Debt Does Matter

Both Republican and Democratic parties say they put a high priority on strengthening the country and looking out for the next generation. However, actions speak louder than words.

There are well known reasons for the ever-rising debt loads (i.e. wars and tax cuts). It’s a bipartisan affair. Both parties are guilty of irresponsible fiscal management. When Democrats are in power deficits don’t matter. Likewise, when Republicans are in power deficits don’t matter.

When Barack Obama was president, congressional Republicans frequently argued that both short-term budget deficits and the long-term accumulation of national debt were acute economic problems that needed to be addressed immediately. Debt aversion was a key reason to not stimulate the economy, not even with tax cuts like the payroll tax holiday that expired in 2012 due to GOP opposition.

Fast forward to the 2016 national election when the Republican Party reclaimed their majority rule.

“It’s a great talking point when you have an administration that’s Democrat-led... It’s a little different now that Republicans have both houses and the administration.” – Representative Mark Walker, Republican of North Carolina

To some critics, this is the epitome of partisan hypocrisy. But to congressional Republicans themselves, it’s, well, partisan hypocrisy. So, as both parties spend with reckless abandon, the federal government appears to be on a shaky fiscal trajectory.
Political parties have taken to the idea of running constant deficits as the normal course of business, and too much accumulation of debt is not healthy for the national or global economy. The U.S. is a prime example of “debt creep” – the country hasn’t posted an annual budget surplus since 2001, when the federal debt was only $6.9 trillion (54% of GDP). Fast forward to today, and the debt has ballooned to roughly $20 trillion (107% of GDP).

U.S. national debt effectively doubled between 2007 and 2014. National debt held by the public is currently 77% of the economy, which includes debt that’s been monetized (it was 35% as recently as 2007); this is the highest debt as a share of the economy under any new president besides Harry Truman.

But let’s face it. The debts have been growing in relatively good economic times. Imagine what would happen if the U.S. economy fell back into a recession.

Twenty trillion dollars is truly a scary number, yet it doesn’t include debt issued by federal agencies and government-sponsored enterprises, nor does it include state and local debt. It also lacks the unfunded liabilities of entitlement programs like Social Security, Medicare and Medicaid. In practice, these benefits are expected to rise sharply as the baby boomers grow older, which will sharply increase deficits and debts.

To better understand how high the U.S. debt is, let’s look at the debt per capita in a typical family. Today, federal debt works out to about $62,000 per person (or just under $250,000 for a hypothetical family of four).

Federal Debt: $250,000 per Family
Does the graph above look healthy to you? There is no trend reversal in sight. Consider the following factoids:

- National debt is forecast to grow by $11 trillion over the next decade.
- Debt held by the public is expected to reach 91% of the economy in ten years; that is more than twice the 50-year average of 40%.
- By 2039, the Congressional Budget Office (CBO) projects the debt held by the public will increase to 101% of GDP and, to 103% of GDP by 2040. The aging population and rising health costs are driving up government spending and revenues are not projected to keep pace.
- Deficits are expected to rise every year after 2018. The CBO forecasts we will again reach $1 trillion in deficits by 2022.

And that is the rosy scenario; it assumes no recessions, wars, terror attacks, tax cuts or federal spending expansions.

The question now is this: How long can this continue?

**WHAT HAPPENS IF RATES RISE?**

While debt has exploded, the cost of servicing that debt has remained relatively low thus far. To wit, last year, the federal government spent $241 billion – roughly 1.3% of GDP – on interest payments. That’s among the lowest at any point since the 1970s.

That’s the “good news.” The “bad news” is rates are expected to rise from here. If so, net interest as a percentage of GDP will rise quite rapidly from here on out.

![Figure 5: Historic and Projected Net Interest (as a % of GDP)](image_url)

Even with today’s low interest rates, the U.S. spends more in interest on the debt than on the Departments of Veterans Affairs and Homeland Security combined. We also currently spend more in interest than on the Departments of Education, Labor, Housing and Urban Development, and Transportation combined.
While the CBO does not expect interest rates to return to their historic levels any time soon, it does project they will rise substantially from today’s near-record lows. By the early 2020s, the CBO projects 10-year notes to pay 3.6% (by comparison, in Fiscal Year 2016 they averaged 1.9%) and three-month bills to pay 2.8%. As such, the CBO baseline projections show interest on the debt will be the fastest growing part of the federal budget over the next decade.

Given its sheer size ($20.4 trillion and counting) if the interest rate on that debt were to rise by even 1%, the annual federal deficit rises by $200 billion. A 2% increase in interest rate levels would up the federal deficit by $400 billion, and if rates were 5% higher, the annual federal deficit rises by a full $1 trillion per year! This is income that is not available for infrastructure, education or defense – or for Social Security or Medicare – because the interest on the debt must be paid.

And if the significant increase in government borrowing somehow brings back the 10% interest rates of the 1980s (unlikely, but not impossible), the annual budget deficit would approach $3 trillion one decade from now. At that point,
Interest on the debt would cost $2.5 trillion per year, totaling nearly as much as current Social Security and Medicare spending combined.

Deficits will grow much faster if Republican policymakers further add to the debt. Interest spending would almost triple under current law, but the CBO estimates it could rise significantly if Donald Trump’s deficit spending tax reform goes into effect. The Tax Policy Center found that the Republican tax framework would reduce federal revenue by $2.4 trillion over a decade and by $3.2 trillion over the following 10 years.

A $1.4 trillion deficit within a decade is risky enough, and deficits of $2 trillion or $3 trillion would be economically catastrophic. This should prompt any policy maker seeking large tax cuts or spending increases to pause.

FIVE REASONS WHY HIGH DEBT AND DEFICITS MATTER

1) Reduces potential for growth. Every dollar the U.S. allocates to interest payments is a dollar spent that does not fund important national public investments that can fuel economic growth — priority areas like education, research and development, and infrastructure. In addition, growing federal debt reduces the amount of private capital for investments, which hurts economic growth. A nation saddled with debt will have less to invest in its own future.

2) Interest rates impact every corner of the financial markets. Whether the Fed carries through and raises interest rates by a total of 2.25% from the floor, or stops before rates get that high, or raises and then lowers – it will have profound implications for every part of the financial markets. Families will feel the effects of rising debt through increased costs of home loans, automobile loans, credit cards and educational expenses because of higher interest rates.

3) Higher debt equals lower income. The CBO projects that our debt would reduce the income of a four-person family by $16,000 on average by 2047. We should all be concerned about stagnating wages and the growing disparities in income and wealth. At the very least, the federal government should not let its own budget imbalances contribute to these harmful trends.

4) Protects the safety net. There is a close relationship between Social Security and Medicare and interest payments on the national debt. Dollars allocated to making higher interest payments are not available for benefit payments. Conversely, dollars allocated to making rapidly increasing benefit payments are not available to make interest payments on a national debt that is also rapidly increasing. Our unsustainable fiscal path threatens the safety net and the most vulnerable in our society.

5) Less flexibility to respond to crises. On our current path, we are at greater risk of a fiscal crisis, and high debt leaves policymakers with much less flexibility to deal with unexpected events. If we face another major recession like that of 2009, it will be harder to work our way out.

The bottom line: Excessive debt growth could damage the economy, undermine our standard of living, and leave future generations worse off.

So, clearly, debt and deficits do matter!

DEBT DOES NOT MATTER

Those who deny that soaring debt can ever be a worry for the U.S. often point out that this debt is denominated in the same U.S. dollars the Fed can print. Therefore, there shouldn’t be defaults on that debt. In this case the debt deniers are
quite right — except they should worry more, not less. Funding the debt by running the printing press would be like pouring gasoline on a fire.

One problem could be a debasement of the U.S. dollar. Since over 40% of the debt is held by foreigners, they are likely to perceive this development as a partial default on the obligations. Result: a selloff in these bonds, which could bring about the fiscal crisis the CBO keeps warning about.

CONCLUSION

In the wake of the financial crisis, McKinsey & Company and other economic consultants argued that the financial crisis was caused by excessive debt. They further argued that the U.S. and the rest of the world needed to deleverage. Debt had become excessive. So, did we deleverage?

No! In fact, we added more debt. It is amazing that we, as a nation and global community, papered over a credit bubble that started to burst a decade ago with a new one. The amount of leverage is so much bigger today, in both absolute terms and relative to national income.

As shown in the following table, while U.S. government debt has risen by almost $10 trillion since 2007, more than $14 trillion has been tacked onto the total level of non-financial debt since the peak of the last credit bubble. Outstanding debt balances are now above $47 trillion!

The only reason why debt-service capabilities are intact, and defaults/delinquencies are low, is because interest rates are so low.

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<th>Non-Financial Debt to GDP</th>
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Herein lies the danger of raising rates. The disproportionate impact on debt servicing costs will drain resources out of the economy. We all know that the economy, both in the U.S. and abroad, could not handle 5% interest rates with the debt burdens of a decade ago. It is very doubtful that this debt can be serviced with rates above 2% this time around given the current uncomfortably high debt levels and ratios (at least not without slowing the economy right down).

Excessive debt is a primary reason why I have argued that interest rates will remain low for an extended period. Yes, we will see higher spikes from time to time, but a secular bear market is not in the cards. If rates were to rise in a sustained fashion, the economy would come to a screeching halt.
Responsible deficit reduction can ensure that future generations are spending their tax dollars on their priorities, rather than making cataclysmic interest payments on earlier expenditures they never voted for.

WRONG AGAIN?

The recent rise in rates has once again brought calls for the end of the “bond bull.”

But this is nothing new.

These bearish calls have been made year in, year out for the last five years. And every time the bond bears proclaim this is the beginning of the end, it has represented a prime opportunity to add bond exposure to portfolios.

Here we come off a week where luminaries like Jeff Gundlach and Bill Gross, once again, declare Treasuries to be entering a new bear market. Here’s the latest proclamation from the “bond king” du jour himself.

“The moment of truth has arrived for secular bond bull market!... Need to start rallying effective immediately or obituaries need to be written.” – Jeffrey Gundlach (aka “Bond King”)

The bond market has seen this movie before. In fact, the opposite case is also possible, if not more likely in my opinion. The economic cycle is long in the tooth, and risks remain weighted to the downside no matter the mainstream commentary (which is generally proven wrong given only enough time).

How bad have forecasts been? As shown in the following graph, Wall Street economists have been embarrassingly off the mark when forecasting where rates are heading.

At the beginning of each quarter, so called “professionals” are asked to predict where the key 10-year Treasury benchmark yield will be 12 months hence. When looking at the past 15 years, the professional forecasts compared to
the actual path of the 10-year Treasury yield erred, on average, by 60 basis points. See the graph above. The dashed lines represent the consensus forecasts. The solid line is the actual 10-year rate.

Amazingly, every year economists have predicted higher long-term rates. And every year, they have been wrong. Is it “group think,” flawed econometric models, a systemic bias or all of the above?

But let’s face it; whatever the reason, being consistently wrong in the same direction for 15 straight years is quite remarkable, if not downright pathetic. It has paid to be a contrarian.

By the way, the most recent Fed survey consensus estimate of the 10-year Treasury yield was 2.9%. Is this the first time in 16 years that economists get it right? Maybe so. However, if the historical margin of error remains true to form, the 10-year note would be closer to 2.3% in the next 12 months.

I also would point to what the legendary John Bogle, founder and retired chief executive of The Vanguard Group, had to say:

“Current bond yields are an excellent predictor of returns for the next 10 years... compared with stocks, bonds are a good value, better than they have been in years. Invest for the long run, but don’t expect too much. If you do that, you won’t be disappointed.”  – John Bogle

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The axiom that the long end of the U.S. Treasury curve responds to economic growth is a myth.

To wit: GDP rose 3% in the third quarter, ahead of expectations. It was the second consecutive quarter of 3% growth.

However, and more importantly, when it comes to the bond market, inflation continued to languish. The core personal consumption expenditures printed at only 1.3%.

As a result, the yield on the benchmark 10-year Treasury ended the week at 2.42%.
Notwithstanding all the buzz and speculation over who will win the competition for Federal Reserve Chair, investors should realize that the course of monetary policy will not be altered much in the medium term. The minutes of the Federal Reserve’s September meeting revealed policy makers’ resolve to stick to their tightening path.

With monetary restraint continuing to weigh on economic growth for the remainder of 2017 and 2018, inflation will continue a downward path. Coupled with extreme over-indebtedness, poor demographics, massive wealth inequality and productivity economic growth is likely to remain below trend.

Should the Fed hike rates in December, expect the yield curve to continue its flattening trend. At the same time, lower inflation and a decline in inflationary expectations will place downward pressure on long Treasury bond yields, thus causing the yield to curve to flatten further.

Consider the following graph, which plots the spread between 5s and 30s. Bond investors tend to concentrate on the spread between the five-year yield and the 30-year yield versus other measures of the curve. The five-year yield can serve as a more accurate reflection of market expectations for short-term rates than the two-year yield, which is largely under the central bank’s control.

After four rate increases in the current hiking cycle, the spread between the five-year yield and the 30-year yield (a method for assessing the curve’s steepness) narrowed to 89 basis points. In the past four tightening cycles, the gap between the five-year yield and the 30-year yield narrowed on average by 98 basis points. But after peaking at 253 basis points in November 2013, the spread has narrowed by 155 basis points. Continuation of hikes rates and quantitative tightening deep into 2018 would probably cause the yield curve to invert.

5s/30s Spread Continues to Flatten

In terms of portfolio strategy, volatility may send yields higher over the short-intermediate term. That said, credit unions should look for the best spot to put money to work. Longer term Treasury yields will ultimately be much lower.
More Information

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@balancesheetsolutions.org or (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

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