Americas CIO View

U.S. Federal Debt: Not a problem, if politicians respect limits

U.S. Federal Debt to GDP: 100% not the limit, but a limit does exist

At the end of 2018, after one year of Trump's tax cuts, federal gross debt to gross domestic product (GDP) was 105%. Gross debt includes the Social Security Trust Fund, which is an interest-bearing but intra-government non-marketable liability. This plus 16 trillion U.S. dollar (USD) of outstanding Treasury bills and bonds, puts U.S. debt at 22 trillion USD vs. 21 trillion USD GDP. Despite debt to GDP being 180% of the 50-year average of 58%, the interest expense/ GDP is among the lowest levels in 40 years. And when the real interest rate on debt is considered, the interest burden on debt is similar to that of the 1960s when debt to GDP was about 40%.

U.S. Federal Deficit is 4.2% of GDP in 2018, acceptable if below nominal GDP growth

Debt to GDP climbs when the deficit as a % of GDP, including interest expense, exceeds GDP growth. The 2018 deficit was 4.4% of the year-start nominal GDP, GDP grew 5.2%, but yearend debt to GDP climbed to 105% from 103% due to other debt issuance. The last 12-month 1 trillion USD deficit was caused by 4.4 trillion USD of spending and 3.4 trillion USD of tax revenue, 20.5% and 16% of GDP, respectively. Spending remains a bit above the nearly 20% norm since 1975 and revenue was at the lower end of the 16 to 18% norm that has persisted with remarkable consistency despite wide variation in tax rates.

Provided the deficit does not materially exceed nominal GDP growth, assuming stable and low inflation near 2%, debt and deficits are unlikely to trouble Treasury investors. Some argue that with 100% plus debt to GDP that a 1% point increase in interest rates would raise the deficit by 1% point of GDP. But the real interest rate must climb 1% point to affect the real interest burden or cause the debt-to-GDP ratio to rise. This is unlikely, but it is comforting that the average time to maturity of U.S. debt is six years.

Slightly elevated deficit in attempt to improve secular growth and productivity

While a 5% deficit 10 years into an expansion is unusual, so are longer than 10-year expansions. We think it is never too late, nor worth waiting for the next downturn, to try to optimize tax rates to best incentivize the economy's supply side and meet the government's demands. If economic growth and productivity trends benefit from lower corporate and top marginal tax rates, the deficit relative to GDP will shrink. Though top marginal income tax rates were lowered, Federal revenue could be more progressive in nature owing to sizable rate cuts at lower income brackets. There

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In a nutshell

- U.S. Federal Debt to GDP: 100% not the limit, but a limit does exist
- U.S. Federal Deficit is 4.2% of GDP in 2018, acceptable if below nominal GDP growth
- Slightly elevated deficit in attempt to improve secular growth and productivity
- Debt-to-GDP metrics can be very deceptive, but respect it with Federal debt
- Fiscal battles likely reemerge this autumn around the budget and debt ceiling
- S&P 500 at full fair value: Best upside Emerging Markets and big U.S. Banks

is risk that tax revenue could be more cyclical in nature the more progressive federal income tax becomes.

Debt-to-GDP metrics can be very deceptive, but respect it with Federal debt

We often argue that corporate or household debt-to-GDP metrics are misleading, because they fail to account for corporate or household assets to GDP. We consider debt to GDP appropriate for government debt, but even the government has some assets. In addition to gold and oil reserves, loans, defense assets and vast land holdings, a "resource" is the U.S. Federal Reserve (Fed). The Fed's balance sheet has assets and liabilities, yet currency in circulation, which is 1.7 trillion USD or 8% of GDP, is a non-interest bearing liability. Thus, cash in circulation can ostensibly be thought of as a government asset. It cannot be used to extinguish debt; because the economy needs the liquidity it provides to operate. But it can fund some of the Fed's holdings of interest-bearing Treasuries conceivably indefinitely. This notion has given rise to Modern Monetary Theory (MMT). But there is nothing new or modern here. It is an old idea that can be very dangerous. The power to coin or print money without backing, or seigniorage, is ancient. This power can be abused as unlegislated taxation through confiscatory inflation. The power to print should only be used as a tool to achieve monetary, not fiscal, policy goals. Monetizing debt is clearly taboo; and attempts to monetize deflation or a shortfall from inflation targets raise many worries.

Fiscal battles likely reemerge this autumn around the budget and debt ceiling

The new federal fiscal year begins October 1 and will require a budget or at least short-term authorization to avoid another partial government shutdown. Moreover, the debt ceiling at 22 trillion USD should have Treasury asking for it to be raised by then. Finding the mix in lifting sequester spending caps on defense and discretionary spending from the Budget Control Act of 2011 will cause much partisan wrangling.

S&P 500 at full fair value: Best upside Emerging Markets and big U.S. Banks

First quarter 2019 earnings season begins next week. We expect S&P 500 earnings per share (EPS) to be flat for the current constituents, but up mid-single-digit excluding Energy, Materials and Apple. Results on a broad basis and guidance should relieve profit-recession concerns. But earnings season is unlikely to be a positive near-term catalyst of S&P 500 gains from current levels.

Glossary

Balance sheet

A **balance sheet** summarizes a company's assets, liabilities and shareholder equity.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Liquidity

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

Real interest rate

The **real interest rate** is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

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