WINTHROP WEALTH

AUGUST 2021 CLIENT QUESTION OF THE MONTH: DEBT

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The federal debt has become a hot button issue in recent years and especially in the last several months as the government has significantly increased its borrowing to combat the effects of the pandemic. The amount of federal debt held by the public now stands at over $22.0 trillion after increasing by 28% over the last two years and doubling over the last ten years. In our August Client Question of the Month, we thought it would be helpful to revisit some of the most common questions associated with the federal debt.

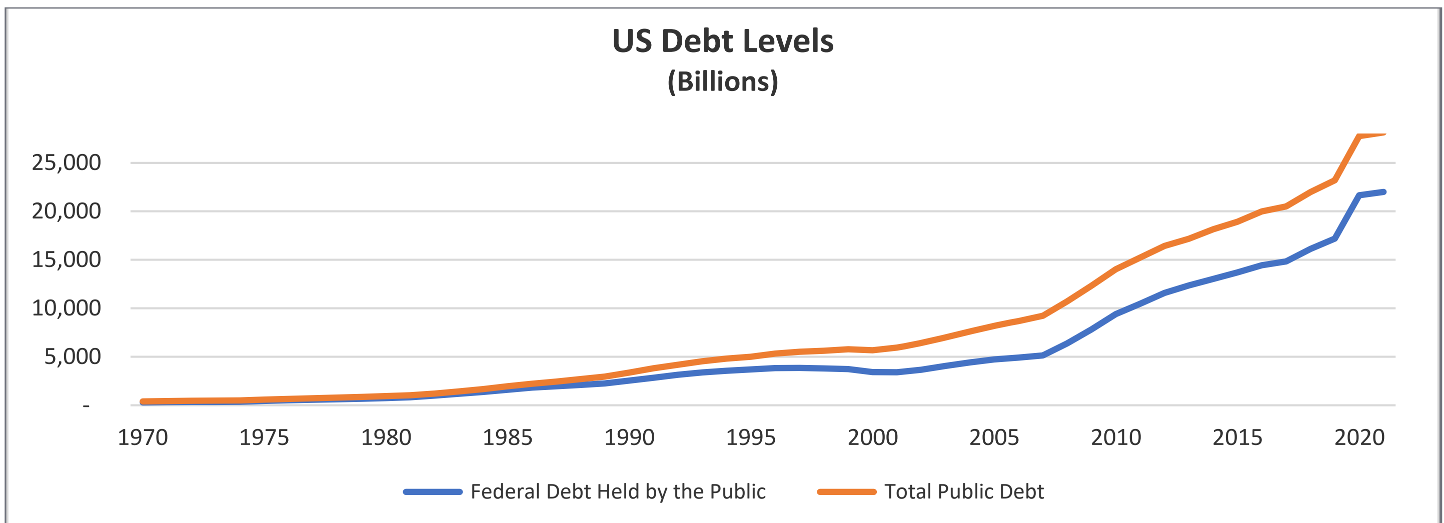
What is the Federal Debt?

The federal debt is simply the amount of money that the United States federal government has previously borrowed and subsequently owes. When the government borrows money, the Treasury Department sells securities to investors in the form of bills, notes, and bonds. Treasury securities ("Treasuries") are backed by the full faith and credit of the United States, which means their principal and interest payments are effectively assured by the government. Treasuries are offered in a wide range of maturities, are exempt from state and local taxes, and are usually very liquid.

The two basic measures of federal debt are debt held by the public and total public debt:

Federal Debt Held by the Public: the most common measure of federal debt and includes debt held by individuals, institutional investors, the Federal Reserve, state and local governments, and international investors. As of July 31, 2021, the total amount of US debt held by the public was $22.0 trillion.

Total Public Debt: is the federal debt held by the public plus debt held by federal trust funds and other government accounts. Social security comprises the largest percentage of debt held by federal trust funds and other government programs. As of July 31, 2021, the total amount of US gross debt was $28.1 trillion.



Source: Federal Reserve Bank of St. Louis

What drives the Federal Debt level?

The growth of federal debt is driven primarily by the government budget deficit. When spending exceeds revenue, the government is running a deficit. When the government incurs a budget deficit, the Treasury sells securities and uses the proceeds to fill the gap between revenue and expenses. Essentially the federal debt is the total accumulation of historical deficits. Typically, government deficits and debt have increased during periods of economic weakness and declined during expansions.

The budget deficit reached a record level of $3.1 trillion in 2020 due to the fiscal stimulus packages and the difference between revenue and expenses. The Congressional Budget Office (CBO) currently estimates the deficit at $3.0 and $1.1 trillion in 2021 and 2022, respectively. The deficit in future years will vary based on the government's priorities.

	2014	2015	2016	2017	2018	2019	2020	2021 Est	2022 Est	2023 Est
US Government Deficit	$485	$442	$585	$665	$779	$984	$3,129	$3,003	$1,153	$789

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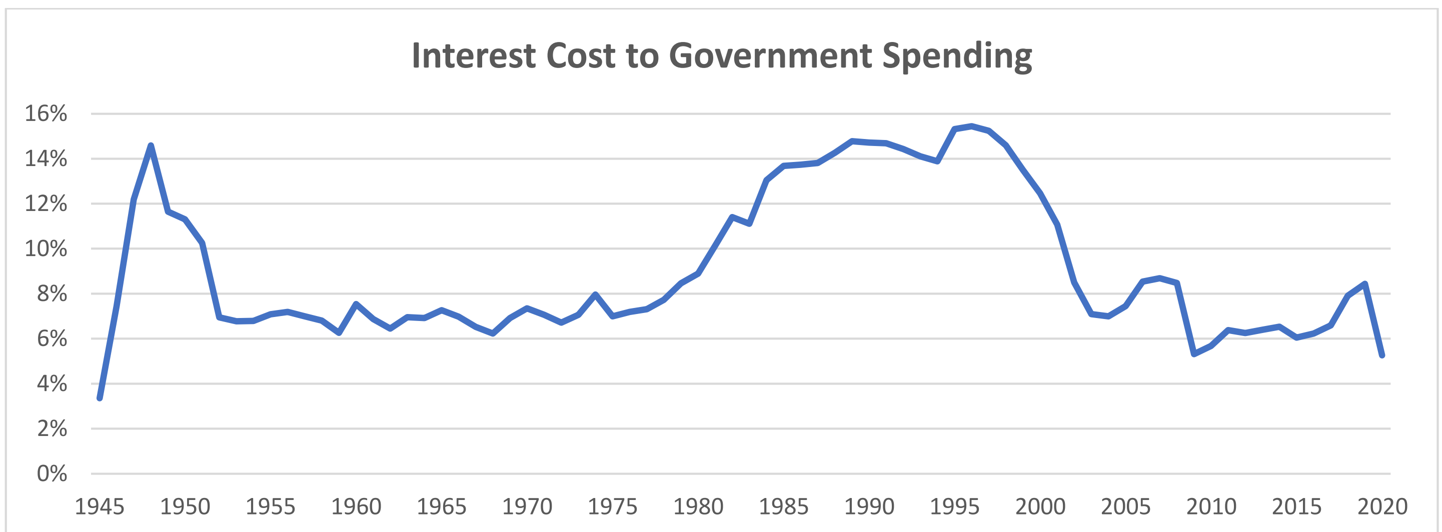
What are the risks of too much debt?
The CBO describes that too much debt has two main consequences:

1. High debt levels decrease economic output over time. As debt levels increase, the government is forced to spend more of its budget on interest costs.
2. Higher interest costs would increase payments to international debt holders, and therefore reduce the income of US households.

Does the debt need to be paid off?
The debt does not need to paid off in full, however the government does need to ensure that interest payments are sustainable. Rather than eliminating the debt, the government manages the debt by including interest costs as part of their overall spending.

The government's interest cost is defined as the payments on federal debt offset by the income received from various sources. The two primary factors that impact interest cost are the amount of debt outstanding and the interest rate on Treasury securities. The interest cost provides important context on how the government can service their debt payments.

In 2020, interest cost was 5.3% of government spending- below the average level of 9.2% since 1945 – despite federal debt held by the public increasing by over $4 trillion from the previous year. The decrease in interest cost was driven by a decrease in interest rates and increase in government spending. Although the increase in public debt is a concern, the interest cost-to-government spending ratio should remain below the peak levels of the mid-1990s for as long as interest rates remain low.



Source: Federal Reserve Bank of St. Louis

Given low interest rates, was this a good time to increase the debt?
Yes. We would like to point out that given the historically low levels of interest rates, this was a good time to increase the debt level. To use a real-world example, a 30-year fixed rate mortgage with a principal of $615,000 and interest rate of 6.00% has the same monthly payment as one with a principal of $1,000,000 and a 2.00% interest rate. Based on the current levels of interest rates, the debt is sustainable for now. However, we all know that interest rates can change and will likely not stay at their present levels forever.

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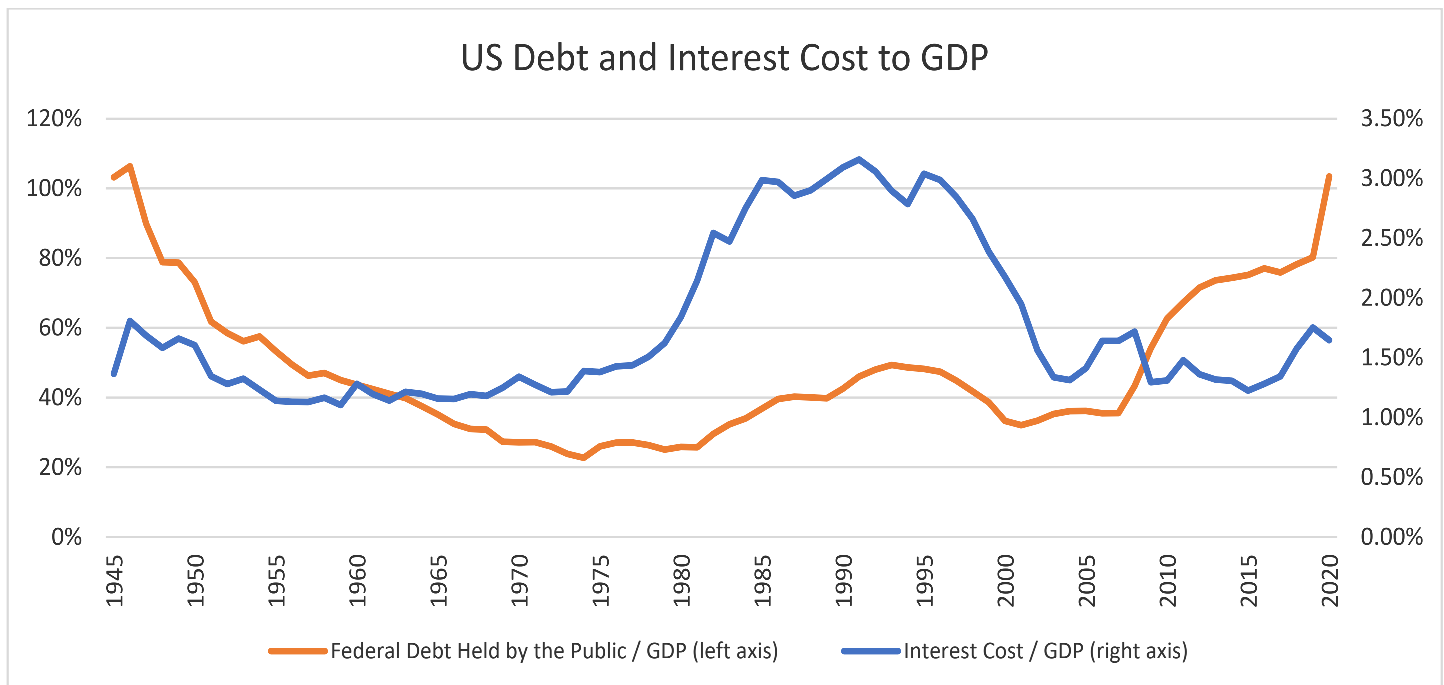
Can you put the debt level in context?
To compare amounts of debt in different years we thought it would be helpful to view both federal debt held by the public and interest cost in relation to the size of the economy (nominal GDP). The following chart shows the debt-to-GDP in orange and the interest cost-to-GDP in blue.

The debt-to-GDP ratio reached 106% in 1946 as the government borrowed heavily to finance defense spending during World War II. The ratio fell over the next several decades as the economy grew faster than the amount of outstanding debt. Since the Global Financial Crisis of 2008, debt levels have been rising significantly. The debt-to-GDP ratio increased to 103% in 2020.

The interest cost-to-GDP ratio hit its peak level of 3.2% in 1991 and then declined along with interest rates. The ratio was 1.65% in 2020, close to its historical average of 1.75%.



Source: Federal Reserve Bank of St. Louis

Why hasn't the market demanded higher interest rates due to the increased debt level?
Counterintuitively, interest rates in the United States have fallen despite the increase in debt over the past several years. Long-term interest rates move based on supply and demand. Typically, you would expect that as the supply of Treasury bonds increase the demand will fall – this would push bond prices down and interest rates higher. The government would prefer to avoid higher interest rates since it would increase their overall interest costs. Notably, interest rates have not moved higher despite the increase in debt for two main reasons:

1. **US interest rates are still attractive for global investors.** The Japanese and German 10-Year yields are now at-0.33% and +0.01% respectively. Currently, there is an estimated $15.0 trillion in global debt with negative yields. While the US 10-Year Treasury yield of 1.30% is near its all-time low, the current yield is still higher than many global rates.

2. **The Fed has become the major buyer of Treasuries and they are not price sensitive.** Market strategist Ed Yardeni coined the phrase "Bond Vigilantes" in 1983 to describe investors who sold Treasuries when they thought government spending was getting out of hand. As a result, the federal government was forced to reign in their spending to avoid higher rates and interest costs. In today's environment, the Fed has replaced the "Bond Vigilantes" as the major buyer of Treasuries. The Fed purchases Treasury bonds specifically to decrease interest rates and subsequently boost the economy, therefore they are not price sensitive. Through their quantitative easing programs, the Fed has purchased over $5 trillion in Treasuries (and climbing by $80 billion per month). Interest rates are unlikely to move materially higher for as long as the Fed remains a major buyer.

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What has the biggest impact on future debt levels?

The following four factors will have the biggest impact on the future of US government debt: government revenue (mainly tax policy), government spending, economic growth, and interest rates.

In a vacuum, each of the following events would increase/decrease the debt level:

Increase Federal Debt Level
Lower Government Revenue
Higher Government Spending
Slower Economic Growth
Higher Interest Rates

Decrease Federal Debt Level
Higher Government Revenue
Lower Government Spending
Faster Economic Growth
Lower Interest Rates

How is Congress thinking about the deficit and debt?

Over the past fifteen months, Congress was far more concerned with fighting the pandemic than balancing the budget or adding to the debt level. The strategy was a success as the massive amounts of stimulus helped avoid a major economic recession. Now that the worst of the pandemic is behind us and the economy is recovering, Congress is split on the best way to move forward. Democrats are pushing for the Biden administration's Build Back Better plan, which could cost several trillion, and include increases to the corporate, individual, and capital gains rates as well as additional funding to the IRS to curtail tax evasion. We should receive more details in the coming months as to whether the proposals are fully paid for or will add to the deficit and debt. Republicans would prefer for a more modest infrastructure bill that does not include major tax increases. We do not see any evidence that either side of the aisle is pushing to balance the budget.

Conclusion

The national debt is a very complicated issue with no clear answer on at what point it becomes unsustainable or the best method to pay it down. Fed Chair Powell recently said that while government borrowing is on an "unsustainable path" the current debt level is "very sustainable" and the government has no problem meeting interest obligations or issuing new debt. Powell believes that while concerns over the deficit and debt are legitimate, the issues should be addressed when "the economy is at full employment and taxes are rolling in." Our view is that Congress should begin to address the deficit and debt before long, as the country cannot count on interest rates remaining low forever.

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