has now fallen for nearly a year and a half straight, indicating the economy is heading into a challenging growth period and possible recession over the next year," said Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board. *"The leading index continued to be negatively impacted in August by weak new orders, deteriorating consumer expectations of business conditions, high interest rates, and tight credit conditions. All these factors suggest that going forward economic activity probably will decelerate and experience a brief but mild contraction. The Conference Board forecasts real GDP will grow by 2.2 percent in 2023, and then fall to 0.8 percent in 2024."*

The chart below shows that seven out of the ten LEI components contributed negatively to the Composite.



The following chart illustrates year-over-year changes.



Putting The Recession In Perspective: When Will The Recession Finally End?

Historically, the stock market bottoms before the recession ends. Typically, the market bottoms in 'capitulation selling' (remember March 9, 2009?) about 70% through the actual recession.

Since recessions generally last 9 to 18 months, if the recession were to begin during the third quarter of 2023, a nine-month recession could see a stock market bottom during the first quarter of 2024. If this turns out to be an 18-month recession, we could see a market bottom in the summer of 2024.

The good news is that this recession is not the world's end. Because of the strong jobs market, this is not 2008. Yes, revenues will be off. Earnings will be off. The U.S. economy will slow because of inflation and Fed rate increases, resulting in a good old-fashioned earnings recession with inflation.

With patience, we will get through this.

While I still expect the S&P 500 Index to trade down to the 3200 level, representing a potential downside of about -25% from now, I also expect an eventual recovery sometime in early 2024 through the third quarter of next year.

Investors Need To Be Patient—And Realistic

As an analyst, I am not a permanent Bull or Bear. I am neither optimistic nor pessimistic.

I look at the facts and data and see where I am now within the larger business economic cycle.

We are entering into a global recession and a contracting business economic cycle.

It is time to be defensive in your investing. Don't take any risks. Hunker down and try to preserve all the capital you have.

Acting appropriately to what you are facing is like battening down the hatches during a storm or hurricane. This is just common sense.

These are natural economic cycles like the day follows night, and spring follows winter.

Investors need to take a deep breath and realize they are living through a natural cycle that has played out for hundreds of years in world economies and stock markets.

When Should We Get Back Into The Stock Market?

The leading economic indicators will show us when the next bull market is starting.

The table on the next page provides current data on the two major composites of U.S. leading economic indicators and their composite indicator components. I've included a column to show the trailing 12-month directional trends and whether each is currently declining, plateauing, or recovering.

This updated monthly table shows investors the long-term directional trends of the significant composites and individual indicator components of the leading economic indicators.

U.S. LEADING ECONOMIC INDICATORS (SEPTEMBER 2023)

Source: YCharts

U.S. Leading Economic Indicators	Trailing 12-Month Directional Trend	Declining / Plateauing / Recovering
Conference Board Composite of Leading Economic Indicators	Recession Signal	Declining
ECRI Composite of Weekly Leading Index	Recession Signal	Declining
Major Leading Economic Indicator Components		
10 Year-3 Month Treasury Yield Spread	Directional Trend Down	Declining
US ISM Manufacturing New Orders Index	Directional Trend Down	Declining
US ISM Services New Orders Index	Directional Trend Down	Declining
S&P 500 Real Price	Directional Trend Down	Declining
US Index of Consumer Expectations	Directional Trend Down	Declining
US 4-Week Moving Average of Initial Claims for Unemployment Insurance	Directional Trend Down	Declining
US Consumer Goods New Orders	Directional Trend Down	Declining
US Construction Materials and Supplies New Orders	Directional Trend Down	Declining
US Manufacturing Average Weekly Hours	Directional Trend Down	Declining
US Manufacturing New Orders	Directional Trend Down	Declining
US Nondefense Capital Goods Excluding Aircraft New Orders MoM	Directional Trend Down	Declining
US Building Permits (SAAR)	Directional Trend Down	Declining
US Weekly Economic Index (NSA)	Directional Trend Down	Declining

On a personal note: As an investment manager, I have relied on this table through three previous recessions and will do so again in this upcoming fourth recession. It has never let me down.

I have been managing investment strategies for over 25 years and through three recessions, not counting the one that will start this year. I have benefited most from dispassionately focusing on data based not on the stock market but on the underlying U.S. and global economy. The data is what it is.

The good news is, at some point, when the U.S. leading economic indicators start to turn up again—as they always do—I expect that as I retire my defensive investment strategies and let my offensive strategies take the field once again, my investments will be worth more as the economy recovers and corporate America resumes another expansionary path.

Paul Dietrich, *Chief Investment Strategist,* B. Riley Wealth

Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as an on-air commentator and contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*