Q&A on Debt, Deficits, and Balance Sheets

Key takeaways

- We do not expect high debt levels to lead to higher rates or Treasury yields in the near or intermediate term.
- The large and diversified nature of the U.S. economy should allow the country to sustain higher debt and deficit levels.

What it may mean for investors

- We do not see Federal Reserve (Fed) balance sheet expansion as inflationary in the current environment.

What is the difference between the debt and the deficit?

The U.S. debt is the total amount of debt that the U.S. government owes to creditors. This total debt has accumulated over a long period of time. The deficit is the annual U.S. government’s shortfall between revenues and spending and adds to the total debt of the United States.

How big is the national debt?

The total U.S. debt is over $25.5 trillion. Almost $6 trillion is held by various government trust funds; these are referred to as intragovernmental holdings. The key number to focus on is the debt held by the public, which is about $19.5 trillion. The money the U.S. owes itself is not something that it needs investors to finance.

It is also important to focus on relative data when analyzing the debt rather than absolute numbers. After all, debt is relative to one’s ability to earn and ultimately make necessary payments. Think of an individual with a $1 million mortgage payment, and how it is impossible to say if this large debt level is unwise without knowing how much the individual earns.

When looking at government debt, we compare it to the earning power or gross domestic product (GDP) of a country. The Congressional Budget...
Office (CBO) has a preliminary forecast of $20.4 trillion in U.S. GDP this year. As debt grows this year, the CBO projects federal debt held by the public will be 101% by the end of fiscal year 2020 and 108% by the end of fiscal year 2021.

How big is the deficit?

Deficits vary by year based on revenue collected and total spending. In the late 1990s the U.S. actually had a budget surplus, bringing in more money than the government spent, which reduced the national debt. Last year, the deficit rose to almost $1 trillion. Unfortunately, the economic decline from COVID-19 will result in a decrease in revenues and an increase in expenses. If no additional emergency funding is authorized, the CBO projects that the federal deficit will be approximately $3.7 trillion in fiscal year 2020 and $2.1 trillion next year.

What are the consequences of high deficits and debt?

Crowding-out effect: A large amount of federal debt issuance could lead to a greater portion of private investment spending and consumption being diverted to Treasury debt, shrinking the pool of capital available for private investment. This would likely result in lower economic output, lower incomes, lower investment of capital, and lower investment returns.

Higher borrowing costs: In the longer term, the laws of supply and demand imply that an increase in debt supply will lead to lower bond prices and higher interest rates—assuming all else remains equal. If rates rise materially, the added cost would require increasing government revenues, reducing spending, or implementing some combination of the two.

Decreased fiscal flexibility: An increasing debt level could restrict policymakers’ ability to respond to unexpected events. Future shocks may have a more significant negative economic impact, as lawmakers might lack flexibility to deal with them fiscally.

How much debt is too much?

It is likely that the United States can support a meaningfully higher debt level than today given the country’s dominant global economic position and the U.S. dollar’s stance as the world’s primary reserve currency. That being said, projected increases in deficits and the debt remain troubling. Keep in mind it is impossible to predict exactly how much federal debt the country could bear before investors lose faith in the government’s ability or willingness to pay, potentially pushing borrowing costs higher and the nation into a fiscal crisis.

How does our debt compare to other countries?

The total debt-to-GDP ratio in the United States looks less concerning when compared against other countries across the world. By far the largest debt-to-GDP ratio in the world is Japan which has a debt-to-GDP ratio of 234%. Japan also has some of the lowest borrowing rates in the world, suggesting investors have little concern about the ability of Japan to pay its debts despite high debt levels.

Will the U.S. ever pay off its debt?

Not likely. Other than for brief periods in the nation’s history, the debt has always grown over time. This is not necessarily problematic, as most individuals, companies, and nations have debt, and some level is entirely appropriate. Ideally, a nation’s debt will grow at a slower rate than a nation’s output or GDP grows. This way, over time, debt becomes less of burden relative to overall earnings. The United States has seen deficits grow at a faster rate than the economy over recent years—a trend that is likely to worsen in the coming years as a result of the pandemic and an aging population.
What can be done to reduce debt levels?

*Spending cuts.* Given the budget's makeup, a significant portion of any cuts would likely need to come from popular social programs, which would be politically challenging.

*Tax increases.* Much like spending cuts, tax increases would likely be unpopular—at least with some segments of the population. In addition, they would go counter to recent policy, which is to simplify the tax code and reduce rates.

*Higher economic growth.* Arguably the best way to reduce debt-to-GDP is to grow GDP. But based on CBO estimates, it appears unlikely we'll be able to reach and maintain a growth rate in excess of spending in the next several years.

*Negative real rates (or an inflation rate greater than interest rates).* An inflation rate greater than the interest rate paid on the debt could help manage an increasing debt load and aid in any deficit reduction efforts. While the Fed can help manage interest rates, there is no guarantee that rates will remain low.

*Inflation or debt renegotiation.* Printing dollars to pay off maturing debt or renegotiating outstanding bonds would likely destroy investors' and citizens' savings and make it difficult to borrow again, and we believe should be used only as a last resort. This option is often referred to as "inflating away our debt."

How is the government paying for all this debt?

Simple—it is borrowing the money. The U.S. Treasury is expected to borrow a record $3 trillion this quarter to fund the government’s bills. Treasury borrowing in the upcoming quarter will more than double the almost $1.25 trillion the Treasury borrowed in all of 2019, even after accounting for tax revenue intake by the government.

Will high debt levels lead to higher interest rates to fund it?

We don't think so, at least not over the near to intermediate term. Economic contraction, disinflation and Fed buying are likely to keep rates low over the near to intermediate term. Longer term, it is likely that the United States will need to increase revenues, decrease spending, or use some combination of both. These actions, if they were to occur, would hamper growth and would likely keep rates low over the longer term. If the United States instead does not confront the longer term fiscal trends we could see an increased need for additional debt issuance, and, if this grows significantly, investors may begin to demand higher rates to compensate for the added supply.

What role do the U.S. Treasury and Fed play in financing the debt?

The Treasury is in charge of paying the bills and borrowing when needed. Borrowings are primarily through Treasury debt auctions. The Fed has no direct role in these tasks and is an independent institution created by Congress to be the central banking system of the United States. The Fed conducts the nation's monetary policy, promotes the stability of the financial system, and promotes the safety and soundness of individual financial institutions.

One tool the Fed has used to implement monetary policy to promote maximum employment and stable prices is the purchase of debt securities. This is referred to as quantitative easing. These Fed purchases of U.S. Treasury securities help finance the growing government debt burden.

How does the Fed buy debt?

The Fed simply goes to the public markets and buys securities. Historically the Fed has purchased Treasuries and mortgage-backed securities during times of quantitative easing. The Fed has expanded into corporate securities and bond exchange-traded funds (ETFs) in this crisis. These actions remove securities from market supply while adding new dollars to the market.
Is the Fed just creating money?

In a sense, yes. While only the U.S. Treasury can actually print money, the Fed is creating digital dollars when it buys securities for its balance sheet. This injection of liquidity is effectively increasing money supply. To the extent this debt remains on the Fed’s balance sheet permanently, the Fed is monetizing the debt. The expectation is that some of the increase in balance sheet size will be temporary, and the Fed will let these securities mature off its balance sheet over time and be absorbed back into the private markets.

What extraordinary actions has the Fed taken to combat the recession?

The Fed has taken a multitude of actions including:

- Made two separate emergency cuts in the federal funds rate—the federal funds rate is now 0.00-0.25% and at the lower zero bound
- Massively increased repurchase agreement facilities
- Announced an unlimited quantitative easing (QE) bond purchase program
- Expanded dollar swap lines with other major central banks.
- Reintroduced the money market liquidity facility
- Reintroduced the term asset-backed securities loan facility
- Announced the primary market corporate credit facility
- Announced the secondary market corporate credit facility
- Announced the municipal liquidity facility
- Announced the paycheck protection program lending facility
- Announced the main street lending program

What additional action or tools might the Fed need to use?

Significant additional lending capacity remains if needed. This additional capacity could be used to expand or create new lending programs to address any problem areas that emerge. The Fed is also considering yield curve controls if needed. This would allow the Fed to target yield expectations for certain Treasury maturities, which would be managed through open market Treasury purchases.

The Fed retains significant additional tools to deploy if needed. This potential additional liquidity is likely to support financial asset prices and limit price declines in riskier assets. This expectation was behind our rationale to upgrade high yield to neutral while continuing to recommend favorable guidance in investment-grade credit, municipal securities and preferred securities.
Do we expect the Fed to implement a negative rate policy?

We do not expect the Fed to implement a negative rates policy as some other countries have in the past in response to economic challenges. Fed members have been very clear that this is not a policy they expect to implement. It is worth noting that the Fed only directly controls short term rate policy, market forces could push longer term rates into negative territory if economic damage is deeper or lasts longer than expected.

How big is the Fed balance sheet?

This is best answered with a chart:

Is the growing Fed balance sheet inflationary?

The Fed balance sheet has increased from a cycle low of $3.76 trillion in September 2019 to almost $7 trillion as of mid-May 2020. The vast majority of this balance sheet increase has occurred over the last two months.

This massive increase in liquidity could lead to inflationary pressures during normal times, but seems entirely appropriate during the steepest economic collapse most of us have experienced in our lifetimes. With the massive drop in economic growth, sustained inflation pressures are unlikely. We expect the Fed balance sheet will continue to grow over the near term. Once the Fed is convinced that a sustained economic recovery has begun, we expect the Fed will slowly stabilize and reduce its balance sheet over many years.

What do these high debt levels and the Fed’s actions imply for investment performance?

Large fiscal spending, high debt levels and an aging demographic make it more likely that asset class return expectations will be lower in the future than we have experienced historically. Every year, we review our longer-term capital market assumptions (CMAs), and we have been reducing those returns over time.
Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Municipal bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. Municipal bonds are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. Municipal securities are also subject to legislative and regulatory risk which is the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income.

Preferred securities are subject to interest rate and credit risks. Interest rate risk is the risk that preferred securities will decline in value because of changes in interest rates. Credit risk is the risk that an issuer will default on payments of interest and principal. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer’s capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

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