NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Fiscal (Un)Sustainability

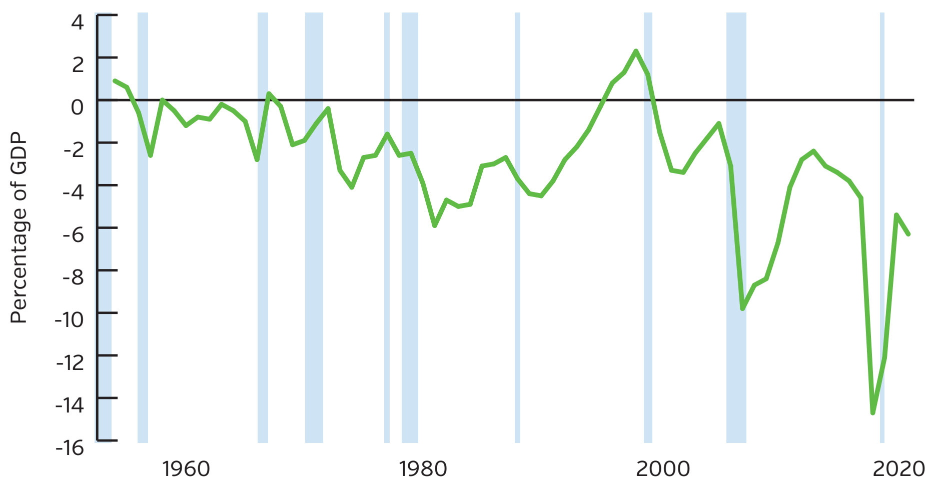
The U.S. is on a path of fiscal unsustainability. At what point do the capital markets take notice?

DEFICITS DON'T MATTER...UNTIL THEY DO

The topic of deficit spending has long been debated. Rooted in Keynesian economics, the theory holds that governments should stimulate the economy by borrowing and spending during an economic downturn, and then reverse once the crisis has passed. But contrary to Keynes' theory, deficits in the U.S. have persisted even during thriving economies. Following the 1981-1982 downturn, the Reagan administration experimented with "trickle down" economics, a supply side approach suggesting lower taxes on higher income earners would encourage more economic growth and investment that would benefit the entire nation. Indeed, U.S. GDP took off as the highest marginal income tax rate was cut from 70% to 30% alongside other tax cuts. The economy went on to grow at an impressive 26% over the 8 years of Reagan's presidency, along with ballooning deficits that continued throughout the decade.

"Reagan proved that deficits don't matter." *– Former Vice President Dick Cheney*

Chart 1. U.S. Budget Surplus/Deficit Percent GDP



Source: National Bureau of Economic Research, Haver, NEAM

Today, the U.S. government is running a substantial fiscal deficit at a time of low employment and (surprisingly) healthy growth – a deficit that is higher than in any other period except the Great Recession (2007-2009) and the 2020 Covid shutdown (see Chart 1). Furthermore, the

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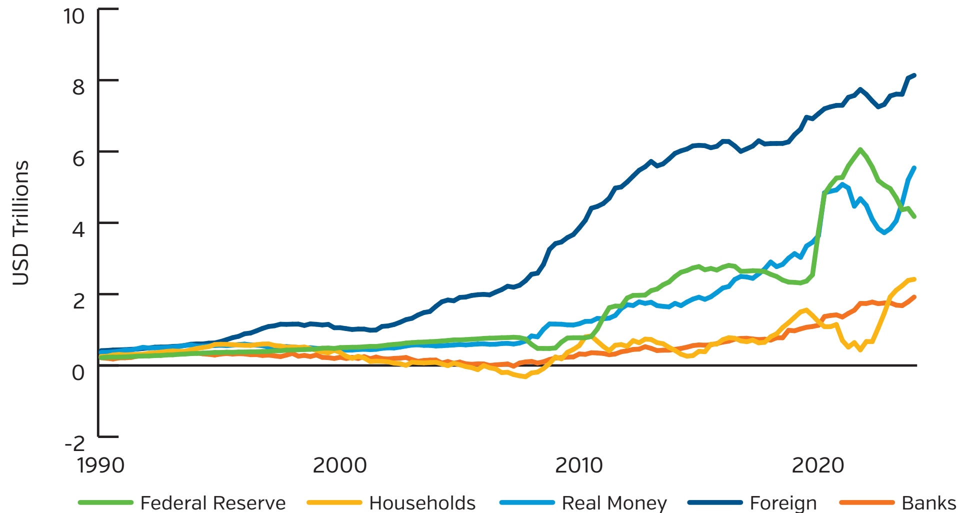
country is on the eve of an election where neither political party is targeting deficit reduction as a policy objective. The capital markets seem unconcerned at present. U.S. Treasury auctions, which have grown in offering size, continue to be met with strong demand from both domestic and foreign buyers (see Chart 2). However, the longer-term implications cannot be ignored. Ever-rising debt issuance intuitively leads to higher term premiums (the compensation that investors require for bearing interest risk across the Treasury curve) which in turn can affect rate volatility and demand dynamics. At some point, that reality may come home to roost.

Chart 2. Holders of U.S. Treasuries



Source: FFunds, Haver, NEAM

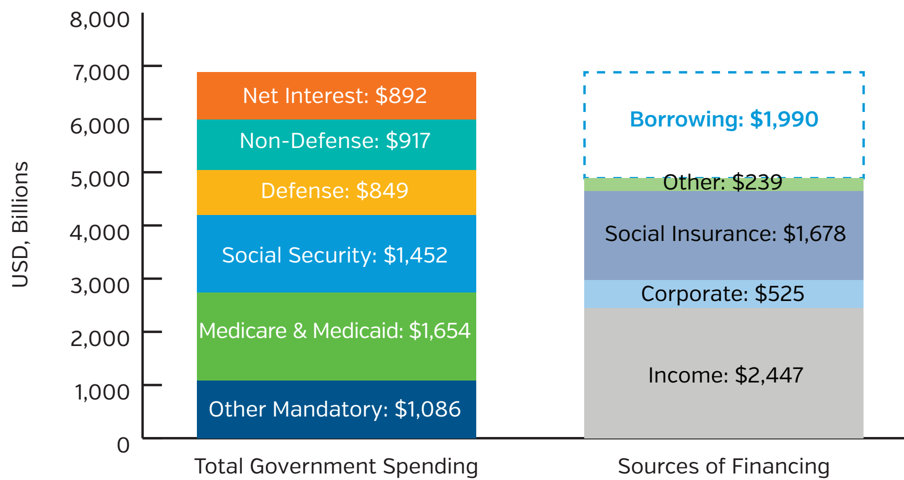
NO END IN SIGHT

"The level of the deficit is sustainable but the path we're on is not sustainable." – *Jay Powell (2024)*

The latest projections by the Congressional Budget Office (CBO) underscore the worsening fiscal trajectory over the next 10 years:

- The 2024 federal budget deficit is now estimated at $2 trillion (see Chart 3), up from $1.5 trillion from the previous estimate (February 2024), bringing the projected deficit to 7% of GDP.
- Overall spending in 2024 is running at 24.2% of GDP, well above the 50-year average of 21%. Revenue, on the other hand, remains at its historical level of ~17% of GDP. Both trends (higher spending, flat revenue) are projected to remain in place over the next 10 years.
- Mandatory Outlays (61% of total expenditures) are the largest contributor to the primary deficit and the hardest to control considering the aging population and spiraling healthcare costs. Entitlements (Social Security, Medicare and Medicaid) are set to reach 14.7% of GDP in Fiscal 2024, a full 3% above the long-term average. Based on current estimates, Social Security and Medicare will be unable to meet their full obligations in 2035 and 2036, respectively. [1]
- Interest costs are expected to climb sharply. With the quantum of debt held by the public projected to increase by 80% through 2034, along with the rising cost, net interest as a percent of GDP will nearly double from 2.1% to 4.1% of GDP.
- Accumulating deficits are estimated to bring the level of debt held by the public from 99% of GDP in 2024 to 122% of GDP in 2034.

Chart 3. 2024 Federal Budget



Source: Congressional Budget Office, NEAM

As dire as the CBO's projections look, they may be *too optimistic* in assuming the expiration of certain provisions from the 2017 Tax Cuts and Jobs Act (TCJA) and no recession during the forecast period. In other words, the future fiscal situation could be even worse than expected because both parties are planning at least a partial extension of the tax cuts, together with the likelihood of an inevitable, eventual downturn at some point over the next 10 years.

CAPITAL MARKET IMPACT AND RISKS

Capital market reaction to the potential risks of fiscal unsustainability has been subdued. Aside from a brief period in September of 2023 when the combined news of a U.S. sovereign debt rating downgrade by Fitch and upsizing of Treasury auction amounts caused a short-term spike in yields across the curve, markets have been relatively unresponsive to the rising trend of the federal debt.

Investors should perhaps pay closer attention to possible long-term implications:

- Cumulative deficit spending adds to the stock of debt outstanding, which must be funded by ever growing Treasury auction sizes. Investors anticipating greater supply will be increasingly focused on the term premium they are currently earning against their expectations for the future, potentially leading to a steeper yield curve.
- To the extent that government spending is fueling economic growth, higher inflation could re-emerge as a concern. Unless improvements in productivity are sufficient to offset an inflation upswing (productivity in the U.S. has been growing), investors will demand a higher nominal yield to account for diminished real returns.
- Persistent and rising deficits could call into question the U.S. dollar's role as the world's reserve currency. The ability of the U.S. to finance its spending and borrowing has been enabled by the status (privilege) of the U.S. dollar as the world's reserve currency. This special status is earned because of a stable government, the Fed's credibility, strength of the balance sheet overall, and the ability to issue debt. We do not view the dollar's reserve status to be a realistic concern. Nearly 60%[2] of the world's central bank foreign exchange reserves are held in dollar-denominated assets and the greenback dominates trade, commodities, and financial transaction activity around the globe. Additionally, there is no viable challenger to the U.S. dollar.

For the time being, markets appear unalarmed by the downside risk associated with the worsening fiscal situation. Note and bond auctions have been easily absorbed, helped in part by T-Bill issuance above the Treasury's target (15% to 20% of total debt) which has helped to alleviate supply stress in the longer end of the curve. But how long will markets remain patient? After all, the "bond vigilantes" of the 1990s have been in hiding for more than three decades. At any moment they could emerge to instill discipline on government fiscal management run amok.

KEY TAKEAWAYS

- Post-pandemic, the U.S. government has continued to spend at a historically high level as new fiscal programs were introduced, and mandatory expenditure costs rose.
- Unabated, the U.S. government is on a path of fiscal recklessness where neither political party is addressing longer-term risks of ever rising debt levels and the cost to fund them.
- The reserve status of the U.S. dollar is not likely at risk due to the dominant position of U.S. dollar denominated transactions and lack of a viable challenger currency. Nonetheless, the topic may arise and contribute to market angst.
- The combined effects of unchecked fiscal spending, higher inflation, and elevated term premiums likely mean a steeper yield curve and increased interest rate volatility.
- From a strategic investment policy perspective, long-run budget deficits and ever-increasing government debt levels will bias us to remain close to duration targets.

ENDNOTE

[1] *The 2024 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, 2024 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds.*

[2] *International Monetary Fund Finance & Development Magazine, "Enduring Preeminence", Eswar S. Prasad, June 2022*

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