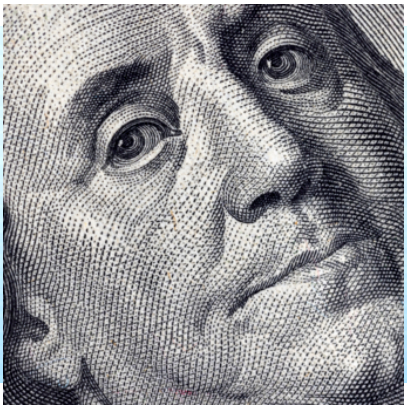

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National Debt – When is it Time to Worry?

Kevin T. Grimes, CFA, CFP® - CEO

We have been hearing about the impending doom of the national debt crisis seemingly forever, at least since the US came off the gold standard in 1971 and started running deficits. Yet year after year, the bill never comes, and problems resulting from stunning amounts of debt never materialize, as the economy powers forward and the markets shake off worry. National debt is not something that I have worried about much throughout my career, because it has always been a problem for the distant future that just did not factor into the 12-18 month look forward that we focus on for portfolios. However, similar to other problems that once seemed for the distant future, like climate change, the incremental math on this problem has shifted, pulling tomorrow's problems into today.

The below chart shows receipts or "money in" for the government (taxes) in blue and outlays or "money out" (spending) in red. The difference between the two is the deficit or surplus. As you can see, with the exception of 1998 to 2001, the US has consistently been in a deficit. It is normal, and necessary, to run big deficits during stress periods like war and recession, and indeed you can see the spikes resulting from the Global Financial Crisis in 2008 and the pandemic in 2020, when massive spending and stimulus were needed to stave off severe economic crisis.

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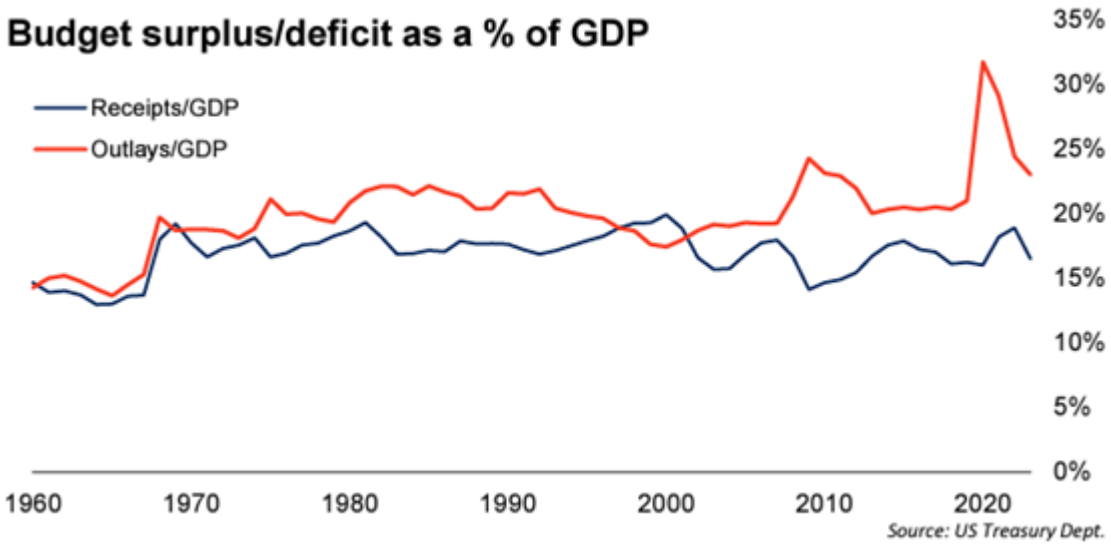

Chart 1

Running a deficit that is more or less in line with GDP growth may not be ideal, but it is generally sustainable for a large country like the US. However, the deficit today is greater than 5%, or twice the long-term average GDP growth, during a time of economic strength and relative stability (not crisis), and this is certainly not sustainable. Moreso, the cost of this debt is the highest it has been since 2007, before the Global Financial Crisis (Ten-Year Treasury yield). As the chart below illustrates, the big increases in spending are Social Security and interest on debt. The interest on debt is double the pre-pandemic high and rising faster each year. This is the crux of the problem – the size of the deficit to GDP and the cost of debt. Both of those things are trending rapidly in the wrong direction, and this is why I fear that the time to worry about debt may be approaching.

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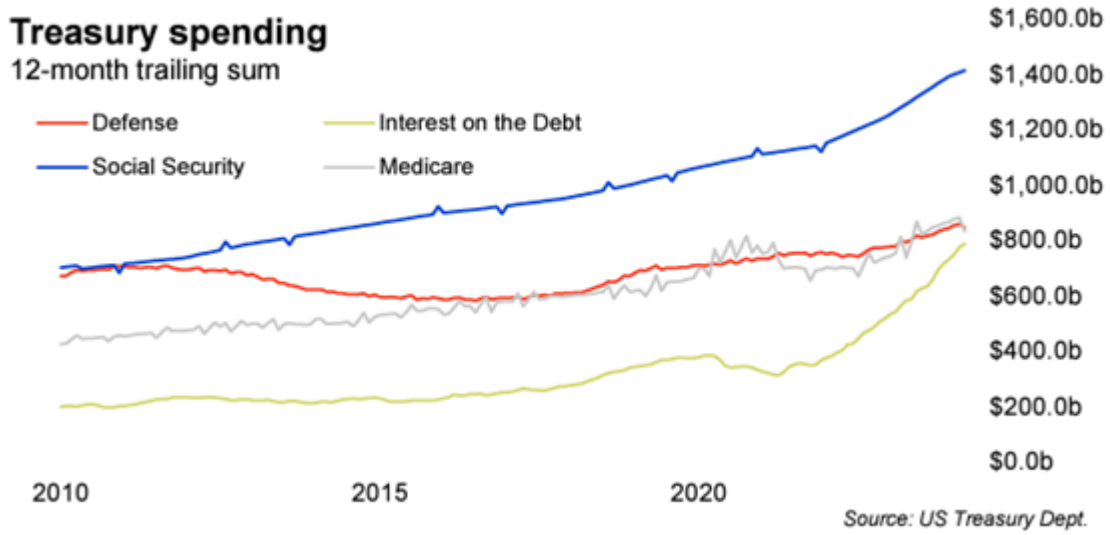

Chart 2

Debt crisis will likely manifest when Treasury bond yields move to higher levels because of failed auctions, when buyers demand more of a default premium. When foreign governments and domestic investors have had enough and demand more yield, the government will have to listen. Politicians will not act until they become worried about their jobs for not doing so, or because they are elected on a platform of reasonable fiscal responsibility. The longer it takes for that to happen, the more difficult it will be to restore balance and confidence. The larger the deficit and the higher the interest rate, the tougher the medicine, which will likely include both tax increases and fewer entitlements, all of which will be unpleasant.

Navigating this difficult period, when it finally comes, will be challenging and without precedent. Using strategies that can manage risk beyond diversification alone could help. Trying to predict how markets and governments will react to debt crisis will be impossible, but having a strategy that measures and reacts to markets could provide a smoother ride and better investment experience.

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