Commerce Trust
Banking | Investments | Planning™

*Conversations with Commerce Trust* podcast
February Episode: U.S. Debt Sustainability
02/13/2024

**David Hagee:** Hello, and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, our Chief Investment Officer at Commerce Trust. Today, we're discussing the U.S. debt, deficit and its sustainability with Brent Schowe, our Director of Research at Commerce Trust. Welcome to the podcast, Brent.

**Brent Schowe:** Hi, David, thanks.

**David:** Great to have you back. I know that this topic is one that we seem to get a lot of questions on. How sustainable is the U.S. debt pile, as well as this deficit spending that we're incurring? Maybe we could get a little background on what that looks like. What is the current deficit spending situation, and how is that affecting the debt pile?

**Brent:** Right now, in the latest (U.S. government) fiscal year that ended, I guess, September of '23 (2023), we generated a deficit of $1.7 trillion. Of course, that's with a "T", and that represents about 6% of GDP (gross domestic product.) To put that in perspective, let's say in the depths of COVID, when we were really hurting in terms of both revenue, and then, of course, spending was going through the roof, 2020 fiscal year came in at -15% of GDP. About two and a half times as large.

I think why we're getting a growing chorus of people wondering about this is we're pretty far past COVID now, and yet the deficit is deeply negative. If you go back to prior years, as recently as 2015, it was about 2.5% of GDP. The question is, how can this go on, and what levers can be pulled to rein that deficit in? I think that's why you're seeing a lot of discussion about the deficit these days.

**David:** I'm struck in an election year that this is an issue that as investment professionals, we are constantly on the lookout for, but it doesn't appear that there's any focus on fiscal restraint at this point. Looking ahead, it looks like we're on pace to have 6% to 7% budget deficits for quite some time. From a national debt point of view, I know we're hitting new highs. Maybe we could talk about how big that's gotten and where that's headed.

**Brent:** The number you see most often quoted is $34 trillion. That is total federal debt. About $7 trillion of that is what we owe to the Social Security Fund. You may also hear something called "debt

held by the public." That's basically all the bonds and whatnot you have to sell out into the system. It's either $34 trillion or $27 trillion. Most people take the top line number, and that represents 120% of GDP.

You'd have to go all the way back to the immediate aftermath of World War II to get to a number at that level. Of course, coming out of a world war, you would expect a lot of deficit financing, but now it's built to the point where it's approaching what we saw in World War II. Again, why the numbers are being touted is because people haven't seen them in 80 years.

**David:** I think that's a great point. Historically, you've seen deficits increase in times of crisis, whether that be war or the pandemic that we just went through. This deficit seems to be very much ingrained into the annual budget and not necessarily a crisis-level spending that we're seeing going on. What happens if we continue to spend at this level to both the deficit and then the debt pile and its repercussions?

**Brent:** The CBO, the Congressional Budget Office, they put out their projections, and they are a nonpartisan entity. They're designed that way. You can trust their estimates to the extent you can trust any economist's estimates. They're talking about 6% to 7% deficits for about as far as the eye can see. One thing that also includes, though, is that they are assuming that the expiration of certain tax cuts that happened in '16 (2016) and '17 (2017) are going to happen. We know those are hard to come by. A lot of times they will extend those types of items.

It's a best-case scenario that we're going to get a 6% budget deficit. It also factors in interest rates. Interest rates are higher so the interest on the debt is consuming more and more of our budget. It is a fairly reasonable assumption. That brings debt to GDP as you move forward into the 30s (2030s) and 40s (2040s), into the 150% to 160% range.

**David:** A couple of thoughts here in terms of what we've seen globally before. Greece was a remarkable spender and got themselves into an issue where they overspent and had too much debt that they couldn't sustain. Where Japan has had around 200% debt to GDP for quite some time. Maybe you could walk through those two experiences and try and understand ours a little bit more.

**Brent:** There's a little compare and contrast there. While Greece is a euro (European Union) member, they did run into some fiscal problems. Typically what we see in an emerging market economy, generally Greece is not considered an emerging market, but let's say you have a country that is not in a currency block like the euro, they have their own currency, we've seen this many

times where debt gets to an unsustainable level that lenders begin demanding higher and higher rates that they can no longer afford, and then you have a devaluation of the currency and a debasement of the debt, et cetera, et cetera. That's how you get the debt down, is basically you essentially default on it.

That's more of the way it's done for non-developed countries. Greece was going down that path, but of course then you had the rest of the euro members stepped in and the central bank stepped in and helped them out of that situation a little bit.

Japan is a different story. They've been a developed country for decades now. Their issue is demographics, and that's something we can talk about a little bit on the U.S. side as well, but a zero-growth country since the late 1990s. With entitlement spending there as well, where you have an aging population, you have to spend for their needs, they have grown their deficit over time to reach, as you said, the total debt pile being over 200% debt-to-GDP.

It hasn't really come to a head yet, but part of that reason is 90%+ of their debt is held by themselves, and half of it is held by their central bank. So, they've kept a lid on it by being a very insular bond market, basically a self-contained bond market for the most part, and they're able to keep their rates at a level that's manageable for their budget.

**David:** It would appear that we have one advantage that both the Greeks and the Japanese didn't have, is that we had a better demographic picture that also led to a more dynamic economy as well. I think the silver lining here is that as our GDP growth rates are well above zero at this point, we can have a little bit more spending than, say, the Japanese or the Greeks because we're growing our way out of it.

Translating that more directly back into federal budget, looking at that, interest expense is the other thing that's been climbing dramatically and is going to start pinching in on other programs. Maybe you could talk a little bit about interest expense as to how that affects both the economy as well as overall government spending.

**Brent:** Much like any household, if rates go up and you're borrowing for a mortgage, and let's say you had an adjustable-rate mortgage, you feel it. Each time that mortgage resets, if you have the same amount of income coming in, you're going to have to either finance that extra interest and borrow to pay it, or you're going to have to take money out of your budget someplace else. That's what the government is seeing, the federal government.

Entitlement spending — the third rail of politics as it's called — those represent about two-thirds of the budget, and so those are almost untouchable, given the factions in Congress where no one is incented, at least at the ballot box, to fix any of the Social Security and Medicare problems. You really only have so much you can cut. With interest costs, you have to pay your interest. You can't default on your debt. Those are growing to approach now 10% of the budget. They'll soon, I think within two years I've seen, will exceed the level of defense spending right now. It does become a problem. It does. It crowds out other things that you can spend money on, or it means you just have to borrow money and it just continues to grow that debt pile.

**David:** Very tough picture looking forward in terms of the path that the government's on in terms of spending and how its longer-term effects are going to build this debt pile that we're going to be dealing with higher interest expense for quite some time. As we translate this into financial markets, what does this look like for us, especially with regard to fixed income?

**Brent:** Obviously, we've seen rates surge higher. We went from 0.5% on a 10-year bond to now 4.25%, touched 5% not all that long ago. We're seeing rates that some investors haven't seen in their lifetime. You had to go back to, I think, '07 (2007), that's almost 17 years ago now that we had rates at this level.

It actually offers a nice tailwind to bond investors, whereas before, if you look at a 1% yield for 10 years, that's not very attractive. Now it's starting to stir up investors in the bond market and makes them understand that stocks aren't the only game in town anymore and if I can earn 4%, 5%, 6% in a bond or a bond fund, that's not a bad thing to hang your hat on as far as an investor.

**David:** Looking at that, certainly it's a welcome relief to have the yields where they're currently at today and definitely gives investors the opportunity to be able to de-risk a portfolio without sacrificing that much return inside of it. In terms of longer-term positioning here, it seems like we're going to have a tremendous amount of debt supply come onto the market. The Federal Reserve (Fed), which controls monetary policy, has embarked on a quantitative tightening or a reduction in their balance sheet, i.e., they're not buying bonds anymore. What does that do for longer-term effects? Maybe you could talk about that in the context of the yield curve.

**Brent:** That's a function of monetary policy and really the two levers they have, the one that they've always had really since the '30s (1930s) is controlling that short-term interest rate. That's that overnight fed funds rate. That's when we're talking about (Fed Chairman Jerome) Powell having his press conferences and whether they're cutting or raising rates. That's in the short end of the (yield)

curve. That's the very shortest overnight market. Quantitative tightening, quantitative easing impacts longer (term) bonds.

When COVID hit, fiscal side went all in and sent stimulus into the system. The Fed also went all in and bought bonds almost to an unlimited amount, growing their balance sheet overnight essentially from $2 trillion to $4 trillion and had since grown it to almost $9 trillion.

As you said, now with the worst of COVID behind us, they've been backing off of that, letting bonds mature. Now they're around a $7 trillion number. What does that mean? That means there's one less source of demand for all these treasury bonds that have to get issued.

At the margin, if the Fed isn't there to buy bonds, someone else has to step in and buy them or rates have to go up to attract another buyer to come get those bonds. It's a function of liquidity in the system and when the Fed withdraws liquidity in terms of buying fewer bonds, that just means higher rates typically, all else equal. As far as the yield curve goes, we've seen they've kept that short rate high. They want to kill inflation. They want to make sure inflation gets closer and closer to that 2% target.

While they're maintaining that short rate at their mid-5% level, that long rate now is also going, it has started coming up as well. The Fed is unwinding those longer bonds that they held before. It's just basically an overall increase in the rate market, something that people weren't that familiar with until it happened, especially in 2022 when it happened in a big way.

**David:** How are we confronting the issue of potentially higher interest rates and how does that translate into the broader financial markets, including stocks?

**Brent:** That short rate that we talk about each Fed meeting. We say it focuses exclusively on the short end, but it is used as a signaling mechanism. The signal that they're trying to give the market now is that they're very, very close to the end of this thing, and they would like to ease when they can. When they see the whites of the eyes of inflation coming down, they will be ready to ease. Right now, the market has pushed that back. March was the idea just a month or two ago and now we're talking about June.

What that does is it suggests to longer bond investors that maybe rates, 10-year (Treasury note) at 4.25(%) is about as high as we're going to get. We may not see 5(%) again. The idea that you want to diversify your bond portfolio much like you diversify your stock portfolio. You want to buy it. You want to have some money market funds. You want to have some two, three, five (year bonds.) You

want to have that ladder fully built out because the next move from the Fed is likely to be lower. You'll be glad you had that 4%-ish 10-year (Treasury note), if and when rates on the short end get to 3% someday.

**David:** Brent, thank you for the discussion today. Always interesting to talk about fixed income and a very popular subject amongst our clients in terms of this sustainability of this deficit spending.

If you've enjoyed what you've heard today, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from. Thank you for joining us on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

Important material disclosures regarding the content of this program follow, Commerce Trust is a division of Commerce Bank. Generally, non-depository investments offered in connection with Commerce Trust and its affiliates are not guaranteed, are not FDIC insured, and may lose value.

Opinions and other information provided are effective as of the date of the recording and presented for the purpose of general education, information or illustration only. Neither Commerce nor any of its affiliates, officers, employees, or agents have made any recommendations to buy, hold, or sell securities, or given any advice as to the terms, beneficial interests, or profitability of any investment strategy or market activity. And information provided may not be relied upon as such.

You as the investor, are fully responsible for any investment transaction you choose to enter into, including determining whether such investment is appropriate in light of your investment objectives and personal circumstance. And you shall not have relied on any of the proceeding or following information from Commerce as the basis for any investment decision. This material is not intended to replace the advice of a qualified attorney, tax advisor, or investment professional.

In considering whether to trade or invest, you should inform yourself and be aware of the risks. Past performance is no guarantee of future results. And the information in the commentary provided is subject to change based on market or other conditions. Diversification does not guarantee a profit or protect against all risk.

Commerce Trust does not offer tax, legal, or specific estate planning advice. And while we may provide information or express general opinions from time to time, such information or opinions are not offered as professional tax or legal advice. Commerce Trust does not provide advice relating to rolling over retirement accounts.

Commerce Trust is not a municipal advisor under Section 15B of the Securities Exchange Act and therefore does not offer advice or recommendations concerning bond proceeds or other municipal advice, subject to this section. Any data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness, or reliability cannot be guaranteed.

February 13, 2024
Commerce Trust is a division of Commerce Bank.