The Federal Deficit…a Widening Gap

November 2020

OVERVIEW

- **The US government's fiscal response to the pandemic-induced recession has led to levels of spending not seen since WWII.**
- **The federal budget deficit reached 18% of GDP for fiscal year 2020 - nearly twice its level during the Global Financial Crisis.**
- **The significant debt accumulation has reignited concerns regarding the level of US debt – namely how much is too much?**

Background

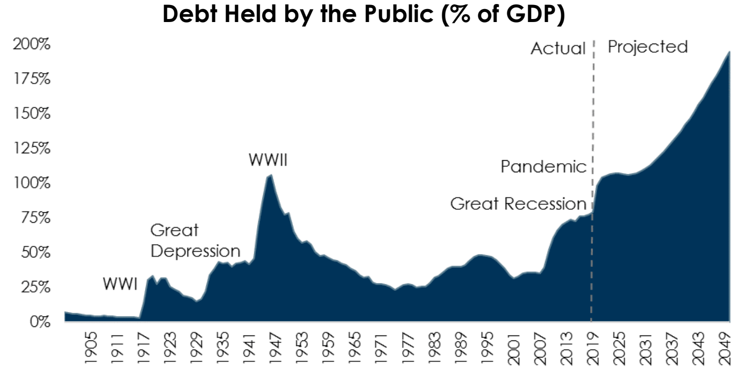
The US Treasury categorizes all government spending into three groups: mandatory, discretionary, and interest on debt. The difference between annual government spending and revenue, which comes primarily from taxes, results in either a budget surplus or deficit – depending upon whether revenues exceed spending, or vice versa. If a deficit arises, the government must then borrow money to make up the difference. Looking back over the past three decades reveals only a brief four-year period spanning the turn of the century during which our federal government ran a surplus.

How Much is the Tab?

The national debt is the accumulation of federal deficits over time. With annual deficits continuing to pile up, this number had become quite large, even pre-COVID. For the fiscal year ending September 2019, the federal deficit of $984 billion contributed to a total debt of $22.8 trillion. When considered as a percentage of the goods and services produced by the US economy, the federal debt amounted to 79% of the gross domestic product (GDP) last fiscal year.

The recession resulting from the shuttering of the US economy in response to the global pandemic, combined with the corresponding increase in government spending via fiscal stimulus efforts, has increased this year's federal deficit by a staggering margin. The deficit for fiscal year 2020 was $3.1 trillion, with the total level of national debt quickly approaching 100% of GDP. This is the highest level since World War II, when the national debt had climbed to 106% of GDP.

Debt Held by the Public (% of GDP)



Source: Congressional Budget Office.

Now that the election is (mostly) in the rearview mirror, investors are focused on the new administration's initiatives – particularly regarding the next fiscal stimulus proposal – and the degree to which additional spending will further expand the government's balance sheet.

Is the Credit Card Maxed Out?

Some worry that sustained excessive government debt can impact economic stability across various factors: growth, dollar strength, employment, and ultimately, the country's global economic and political power. Modern monetary theorists, on the other hand, believe the national debt is manageable and should not be a focus.

In truth, there's no standard rule of thumb regarding how much debt is "too much." The main determinant is the credit worthiness of the borrower. But there's no evidence that investors are presently concerned about default risk, as indicated by near-historic low interest rates at which the government can borrow. This is partially driven by the US dollar's status as the world's reserve currency, providing consistent demand for Treasury securities used to finance the debt; if a viable alternative to the US dollar arises in the future, however, this could reduce demand and increase yields.

From a structural standpoint, the central bank's independence from the US government remains integral to its credibility as an institution. This ensures that the bank will not be pressured by the government to print money to pay its debt, which would essentially lead to a "soft default" through currency devaluation.

An ancillary concern has been that the burgeoning debt issued by the US Treasury may crowd out private sector borrowing. This does not appear to be an issue currently; despite the significant increase, Treasury bonds still only represent about one-quarter of total outstanding debt issuance. And the significant amount of savings on the sidelines across the globe indicates that there is more than enough money available to finance additional investment.

ACG's Position

It is too early to gauge the near-term impact for investors given that we don't yet know what policies will be implemented by the new administration or the path of recovery from the COVID-related recession. If the significant fiscal and monetary support this year accomplishes the intended effect of bolstering the economy, inflationary pressures could arise as early as 2021. Conversely if economic growth does not improve, investors' concern regarding the government's ability to repay its debt could lead to higher interest rates and potential US dollar weakness.

Longer-term, a key concern for US-based investors is the tax implications of the debt scenario. Whether or not it's an issue today, this level of spending is not sustainable indefinitely. Eventually the government will have to repay what it has borrowed, and this is likely to come in the form of higher taxes.

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