HB RETIREMENT®

FINANCIAL MARKET SNAPSHOT

November 2023

The Ballooning US Deficit

In this edition of the Market Snapshot, we take a look at Federal deficits and their potential impact on interest rates. The federal budget deficit, an on-again, off-again concern for the US electorate and economy, is back on. In annual polling by the Pew Research Center, the share of Americans naming the deficit as a top priority peaked at 72% in 2013, declined to 42% by 2021 but is trending upward again, reaching 57% in 2023.

A spending surge under President Joe Biden, following tax cuts under Donald Trump, swelled the gap between revenue raised and funds committed just as a spike in interest rates made carrying debt more expensive. With projections pointing to outsized gaps for years to come, and politicians in Washington in repeated brinkmanship over the issue, concern about deficits is beginning to rattle financial markets.

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What is the Difference Between the Deficit and the Debt?

The deficit is the difference between the money the government takes in, called receipts, and what the Government spends, called outlays. Receipts include the money the government takes in from income, excise and social insurance taxes as well as fees and other income. Outlays include all Federal spending including Social Security and Medicare benefits along with all other spending ranging from medical research to interest payments on the debt. When there is a deficit, the Treasury must borrow the funds needed for the government to pay its bills.

The government borrows the money by selling Treasury securities like bills, notes, Treasury Inflation-Protected securities and savings bonds to the public. Additionally, Government Trust Funds – like Social Security – are required by law to invest accumulated surpluses in Treasury securities. The Treasury securities issued to the public and to Government Trust Funds (intragovernmental holdings) then become part of the total debt.

Historically, periods with spikes in deficits and corresponding increases in the national debt have been periods associated with war or a severe economic downturn. However, more recent deficits have become the norm and are no longer caused by periodic spikes in wartime or recession-related spending, but rather by a long-term, structural mismatch between spending and revenues.

The debt is the total amount of money the U.S. government owes at a given point in time. It represents the accumulation of past deficits, minus surpluses. You might think of this debt like the balance on your credit card statement, which shows the total amount you have accrued over time.

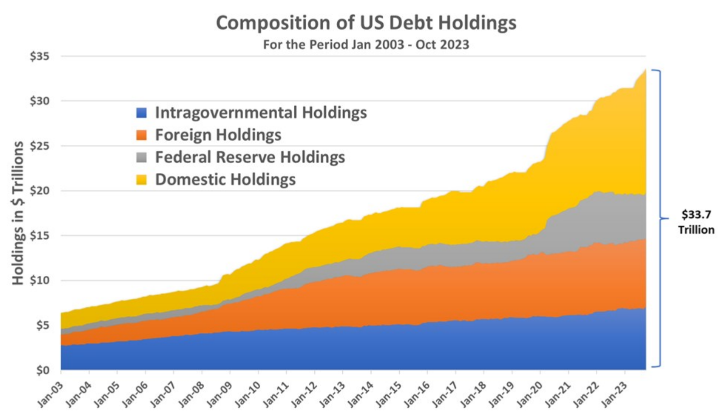
How Large is the Federal Deficit?

In fiscal 2023, the US Federal deficit clocked in at a whopping $1.7 trillion, up from $1.38 trillion in 2022. That sort of surge typically happens only when the government is in recession-fighting mode, not when the economy is growing at a decent clip. Even when judged in the context of the overall US economy, the deficit is imposing. It equaled 6.3% of gross domestic product in 2023, a level untouched for six decades until the 2008 global financial crash. Moreover, the annual shortfall has been forecasted to keep growing, reaching $2.6 trillion in 2033. Each additional deficit adds to an already mammoth amount of publicly held debt – which stood at $26.5 trillion as of October 2023, nearly the size of the US economy.

Over the past two decades, the fiscal situation was exacerbated by two emergencies. First, the global financial meltdown of 2008, which triggered a severe economic contraction that led to a four-year run of trillion-dollar deficits. Second, starting in 2020, was the Covid pandemic which necessitated a wave of government money to households and businesses to keep the economy afloat.

How Much Total Debt Does the Federal Government Currently Have?

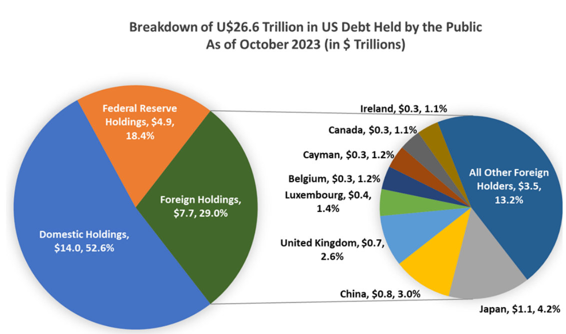
As of October 2023, US public debt outstanding currently sits at $33.7 trillion and is expected to surge by an additional $20 trillion to $54 trillion within the next decade amid fiscal excess in the 2020s. According to an analysis from the Bank of America, that's equivalent to growing $5.2 billion every day. As a consequence, growing deficits are forcing the Treasury Department to auction trillions of dollars of fresh bonds.



Source: US Treasury and Bloomberg

Who Holds the Public Portion of the US Debt?

Of the $26.6 trillion of debt held by the public, about 29% is owned by foreign entities, roughly 52.6% by private and public domestic entities, and about 18.4% by the Federal Reserve Bank. The Federal Reserve has significantly expanded its Treasury holdings since the COVID-19 public health and economic crisis began in 2020.



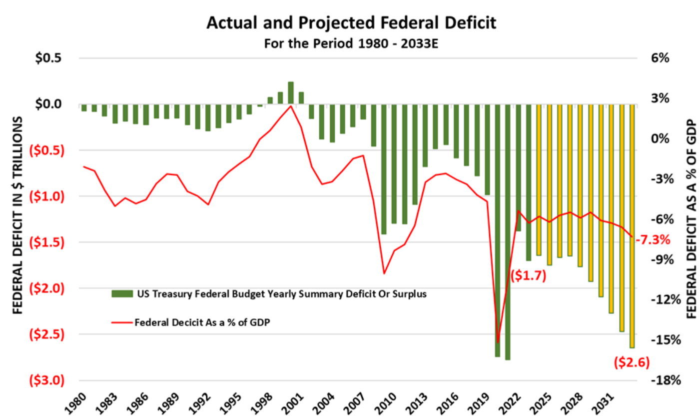
Source: Bloomberg and the US Treasury

Foreign holdings come from a mixture of foreign individuals, businesses, banks, and governments. Of the roughly $7.7 trillion of foreign-held debt, over 13% ($1.1 trillion) is held by Japan and 12% ($869 billion) is held by China. The next largest holders are the United Kingdom, Belgium, and Luxembourg, who each hold between $329 billion and $705 billion of U.S. debt. On a combined basis, the Eurozone holds about $1.4 trillion, and Organization of Petroleum Exporting Country (OPEC) member nations together hold $256 billion of U.S. debt.

In terms of the roughly $12 trillion of domestic holdings not held by the Federal Reserve, a large share is held by the financial sector. Mutual funds hold ~20% of domestic debt holdings not held by the Federal Reserve, depository institutions hold 13%, private pension funds hold 4%, and insurance companies own 3%. About 14% is held by state and local governments, who invest in "State and Local Government Series" securities as a way to comply with federal tax laws and anti-arbitrage regulations when they have funds from issuing tax-exempt bonds, and another 3% is held by pension funds for their employees. Approximately 2% is held by the owners of savings bonds, which are sold directly by the Treasury and are not traded on the private market. The remaining 36% is held by other investors, including households, nonfinancial businesses, and Government-Sponsored Enterprises (GSEs).

How Much is the Deficit Projected to Grow over the Next Decade?

The total deficit – including net outlays for interest – is estimated to be ~5.8% of GDP in 2023, comparable to what it was in 2022. In fiscal 2033, the CBO projects the Federal deficit will grow to 2.6 trillion, accounting for 7.3% of GDP.

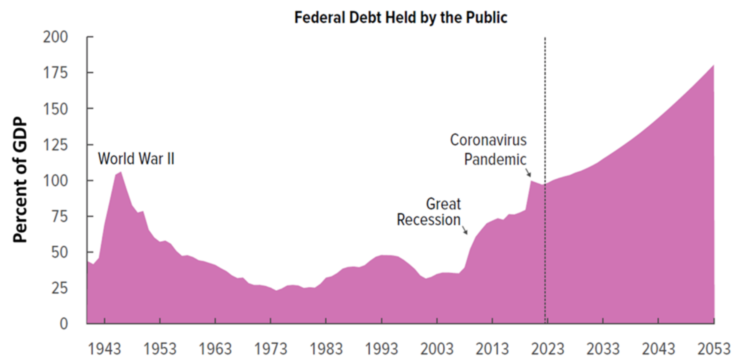


Source: US Treasury and the Congressional Budget Office

In CBO's projections, the deficit somewhat declines through 2027 before increasing steadily through 2053. At that point, the deficit – which is projected to be 10% of GDP – will be significantly larger than the long-term (50 year) average of 3.6% of GDP.

How Much Additional Debt is Expected to be Added Over the CBO's Forecasting Period?

Growing deficits are expected to push federal debt held by the public higher throughout the CBO's 30-year projection period, reaching 181% of GDP in 2053 – and continuing to rise thereafter.

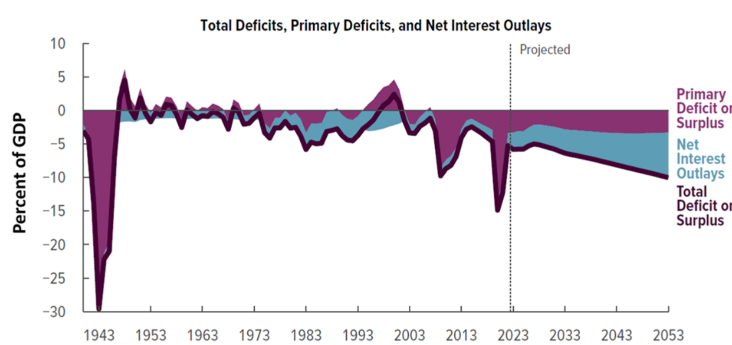


Source: Congressional Budget Office

As shown in the chart above, the CBO expects the debt ratio to rise from here. As dark as it is, the CBO projection may be too optimistic. For one thing, the CBO is compelled by law to assume in its baseline forecast that the 2017 Trump tax cuts will expire at the end of 2025 as scheduled – whereas the political reality is that they could be partially extended, at a considerable cost to the Treasury.

What Percent of the Annual Budget Do Interest Payments on the Debt Account For?

Over the past 50 years, the government's net interest costs have ranged from 1.2% of GDP to 3.2%, averaging ~2.0% of GDP. In the CBO's projections, such costs amounted to 2.5% of GDP in 2023. By 2033, those costs are projected to increase to 3.6% of GDP, as federal debt grows and interest rates rise.



Source: Congressional Budget Office: The Long-Term Budget Outlook, June 2023

As the chart above shows, in 2053, the primary deficit is expected to be 3.3% of GDP. However, driven by large and sustained primary deficits and by rising interest rates, net interest outlays are expected to reach 6.7% of GDP in that year (3.3% + 6.7% = 10.0% of GDP).

If projections are correct, interest payments would be higher (as a percentage of GDP) in 2053 than spending on Social Security, discretionary outlays, or all mandatory spending other than that for the major health care programs and Social Security – and more than twice the highest amount observed since at least 1940 (the first year for which the Office of Management and Budget reported such data).

The projected increase in net outlays for interest is the result of escalating interest rates and the rising amount of debt. On average, in the CBO's projections, increases in the average interest rate account for about two-thirds of the rise in net interest costs over the 2023–2053 period.

How are Changing Demographics Impacting the Deficit?

The US has recorded annual surpluses only six times since 1960, the last time was in fiscal 2001. A significant challenge legislators face is America's aging population. As more people retire, the government has to shell out more in Social Security pension payments and Medicare health benefits.

Over the 2023–2053 period, about one-third of the projected increase in total spending on the major health care programs, measured as a percentage of GDP, is attributable to the aging of the population. The lion's share of the increase results from greater spending on Medicare, because Medicare is the largest of those programs and most beneficiaries qualify for it at age 65. As the group of people who qualify for Medicare becomes larger and, on average, older, Medicare spending is expected to grow, not only because of the greater number of beneficiaries but also because spending on health care tends to increase as people age.

What Might be Done About the Deficit?

An economic boom that boosts tax revenue would certainly help. The fiscal 2024 deficit (which began on Oct. 1st), will likely shrink as taxes are paid to reflect the positive performance of financial markets in the 2023 calendar year. Unfortunately, there's hardly any consensus in Washington right now on how to increase revenues. Republican candidates for president are pushing for more tax cuts, arguing that will spur growth and lift receipts – an argument made by the George W. Bush and Donald Trump administrations when they reduced rates. In contrast, Democrats have proposed rolling back some of those past reductions and introducing a levy on unrealized capital gains for ultra-wealthy households.

However, with few signs that the 2024 US election will prove a decisive win for one party over the other, it would seem that partisan divides over fiscal policy will likely leave the trajectory untouched. Without a return to the super-low interest rates of yesteryear or a shocking new fiscal consensus in Washington, giant deficits may be here for a long while.

Looking Ahead

While it is very difficult to predict the long-term consequences of the current debt levels, investors should be aware of some potential risks that could present themselves if the debt continues to rise.

- Economic Instability: A high level of debt relative to GDP can be signs of economic instability which then could lead to higher interest rates, inflation, and economic volatility

- Higher Taxes: Investors may become fearful the government will increase taxes to cover the debt which in turn might reduce corporate profits and decrease disposable income for consumers.

- Higher Interest Rates: Large government borrowing could increase demand for loans, leading to higher interest rates, thus making borrowing more expensive.

- Lower confidence in the economy: High debt levels may lead to investors and the public losing faith in the government's ability to manage debt and that could lead to lower investment and overall economic growth.

At HB Retirement, we intend to follow the data and adjust our outlook and portfolios accordingly – and while accounting for these risks, we remain cautiously optimistic as we look out over the next several quarters. We remain committed to our disciplined and repeatable investment process, which is based both on top-down, macro analysis coupled with bottom-up, fundamental research. We firmly believe that having a disciplined investment process – and sticking to it – will pay off in the long-term.

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