Bristol Gold Group September 22, 2023

What, Me Worry?

On 8/1/23, Fitch Ratings downgraded the United States Issuer Default Rating (IDR) to AA+ from AAA. In doing so, Fitch became the second of the big three credit agencies to strip the U.S. of its AAA rating, echoing Standard & Poor's 2011 downgrade. Fitch was concise in its reasoning,

> The rating downgrade of the United States reflects the expected ***fiscal deterioration*** over the next three years, a ***high and growing general government debt burden***, and the ***erosion of governance*** relative to 'AA' and 'AAA' rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions.

Predictably, economists and government officials promptly dismissed the Fitch downgrade as a head-scratching anomaly. Former Treasury Secretary Larry Summers called the decision "bizarre and inept." Allianz's Mohamed El-Erian confessed he was "perplexed." Treasury Secretary Janet Yellen brushed off the downgrade as "puzzling" and "entirely unwarranted," while criticizing Fitch analysis as "flawed" and "outdated." Goldman Sachs Economist Alec Phillips predicted limited market impact due to a dearth of "major holders of Treasury securities who would be forced to sell." And most tellingly, the DXY Dollar Index shrugged off the news by rallying 0.44% on the day and 2.16% over the next four weeks.

We view such widespread dismissal of a major U.S. sovereign downgrade as Roaring 20's-type indifference. In today's Fed-centric world of unbridled liquidity, it is hard to remember that when Standard & Poor's stripped the U.S. of its AAA rating on Friday 8/5/11, the S&P 500 plunged ***7%*** on the following "Black" Monday. Then, in thinly veiled retribution (2/5/13), the Justice Department singled out Standard & Poor's in a $5 billion lawsuit over "fraudulent" MBS ratings prior to the GFC. Point being, given the expected blowback and reputational risks involved in a U.S. sovereign downgrade, how can consensus so easily dismiss the Fitch decision as meaningless?

The obvious answer is that outside the gold community, few investors are troubled by the state of U.S. finances. Everyone knows dollar bears have fretted over the budget deficit for decades with little to show for their troubles. And now $10 trillion of post-Covid fiscal and monetary stimulus has inured investors to unprecedented levels of federal spending. Quite simply, these numbers have been so large for so long, no one really bats an eyelash over them anymore.

In a decidedly non-consensus view, ***we believe the U.S. fiscal situation is more dire and deteriorating faster than commonly appreciated.*** Specifically, we are troubled that the Fiscal Responsibility Act of 2023 has quietly normalized pandemic spending levels as the baseline for future budgets. Consequently, federal outlays are now decoupling from federal receipts in unsustainable fashion. In anticipation of the popular pushback that it is impossible to predict when the U.S. deficit will finally matter, we highlight in this report ***five reasons why today's fiscal challenges are more troublesome than in years past.*** We believe longstanding deterioration in federal finances is approaching an important tipping point which will pressure the U.S. dollar to gold's reflexive benefit.

1) Erosion of Governance

A primary reason cited by Fitch for its U.S. credit downgrade is erosion of governance. Fitch's Sovereigns staff writes (8/1/23):

> In Fitch's view, there has been a steady deterioration in [U.S.] standards of governance over the last 20 years, including on fiscal and debt matters…The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process. These factors, along with several economic shocks as well as tax cuts and new spending initiatives, have contributed to successive debt increases over the last decade.

With all due respect to the luminaries we quoted on page one, it is tough to find a single word in the Fitch analysis with which we disagree. Skipping the play-by-play, the Trump and Biden administrations have progressively lowered the bar not only on fiscal discipline but also on official truthfulness. In the case of President Biden, whether it be his age, mental condition or simply his character, a troubling percentage of his public statements have devolved into misstatements and gas lighting—a highly disconcerting profile for the leader of the free world.

Perhaps the most head-scratching of President Biden's erroneous claims is his frequent assertion that his administration has accomplished record deficit reduction. In reality, precisely the opposite is true. In the first 19 months of President Biden's term, public U.S. Treasury debt increased ***$5.078 trillion***, exactly double the ***$2.531 trillion*** increase in the first 19 months of the Trump Presidency. And in a perfect example of the erosion of governance cited by Fitch, the Biden administration has blamed everyone but itself for the Fitch downgrade. On 8/2/23, Biden spokesman Kevin Munoz raised eyebrows in asserting (8/2/23),

> This ***Trump*** downgrade is a direct result of an extreme MAGA Republican agenda defined by chaos, callousness and recklessness that Americans continue to reject. ***[Huh?]***

No matter what one's political leanings may be, it is difficult to argue that United States governance trends are befitting of the issuer of the world's reserve currency. Unprecedented fiscal irresponsibility only compounds the dollar's global challenges.

2) Bad Math

Beneath the Biden administration's bravado and finger-pointing, post-pandemic federal spending continues to accelerate. Through August, the fiscal 2023 (Sept.) deficit stood at ***$1.524 trillion***, up ***61%*** from ***$945 billion*** during the first 11 months of 2022. Amazingly, the 2023 deficit would be much worse if not for the June Supreme Court decision striking down President Biden's student loan forgiveness plan. Reflecting this ruling, Treasury booked in August a ***$319.6 billion*** accounting gain from reversal of 2022 accruals for the present value of student loan forgiveness. This book entry reduced August '23 federal outlays from $513 billion to $194 billion and flipped the August deficit from $230 billion all the way to a surplus of $89 billion.

Without this accounting reversal, the 11-month U.S. operating deficit was actually ***$1.843 trillion***, up a staggering ***95%*** year-over-year. Worse still, federal revenues and outlays are both headed in the wrong direction. During the first 11 months of FY23, total (gross) outlays ***increased*** by 9% to $5.814 trillion while total revenues ***declined*** by 10% to $3.972 trillion.

For the life of us, we cannot understand why recent budget trends are not raising more concern. As unsophisticated as this may sound, it seems there is just enough good news in headlines to lull markets into a false sense of security. Fatigued by pandemic trillions, investors are relieved by the debt-ceiling deal and soothed by AI-powered equity ebullience. We have reached an Alfred E. Neuman moment—what, me worry?

3) Pandemic Normalization

We believe history will view the fine print of this past June's debt-ceiling deal far more harshly than current consensus. Not only did the Fiscal Responsibility Act of 2023 (FRA) suspend the debt ceiling through 1/1/25, it also normalized federal spending caps at the grossly elevated levels of the pandemic years. Conceptually, it seems obvious that pandemic rates of emergency spending are no longer appropriate now that the U.S. economy is chugging along at 2.1% real growth and 3.8% unemployment. Graphically, to project ever higher rates of future federal spending, without first recalibrating budgets back to pre-emergency levels, paints a clearly unsustainable picture vis-à-vis underlying revenues.

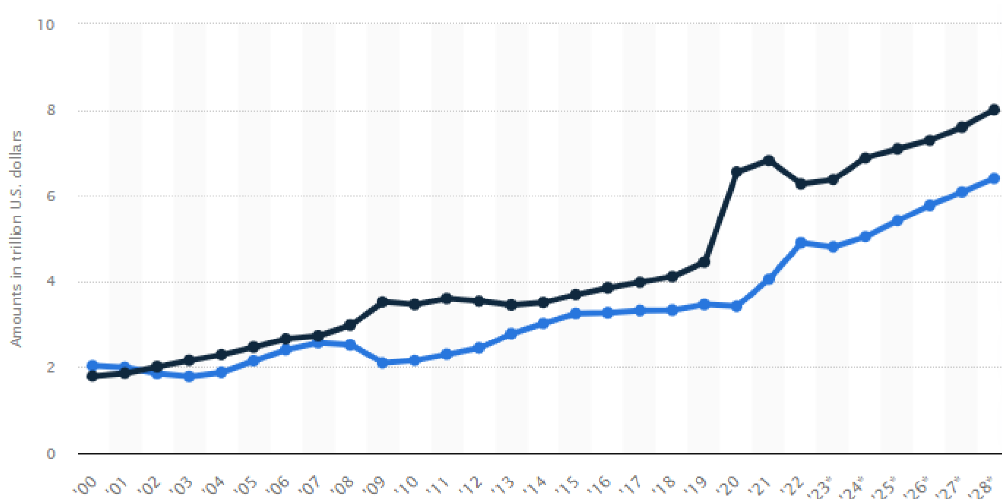

Figure 1:* Total U.S. Federal Outlays *vs.* Total U.S. Federal Receipts *($Trillions) (2000-2028E)
[U.S. Treasury; Congressional Budget Office; Statista]

In Figure 1, above, we incorporate Congressional Budget Office (CBO) projections to plot total federal outlays (black line) versus total federal receipts (blue line) from 2000 through 2028E. Between 2009 and 2018, post-GFC federal outlays ranged between $3.5 trillion and $4.1 trillion. Then during the Covid years of 2020 and 2021, federal outlays exploded to $6.6 trillion and $7.2 trillion respectively. Looking forward, rather than receding back toward the pre-pandemic $4 trillion zip code, federal outlays are slated to remain at an eye-popping $6.4 trillion, $6.7 trillion and $7 trillion in 2024-2026. What the heck?

Not to mention the fact that CBO projections for the revenue side of the equation (blue line) appear highly optimistic. Along these lines, as recently as this past May, CBO's *Budget and Economic Outlook* was projecting total 2023 federal receipts to decline just ***1.7%***, way off the mark from the ***9.9%*** revenue plunge now on the books for the first 11 months of the fiscal year. Needless to say, future shortfalls from CBO revenue estimates will only exacerbate already unprecedented deficits projected for the next decade.

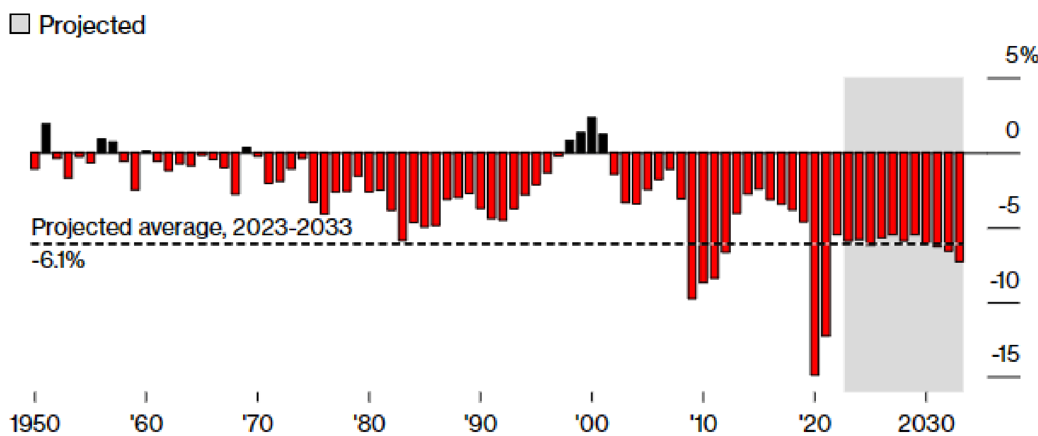

Figure 2: Annual U.S. Budget Deficit as Percentage of GDP (1950-2033E)
[Congressional Budget Office; Office of Management and Budget; Bloomberg]

For perspective, we plot in Figure 2, above, annual U.S. budget deficits (as a percentage of GDP) from 1950 through 2022 alongside CBO projections for 2023 through 2033. As shown by the dotted black line, CBO is forecasting that U.S. budget deficits will ***average 6.1% of GDP for the next decade.*** Even during emergency years of GFC and Covid, federal budget deficits have never averaged 6.1% for an entire decade. Ever! The U.S. budget deficit is entering totally uncharted waters.

4) Soaring Interest

Among troubling internals of U.S. deficits, none is more worrisome than soaring costs of financing outstanding U.S. debt. Interest costs to fund Treasury borrowings totaled ***$352 billion*** in fiscal 2021 and ***$476 billion*** in fiscal 2022. Through the first 11 months of 2023, year-to-date interest costs already exceed ***$630 billion***, and annualization of the $68 billion August expense implies an ***$816 billion*** run rate. Throwing in financing costs of intragovernmental holdings, the Bloomberg CIX function for total annualized federal interest costs [.USDEBTC Index] hit ***$960 billion*** in August.

Even worse, Fed rate hikes have yet to be fully reflected in the blended interest rate Treasury is now paying. Since the Fed began its 525-basis point tightening cycle, the blended interest rate on total U.S. marketable debt has only risen from ***1.57%*** in February 2022 to ***2.92%*** in August 2023. As shown in Figure 3, below, ***$7.6 trillion*** of Treasury debt (31% of the publicly held total) matures during the next ***12 months*** and will need to be refinanced at higher interest rates.

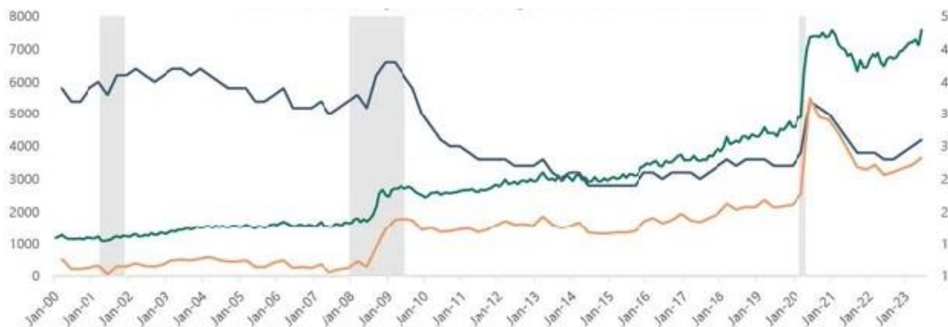

Figure 3: Treasury Debt Maturing During Next 12 Months ($Billions; % of Total Outstanding; % of GDP) (2000-August 2023) [U.S. Treasury; Apollo Global Management]

On 9/15/23, total U.S. public debt exceeded ***$33 trillion*** for the first time (marketable debt plus intragovernmental holdings), up ***$1.6 trillion in 3 ½ months*** since the 6/3/23 debt ceiling deal. It would be fair to assume the blended interest rate paid by Treasury on this total will be approaching 4% by next year, implying an annualized interest tab of ***$1.3 trillion***. Exponential growth in the costs of financing U.S. debt has renewed bearish discussion of the dreaded doom loop, in which spiraling interest costs on U.S. debt necessitate additional Treasury issuance, further driving up interest costs and so on and so forth.

5) Foreign Agita

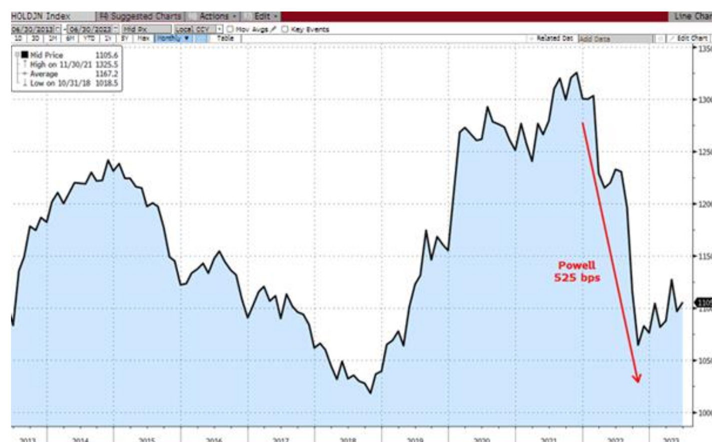

Figure 4: Total Japanese Holdings of Treasury Securities (6/30/13-6/30/23) [U.S. Treasury; Bloomberg]

While domestic consensus remains unperturbed by the deteriorating U.S. fiscal position, the same cannot be said about the largest foreign holders of Treasuries. As recently as 2007, China and Japan owned over ***20%*** of outstanding U.S. Treasuries. As of Q2 2023, this percentage had fallen to just ***7.6%***. In the case of Japan, as shown in Figure 4, above, total Treasury holdings have fallen some $200 billion during the Powell Fed's 525 basis point tightening cycle.

And in the case of China, as shown in Figure 5, below, total Treasury holdings have been in steady decline since 2013, falling from $1.3 trillion to $835 billion, with clear acceleration of the liquidation trend during both the Yellen (red arrow) and Powell (purple arrow) tightening cycles.

Figure 5: Total Chinese Holdings of Treasury Securities (6/30/13-6/30/23) [U.S. Treasury; Bloomberg]

Between March 2020 and March 2022, the Fed was by far the world's largest buyer of U.S. sovereign paper, scooping up a cool $2.91 trillion worth of Treasuries. While we recognize Western and Caribbean (hedge fund) institutions have become steady buyers of Treasuries in recent years, the fact remains that the world's ***three largest holders*** (Fed, Japan & China) are in active liquidation mode just as the U.S. budget deficit is normalizing at emergency pandemic levels and the threat of recession looms squarely on the horizon.

This confluence of events goes a long way in explaining record gold purchases by global central banks during the past two years. We certainly do not expect this enthusiasm to end anytime soon.

Please review our Addenda Graphs for interesting details of the performance of spot gold surrounding U.S. recessions and initial Fed rate cuts.

Sincerely,

Trey Reik
Managing Member
Bristol Gold Group LLC
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Addenda Graphs

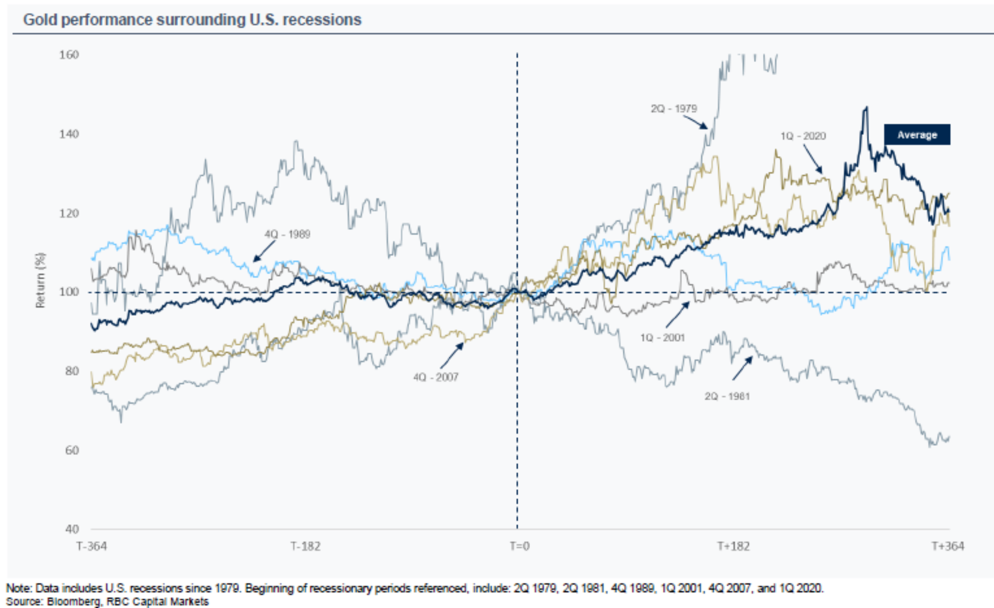

Figure 6: Performance of Spot Gold Surrounding U.S. Recessions (1979-Present) [RBC Capital Markets]

In our 9/6/23 report (*Hard or Soft*), we reprinted a proprietary Bloomberg graph plotting the average performance of spot gold versus other asset classes surrounding the seven U.S. recessions since 1973. The graph demonstrated that on average gold significantly outperformed stocks, commodities, corporate debt and U.S. Treasuries for at least the first seven months following onset of recession.

RBC's virtuoso analyst Josh Wolfson has since published more detailed analysis looking beneath gold's ***average*** performance to track gold's ***individual*** performances during the six recessions since 1979. In Figure 6, above, Josh plots the performance of spot gold for 364 trading days prior and following recessions beginning 2Q'79; 2Q'81; 4Q'89; 1Q'01; 4Q'07 and 1Q'20 (each series identified by arrow).

Additionally, looking forward to the inevitable Fed pivot, Josh plots in Figure 7, below, the performance of spot gold for 364 trading days prior and following the initial rate cut of the FOMC's nine cycles of multiple successive rate cuts since 1980 (2Q'80; 4Q'84; 2Q'89; 3Q'90; 4Q'00; 3Q'02; 3Q'07; 3Q'19).

Whether contemporary investors are positioning for potential recession or inevitable Fed pivot, the history of the past five decades suggests strongly that a gold allocation will improve prospects for future portfolio performance!

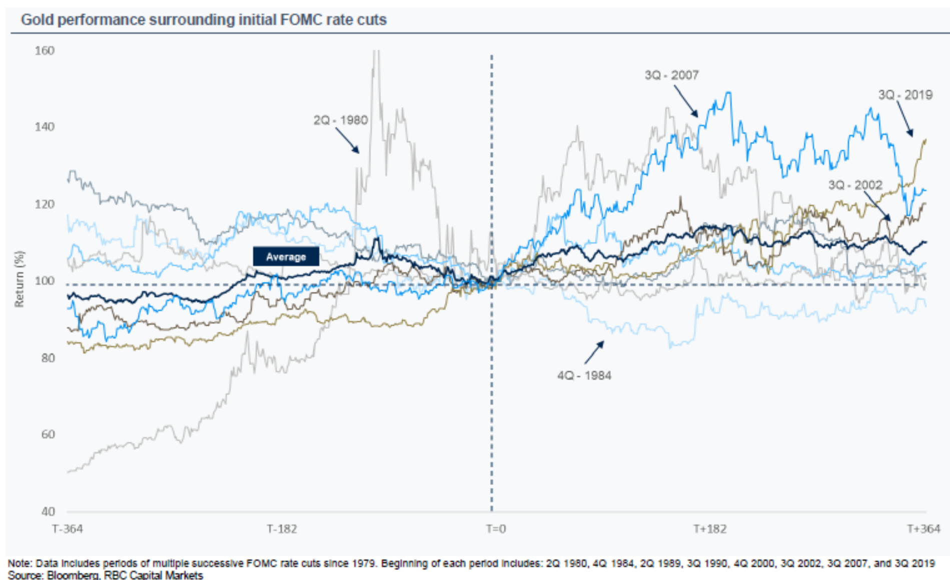

Figure 7: Performance of Spot Gold Surrounding Initial Fed Rate Cuts (1980-Present) [RBC Capital Markets]

Dollar Sentiment Quotes

We are at the beginning of a late, big-cycle debt crisis when you are producing too much debt and have a shortage of buyers.
Ray Dalio, Co-Founder, Bridgewater Associates, 6/7/23

We must persist in thinking and handling military issues from a political perspective, dare to fight, be good at fighting and resolutely defend our national sovereignty, security and development interests.
Xi Jinping, President, People's Republic of China, 7/6/23

There's a bureaucratic dogmatism at the Fed. They've got these algebraic models, my goodness, how formidable they look on a blackboard, but they don't actually function very well so far as the future's concerned. And the Fed was in fact, dogmatic through 2021 into 2022 buying mortgages recently—I think up to March 2022. So, you asked about their inflation fighting tools? They're rusty…

I am of the view that try as Jay Powell might to emulate Paul Volcker, Mr. Powell is not working with Paul Volcker's economy. There is much more debt, therefore much more fragility…

People are head over heels over private credit. They contend that this is a not quite Nvidia-quality breakthrough in the history of finance. But it's up there. And, but you know, private credit is a manifestation of the imperative to build leverage…So, there's a lot of leverage. And I would say with respect to the paradox of nothing breaking much yet, just be patient. I expect it might.
Jim Grant, Editor, *Grant's Interest Rate Observer*, 7/12/23

My big worry is if the Fed focuses on 2% [inflation target] in a relatively rapid time frame, we will end up in recession. There is no reason for the U.S. economy to fall into recession. The endogenous elements of this economy are strong enough to power through this period. ***The big risk is that we follow the wrong inflation target and end up tipping this economy into recession.***
Mohamed El-Erian, Chief Economic Adviser, Allianz, 7/21/23

I strongly disagree with Fitch Ratings' decision. The change by Fitch Ratings announced today is arbitrary and based on outdated data. Fitch's quantitative ratings model declined markedly between 2018 and 2020 – and yet Fitch is announcing its change now, despite the progress that we see in many of the indicators that Fitch relies on for its decision. Many of these measures, including those related to governance, have shown improvement over the course of this Administration, with the passage of bipartisan legislation to address the debt limit, invest in infrastructure, and make other investments in America's competitiveness…

The American economy remains the world's largest and most dynamic economy, with the deepest and most liquid financial markets in the world. To build on this, President Biden and I have been focused on making critical investments in our country's core economic strength and productive capacity. President Biden and I are committed to fiscal sustainability. The most recent debt limit legislation included over $1 trillion in deficit reduction and improved our fiscal trajectory. Looking forward, President Biden has put forward a budget that would reduce the deficit by $2.6 trillion over the next decade through a balanced approach that would support investments for the long-term.
Janet Yellen, Secretary, U.S. Treasury, 8/1/23

The numbers justify it [Fitch downgrade], regrettably. We've had an explosion of debt since the global financial crisis. We don't appear to have a lot off discipline…When there's a crisis in the world, they [foreigners] buy our securities. But that doesn't last forever if there isn't discipline.
Steve Schwarzman, Chief Executive Officer, Blackstone, 8/4/23

Usually [Treasury] supply and demand don't really matter that much because federal deficits tend to widen during recessions when the Fed is lowering interest rates. ***This time we have federal deficits widening when the economy is doing well.*** I think the bond vigilantes are quite concerned about that. There's way too much supply.
Dr. Ed Yardeni, President, Yardeni Research, 8/20/23

Core inflation excluding energy and food is still more than 4%. ***Especially in services, inflation is sticky. So, there is still a lot for us to do***…What we need now is a slowdown in demand...I believe that the balance sheet reduction can and should continue in the background even if we stop raising the interest rate or even lower it…History has taught us that the cost of returning to price stability is even higher if we tighten too little. Given the strength of the labor market and the strength of underlying demand, I believe that currently the costs of insufficient tightening are greater.
Loretta Mester, President, Federal Reserve Bank of Cleveland [2024 FOMC Voter], 9/5/23

The risk of inflation staying higher for longer must now be weighed against the risk that an overly restrictive stance of monetary policy will lead to a greater slowdown in activity than is needed to restore price stability…This context calls for a patient and careful, but deliberate, approach to policy, allowing time to assess the effects of policy actions to date, and then acting appropriately. Susan Collins, President, Federal Reserve Bank of Boston [2025 FOMC Voter], 9/6/23

I think we are much nearer now to the top of the cycle. And I'm not therefore saying we're at the top of the cycle because we've got a meeting to come. But I think we are much nearer to it on interest rates on the basis of current evidence…Many of the indicators are now moving as we would expect them to move, and are signaling that the fall in inflation will continue and, as I have said a number of times, I think will be quite marked by the end of this year…We're still seeing in my view anyway quite a slow cooling of the labor market. Andrew Bailey, Governor, Bank of England, 9/6/23

It's probably wise from a risk-management perspective, and probably necessary based on the data that we've gotten, that they keep that extra rate hike in there…***I think the Chair was right at Jackson Hole to say, 'Hey, this isn't over yet.'*** Core inflation is not down to 2%, we've got to maintain flexibility going forward and it's possible that inflation would stall out or would even head a little bit higher. James Bullard, Former President, Federal Reserve Bank of St. Louis, 9/6/23

We'll have to keep watching the data carefully analyzing all of that and really asking ourselves the question: ***is this sufficiently restrictive?*** Do we need to maybe raise rates again to make sure that we're keeping that steady progress in terms of shrinking imbalances in the labor market and bring inflation back down?

John Williams, President, Federal Reserve Bank of New York [Permanent FOMC Voter], 9/7/23

Another skip could be appropriate when we meet later this month [Sept.]…***But skipping does not imply stopping.*** In coming months, further evaluation of the data and outlook could confirm that we need to do more to extinguish inflation…My base case, though, is that there is work left to do…Economic activity is picking up — contrary to expectations all year that the economy would slow down. To sustain low inflation, supply and demand need to be in balance. Last year, labor demand greatly outpaced supply.

Lorie Logan, President, Federal Reserve Bank of Dallas [2023 FOMC Voter], 9/7/23

Today the intelligence couldn't be clearer. Whatever its actual intentions maybe I could not say, but ***China is preparing for a war and specifically for a war with the United States***. Frank Kendall, Secretary, U.S. Air Force, 9/11/23

I would not be a buyer of [10-yr.] Treasuries at 4.2%, nor would I be a buyer of credit spreads at these spread levels…I just think people make a mistake to look at real-time numbers and not look at the future. And the future has quantitative tightening. We've been spending money like drunken sailors around the world, this war in Ukraine is still going on. Those are really big 'buts.' To say the consumer is strong today—meaning you got to have a booming environment for years—is a huge mistake…

The banks are quite upset [about new capital requirements]. I'm not sure it's a great thing that we have these constant battles with regulators as opposed to open, thoughtful things. We used to have real conversations with regulators. There's none anymore in the U.S., virtually none. It's all from the top imposed down below. Of course, we simply have to take it because they're judge, jury, hangman…***Do [regulators] want banks ever to be investable again? I wouldn't be a big buyer of banks***…Do you think the NPR's [notices of proposed rulemaking] are going to make a shit of a difference? It's my academics arguing with their academics. They're going to do what they want anyway.

Jamie Dimon, Chief Executive Officer, JPMorgan Chase, 9/12/23

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