White Paper Report
The Hidden Costs of America's Debt

In the decade leading up to the pandemic, global Governments, businesses and even consumers were spoiled with ultra-low interest rates. They used this opportunity to not only restructure balance sheets but also gorge on cheap debt. In fact, in a recent report from the Institute of International Finance, it was reported that global debt made a new record high in 1Q24 at $315 trillion which amounts to ~330% of global GDP.[1]

Despite the era of easy money being a thing of the past, the Government sector continues to spend as though money is cheap. Global Government debt alone stood at $91 trillion in 1Q24, which is close to 100% of global GDP. While some of this can be blamed on pandemic related spending, the lack of fiscal discipline is contributing to an alarming amount of debt. In this white paper, we will focus specifically on the deterioration in the U.S. federal budget, the scary cost to fund excessive spending, and what that means for the stability of the country, interest rates and the future of the U.S. economy.

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com
Past performance is not indicative of future returns

U.S. Budget Deficit Has Gone From Bad to Worse

The Congressional Budget Office (a non-partisan group) recently released an updated 10-year outlook on the U.S. Government budget deficit. Unfortunately, the deficit is approaching $2 trillion this year and is expected to swell to $2.8 trillion by 2034. To be clear, the U.S. running a budget deficit is not uncommon. However, the level to which our deficit is expected to expand is staggering. To understand the severity, the deficit will make up ~7% of GDP by 2034 which is almost double what our deficit has made up of GDP over the past 50 years (3.7%). **(Chart 1).** The drivers of the deficit over the next decade include increased spending on the aging population and rising net interest costs.

To fund our deficit, the Government issues Treasury securities. When interest rates were historically low the Government was able to spend frivolously because our interest costs were manageable. For example, the U.S. Federal Government increased the amount of Treasury debt outstanding by ~$10 trillion in the 10 years leading up to the pandemic (2009-2019), while the net interest costs the Government had to pay on that debt only increased by ~$190 billion. The net interest costs were less than 2% of GDP during that time. However, as the era of easy money is behind us and the Federal Reserve has aggressively raised interest rates, net interest costs are expected to double to ~4% of GDP over the next decade **(Chart 2 – next page).** To put this in perspective, the U.S. Government is currently spending more to pay our interest costs than what we spend on national defense. This is the first time that has occurred since the Congressional Budget Office started keeping records in 1940.

Chart 1

Deficit is Projected to Worsen

Data is as of June 2024 CBO projections. Source: Congressional Budget Office, Verdence Capital Advisors

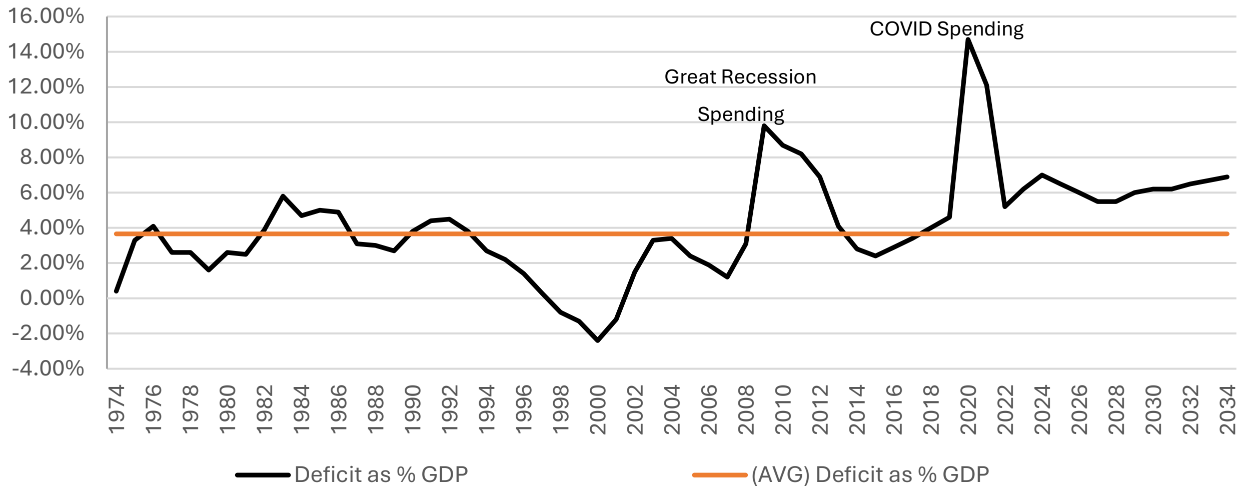

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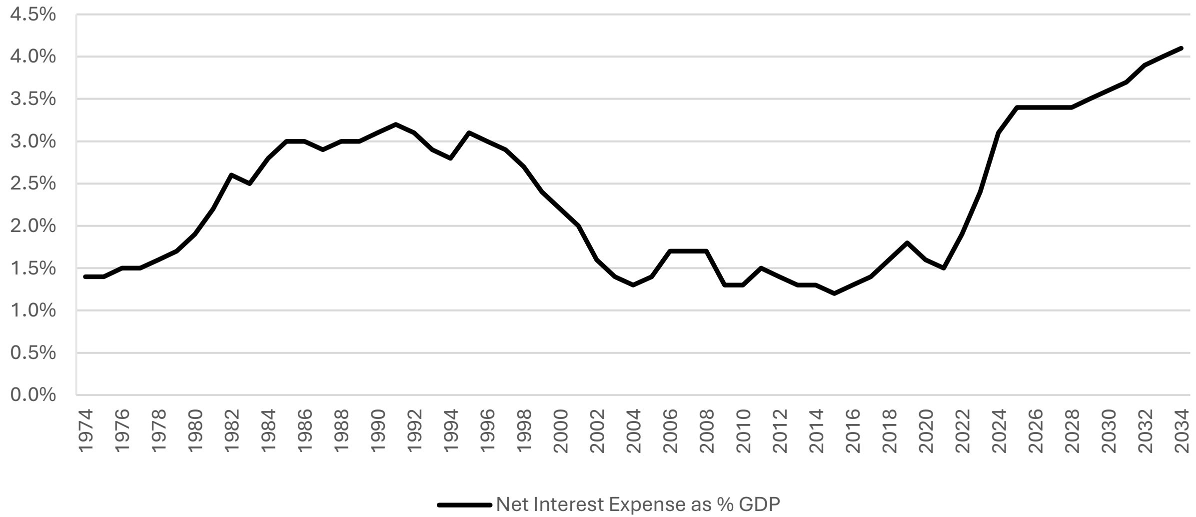
Chart 2

Net Interest Costs Rising to Record High

Data is as of June 2024 CBO projections. Source: Congressional Budget Office, Verdence Capital Advisors



Massive Supply of Treasuries Needs Buyers

As projections for the deficit continue moving higher, so does the expectation for Treasury debt issuance. It is estimated that Treasury securities will make up over 120% of GDP by 2034, up from 99% this year. This is a record high and surpasses the debt issued during World War II. **(Chart 3).** All this supply needs a buyer which has typically not been an issue for the U.S. However, this year we have witnessed rather sloppy Treasury auctions. We have seen demand for some auctions be weak and yields rise as a result. For years, U.S. Treasuries were offering much better yields compared to the zero and negative interest rates in many developed countries. However, with yields higher around the world, international demand at auctions has been mixed. If demand does not meet the excess supply, this can push yields higher, which could push the projections for net interest costs even higher.

Chart 3

Treasury Debt Projected to Reach Record High

Data is as of June 2024 CBO projections. Source: Congressional Budget Office, Verdence Capital Advisors

Leaves Minimal—if any—Wiggle Room for Economy

There have been several instances in history where an exogenous event, economic collapse or geopolitical event has forced the Government to unexpectedly increase spending. Having the ability to do this has helped the U.S. avoid a full banking system collapse in the aftermath of the Great Financial Crisis, and it saved the economy from plunging into a deep and long depression after the COVID lockdowns. In addition, we were able to increase defense spending by 50% in the decade after the September 11th attack on the U.S. However, in all these instances our deficits were much smaller than where they are now. For example, we were running a budget surplus in 2001. In 2007, before the Great Financial Crisis, our budget deficit as a percent of GDP was ~1% and leading up to the pandemic it was 4.6% (in 2019). In these historical instances, the U.S. had much more flexibility to support the economy than they do now with deficits running ~7% of GDP. This leaves our Government with very little wiggle room, if any, for any unforeseen event (e.g., economic or geopolitical). It is not just about not having money to support the economy in an unforeseen event. It reduces our ability to invest back into our country and invest in our citizens which in turn puts our long-term economic growth prospects at risk.

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The Impact on our Credit Rating and Global Standing

We have witnessed what burgeoning budget deficits can do to the credit rating of our country. In 2011, Standard and Poor's downgraded our country's credit rating from the highest AAA status to AA+ after a battle over the debt ceiling increase. In August 2023, rating agency Fitch downgraded their credit rating on U.S. debt from AAA to AA+, citing the Government's inability to control spending and concern over growing budget deficits. While these actions have not significantly impacted our bond market, further declines in credit quality should be a concern for the U.S. Government. Historically, we have been a global safe haven, but additional credit downgrades could undermine confidence in our economy and currency.

Is Austerity Ahead?

The definition of austerity is a combination of spending cuts and tax increases.[2] In the U.S., we have not seen austerity in any form since 2011. In 2009, the U.S. budget deficit had climbed to almost 10% of GDP because of the massive fiscal stimulus that was implemented to prevent the Great Financial Crisis of 2007-2009 from becoming another Great Depression. However, by 2011, economic growth was expanding, the unemployment rate was falling, and consumers were spending again. In addition, in the 2010 midterm elections, the Democratic party suffered massive losses in what President Barack Obama called a "shellacking."

By 2011, the new congress took a hardline approach against unlimited increases in the debt ceiling as the concern over the deficit grew from both parties. As a result, the Budget Control Act of 2011 was signed into law on August 2, 2011. In this act, Government spending was to be pulled back, and the Bush tax cuts were set to expire. However, over the years since the Act was signed, through many different iterations, laws, and extensions, the reduction in spending has been subdued, and changes to avoid massive tax increases were imposed. In addition, our economy was dealt another blow with the pandemic, which only expanded the Government's budget deficit. Unfortunately, we see austerity in some form as unavoidable. It is too early to know what form this may take, but avoiding the issue or punting it down the road has now become impractical, given the growing costs of paying for past fiscal irresponsibility.

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mhorneman@verdence.com

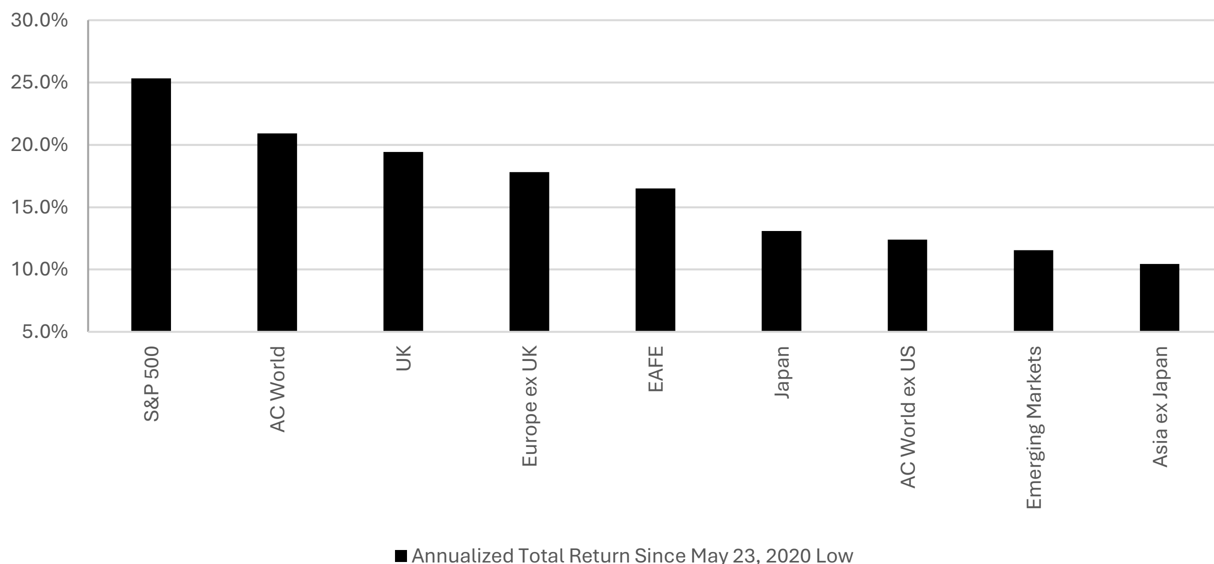
Where is the Market Risk?

The U.S. equity market has been the leader since the pandemic. In fact, the S&P 500 has outperformed its developed market counterpart (i.e. MSCI EAFE) by nearly 9% per year since the March 2020 pandemic lows. **(Chart 4).** This has occurred during the most aggressive central bank tightening cycle since the 1970s/1980s. What we witnessed in 2022 is that equity markets do not like higher Treasury yields and/or volatility in Treasury yields. If demand does not meet the excessive supply in the Treasury market, it can put the equity rally at risk, especially high price to earnings in multiple sectors (e.g., technology and communication services). In addition, from a fixed income perspective the massive amount of supply keeps us defensive in relation to maturity. Long-term bonds will be the most at risk if supply outstrips demand and yields move higher.

Chart 4

U.S. Equity Market has Been Global Leader

Time period reflects March 23, 2020, to June 26, 2024. Total Return is annualized. Source: Bloomberg Finance LP, Verdence Capital Advisors



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Our View

The U.S. has enjoyed decades of being able to fund burgeoning budget deficits due to low interest rates and the U.S. dollar being the world's reserve currency. However, the current debt trajectory is not sustainable. One of our themes in 2024 was "Austerity Rhetoric to Heat Up." In an election year, we did not expect this to come from politicians. Instead, we are hearing the concern from high-profile business executives and even the Federal Reserve Chairman. We expect this will be an emergent topic during election season, especially as it relates to the Trump tax cuts that are set to expire at the end of next year. We will watch our portfolios closely and remain defensive in our fixed income exposure. In addition, we see this as another risk to an equity market that is sitting near record highs, especially since it puts our long-term economic growth prospects at risk.

If you have any questions or comments, please feel free to reach out to your financial advisor.

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[1] https://www.iif.com/Products/Global-Debt-Monitor. Dated May 7, 2024.
[2] https://www.britannica.com/money/austerity

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