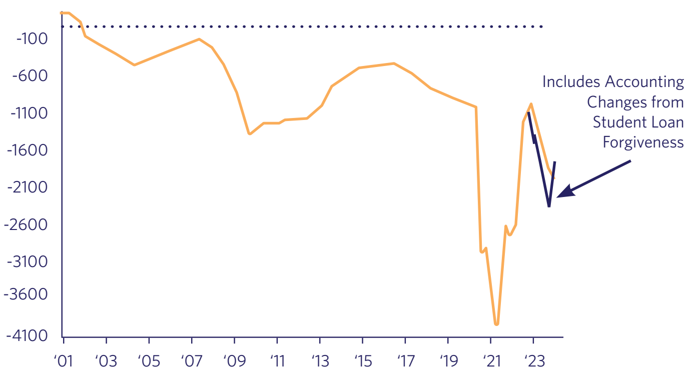
Unsustainable

The U.S. federal government officially ran a $1.7 trillion budget deficit in fiscal 2023, which ended in September. The accounting around the timing and amount of student loan forgiveness programs understated what was actually a cash deficit of $2 trillion (Chart 1). Either of the above annual deficit figures exceeds the entire national debt as of 1985.

CHART 1

Federal Government Surplus / Deficit
(12 Mo. Rolling, $BN, Excluding Student Loan Forgiveness)



Source: Strategas Research Group

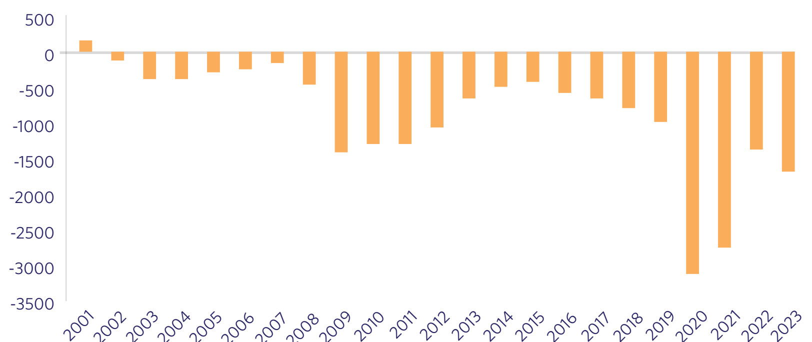
Prior to the 20th century, governments generally didn't incur budget deficits in peacetime. Governments used debt to finance wars, but deficits weren't accepted as a permanent condition. English economist John Maynard Keynes developed the theory of counter-cyclical government deficits to bolster aggregate demand which was deployed during the 1930s' Great Depression. His thesis included the expectation that the stimulus and "shock absorbers" would be removed once the economy improved and there would be budget surpluses during good times. Modern U.S. policymakers have forgotten the second part. What makes the 2023 U.S. deficit so concerning is that the economy wasn't in a recession and was near full employment.

The United States has embarked on a series of escalating fiscal spending initiatives during the 21st century. Brown University estimates that the War on Terror cost the U.S. an estimated $8 trillion over two decades. The Global Financial Crisis ("GFC") ushered in unprecedented fiscal and monetary stimulus in efforts to prop up economic growth; President Bush signed the $152 billion Economic Stimulus Act of 2008, while President Obama signed the $787 billion American Recovery and Reinvestment Act of 2009.

Some policymakers viewed the U.S. government as being too timid during the GFC aftermath and attributed the subpar economic growth of the ensuing decade to this reticence. After much of the U.S. economy shut down during the early days of the pandemic, a series of spending packages followed which eventually totaled over $6 trillion. Subsequently, the Inflation Reduction and CHIPS Acts of 2022 promise over $800 billion in funding. We are in an era of increasing budget deficits (Chart 2).

CHART 2

Federal Budget Surplus/Deficit By Fiscal Year ($BN)



Source: Strategas Research Group

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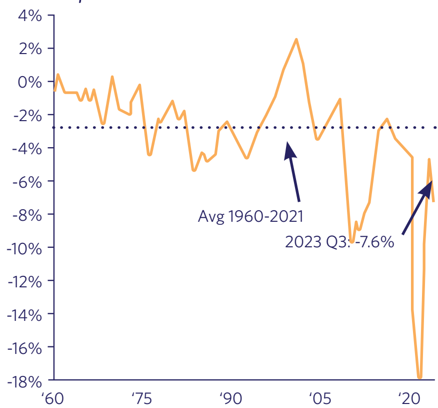
CHART 3
Federal Budget Surplus / Deficit % of GDP

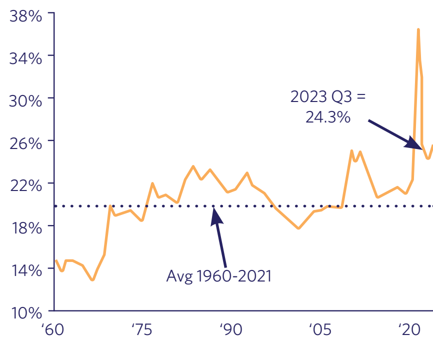


Source: Strategas Research Group

Not only are deficits expanding, but they are increasing as a percentage of the U.S. economy (Chart 3).

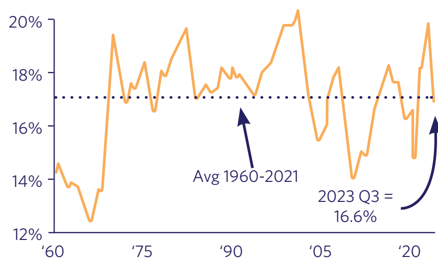
The government has two levers to address its budget deficit: spending and tax revenues. As currently configured, there is a mismatch between the level of spending and taxes (Chart 4 and 5).

CHART 4
Federal Spending, % of GDP



Source: Strategas Research Group

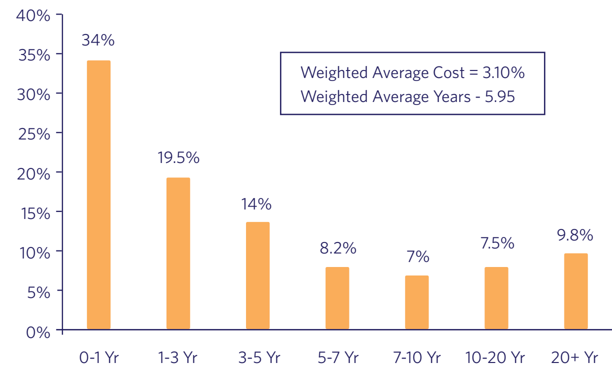
CHART 5
Federal Tax Revenues, % of GDP



Source: Strategas Research Group

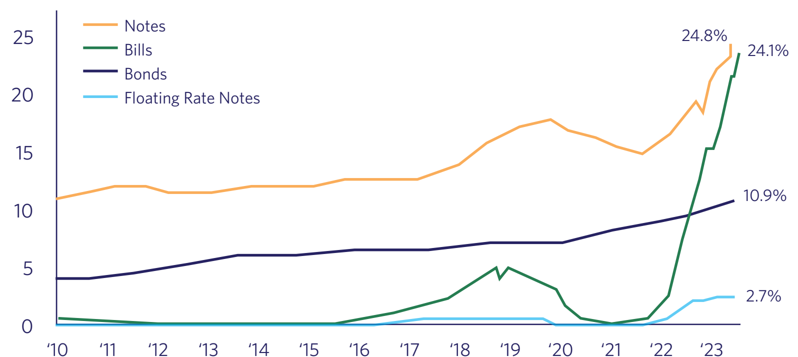
The post-GFC and pandemic periods experienced a very low interest rate regime, which made it easier to add new programs and incur larger debt levels from a budgetary perspective. The Federal Reserve's tightening financial conditions has resulted in the U.S. government interest expense exploding higher. While the private sector took advantage of the historically low-rate period to extend debt maturities, the U.S. government did not. Over one-third of U.S. marketable debt will mature within the next year and over 50% within the next three years (Chart 6). Since Treasury Bills have maturities of one year or less and therefore roll over quicker, the interest spike is already notable (Chart 7).

CHART 6
U.S. Outstanding Marketable Sovereign Debt (by Maturity Timeline)



Source: Strategas Research Group

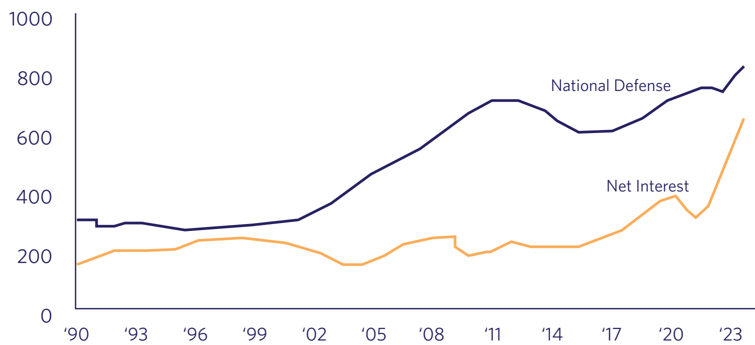
CHART 7
Monthly Interest Expense by Treasury Security ($BN)



Source: Strategas Research Group

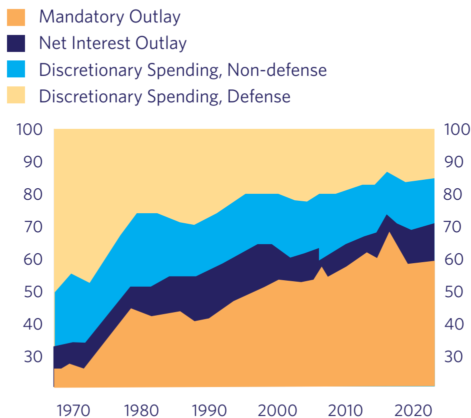
The U.S. government net interest spending is rapidly accelerating to the level of Defense spending (Chart 8). Mandatory and net interest outlays now exceed 70% of total U.S. government spending, squeezing discretionary Defense and Non-Defense spending. For some perspective, in 1980 non-discretionary spending was slightly higher than 50% (Chart 9). In addition to having to roll over debt maturities at higher interest rates, the aging U.S. population will result in significant mandatory expenditure increases in the upcoming decade in the form of increasing Medicare and Social Security outlays (Chart 10). The Congressional Budget 10-Year expenditure projections can only be viewed as alarming (Chart 11).

CHART 8
Defense & Net Interest Spending (12 Mo. Rolling, $BN)



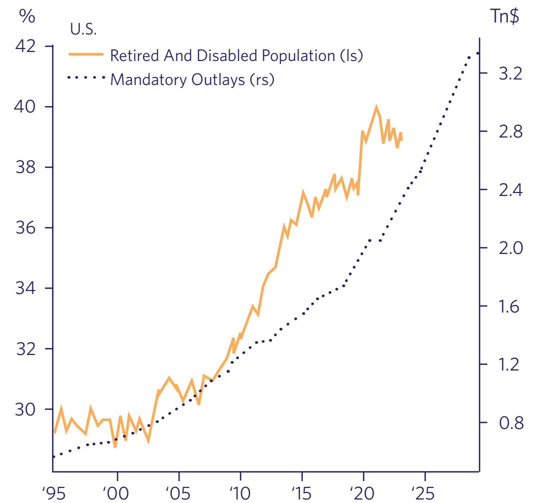
Source: Strategas Research Group

CHART 9
Discretionary Spending as a Share of Total U.S. Spending Has Long Been Squeezed



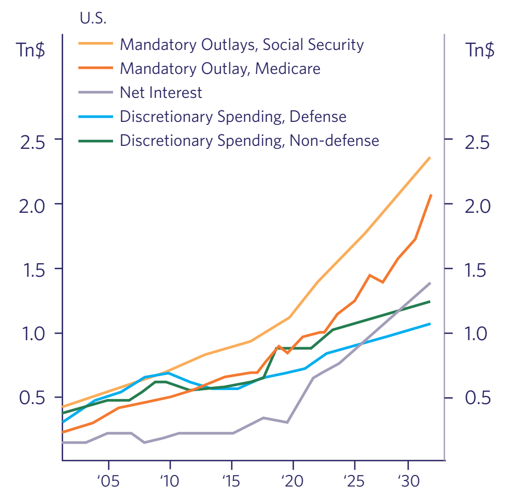
Source: Alpine Macro, Congressional Budget Office

CHART 10
An Aging Population Means Higher Demand For Social Programs



Source: Alpine Macro

CHART 11
Net Interest Spending And Mandatory Outlays Will Increase The Most



Source: Alpine Macro, Congressional Budget Office

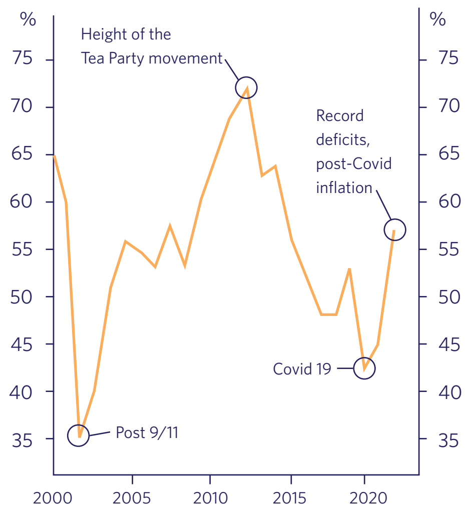
A review of U.S. government finances over the past 50+ years indicates that more restrictive fiscal policies occur when net interest costs cross the 14% of tax revenues threshold. It currently exceeds 15% and is rising rapidly (Chart 12).

The recent Republican House Speaker drama was a preview of escalating battles over spending, budgets, and taxes. Different ideologies, constituents, and priorities are a volatile mix when money becomes scarce. The widespread belief that the size of the stimulus programs has contributed to inflation is elevating deficits as a voter priority (Chart 13).

We are not debating the merits of any specific policy or agenda. However, the U.S. fiscal situation is increasingly unsustainable. Increased spending has occurred in both Republican and Democratic Administrations. Neither political party can claim to be a "small government" party, and the leading Presidential candidates are proven big spenders. Both parties promise their constituents economic benefits while minimizing the explicit and inflationary costs of their programs. Having the world's primary reserve currency, the U.S. has the exorbitant privilege to conduct its financial affairs in ways unavailable to other countries.

CHART 13

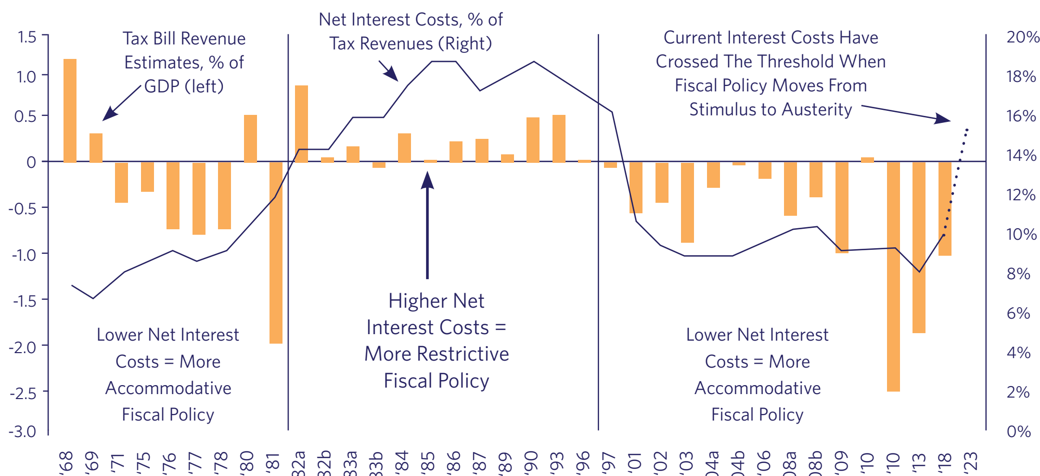
Voters Who Feel Reducing The Budget Deficit is Top Priority



Source: Alpine Macro, Pew Research Center

CHART 12

Tax Bill Revenue Estimates, Pct of GDP Since 1968
(Annual avg. for first two years after enactment, Treasury Dept.)

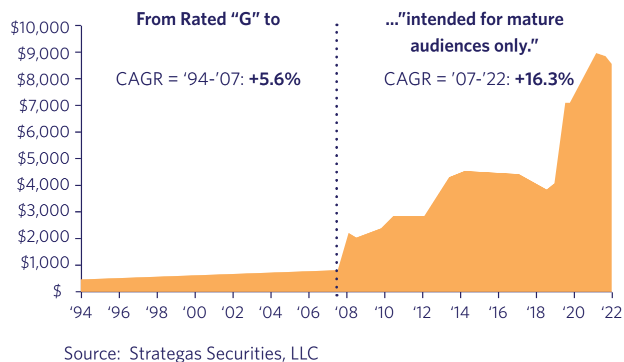


Source: Strategas Research Group

Japan runs a much higher government debt to GDP than the U.S. (over 260% versus 100%), suggesting that the U.S. may be a long way from needing to address the issue. A critical difference is that Japan is a net creditor nation. It is a closed loop, and its private sector owns Japan's government debt. The U.S. externally finances almost half its marketable debt with reliance on global investors.

CHART 15

Federal Reserve Assets ($BN)



Source: Strategas Securities, LLC

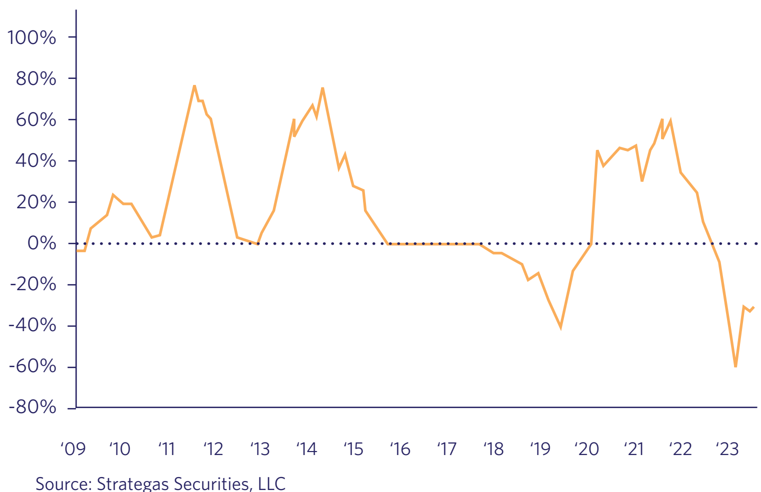
Note that this comparison describes general market structures since both countries' central banks did aggressively purchase bonds in recent years to depress yields and stimulate economic activity.

There has been considerable concern and some evidence in recent months that the bond market may have trouble digesting the ever-increasing amount of U.S. government debt. The worry is that higher rates will be necessary to attract investors. There are certain investors, such as foreign central banks, pension funds and life insurance companies, that need high quality, long maturity, liquid debt in their portfolios. These are generally referred to as "price-insensitive" investors, and they will buy U.S. Treasuries regardless of yield. Of course, in the years since the GFC the biggest price-insensitive buyer has been the Federal Reserve which has absorbed a huge amount of U.S. government bond issuance. Given the economy's continued strength, the Fed is not buying new bond issues and letting bonds mature to reduce its balance sheet (Charts 14 and 15).

It has been reported that foreign buyers are shunning U.S. debt, citing that overseas investor holdings have dropped from 43% to 30% over the past decade. However, this is misleading in that the lower percentage is due to the increased debt outstanding as well as the Federal Reserve's huge portfolio. Interestingly, Japan is the top foreign holder with $1.1 trillion. Net purchases of U.S. Treasury Bonds and Notes by foreigners is still strong (Chart 16).

CHART 14

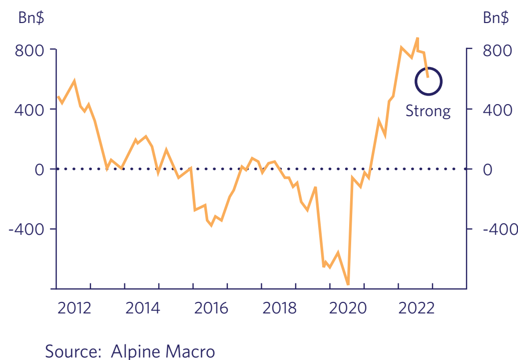
Fed Purchases of Treasuries, % of U.S. Public Debt (M/M, 12mo Rolling)



Source: Strategas Securities, LLC

CHART 16

Net Purchases of U.S. Securities by Foreigners: Treasury Bonds & Notes



Source: Alpine Macro

Notable economic observers, such as Stanley Druckenmiller, Jamie Dimon, Ray Dalio, and Jason Trennert, have highlighted the unsustainability of the current fiscal path for years. Lyell Wealth Management's view has been that it is impossible to forecast when the markets will compel U.S. policymakers to address the issue. It is tempting to disregard concerns now. However, note that when then Vice President Dick Cheney said that "deficits don't matter" in 2002, the government was only running a $158 billion deficit. Most investors, including Lyell Wealth Management, are "price sensitive" buyers. Price is an important component in determining whether to purchase a security and how much. Given that "price-insensitive" buyers are already in the bond market, then by definition the increased debt supply must be purchased by "price-sensitive" buyers. All things being equal, larger deficits and debt should result in higher yields than otherwise.

Bipartisan fiscal consolidation occurred in 1982/83, 1986, 1997 and 2011 even with divided government. In 1994 President Clinton's advisor James Carville made a famous quote "I used to think that if there was reincarnation, I wanted to come back as the President or Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." Turmoil and volatile interest rates led to the 1997 deficit reduction deal. Some sort of interest rate, currency or other market event will likely force the parties to address the budget excesses.

From a political perspective, popular support is needed for fiscal reforms. Given that 2024 is a Presidential election year, fiscal reform is unlikely to be imminent. However, the building pressure outlined in this Perspective makes something likely in 2025 regardless of the election results.

Lyell Wealth Management emphasizes that clients maintain a diversified, balanced strategy at all times, and we accept that market drawdowns occur. We don't practice market-timing. However, the issues addressed in this Perspective may factor into how one plans for retirement, and taking advantage of a higher interest rate regime is a prudent investment strategy. Although a fair case can be made that lower income tax rates generate higher tax revenues, the political realities may mean income tax rates will increase in the future (especially for high earners). Corporate tax reform will likely resurface soon, and entitlement eligibility may be tightened, pushed back and means-tested. These changes would seem to be more achievable in an environment in which the government is increasingly desperate for revenues and the politics are more populist.

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