How the U.S. Government Could Pay for the Stimulus

Key takeaways

- U.S. government debt levels, while increasing, remain manageable—even after accounting for stimulus spending.
- We do not expect a negative near-term capital market reaction to the increase in Treasury debt that will be required to fund new deficit spending.

What it may mean for investors

- Longer term investors are likely to see lower interest rates, lower economic growth rates, and potentially lower investment returns than we have experienced historically.

In response to the coronavirus (COVID-19) pandemic, the U.S. government recently passed the CARES Act, a massive $2.2 trillion government spending package. This single bill amounts to almost half of what the U.S. government spent over the entire 2019 fiscal year. While there is little question that fiscal policymakers needed to act in a significant way to address unprecedented challenges, the spending will need to be paid for—or financed—through additional issuance of U.S. Treasuries. We think markets will readily absorb this new Treasury issuance. The U.S. remains the strongest economy in the world, and the dollar is in demand across the globe. We don’t expect investors’ worst fears of substantial increases in interest rates or runaway inflation to come to fruition. That said, massive deficit spending does have consequences that investors can expect to face in the future.
The cost

There is currently over $23.5 trillion in outstanding Treasury securities financing the national debt, and as the CARES Act is financed, we expect this total to quickly increase. While $23.5 trillion is an eye popping number, it doesn’t tell the whole story. The government owns almost $6.5 trillion of its own debt in government trust funds. The Federal Reserve (Fed), while somewhat independent from other government institutions, has been buying Treasuries at a rapid pace.

Recently the Fed had over $3 trillion of Treasuries on its balance sheet, a number that continues to grow. This leaves about $14 trillion in Treasuries that the government needs to finance in the capital markets. Fourteen trillion dollars is still a number that is difficult to comprehend, but to put this into further context, the gross domestic product (GDP) of the U.S. economy currently stands near $21.5 trillion. When viewed in comparison to the annual earning power of the U.S. economy, finding buyers for $14 trillion in Treasuries appears to be more manageable.

Chart 1: U.S. federal debt held by the public as a percentage of gross domestic product (GDP)

When we include Treasuries owned by the Fed, which theoretically could one day be put back in the public realm, public debt-to-GDP stands just under 80%. (See Chart 1.) A high debt-to-GDP ratio increases the risk that investors might, at some point, begin to doubt the government’s ability or willingness to pay off the public debt. That could result in benchmark interest rates rising and drastic austerity spending measures being necessary to maintain creditor support of the government’s debt. Looking across the globe, we see many developed countries with fewer economic advantages compared to the United States that have a far higher debt-to-GDP ratio. Japan has a public-debt-to-GDP ratio of over 230%, yet its government yields remain among the lowest in the world. Its 10-year bond recently traded at 0.00%, while the U.S. 10-year Treasury has traded near 0.61%.

In our view, the markets should easily absorb the added costs of current stimulus spending. The danger zone is not in the near or even intermediate term, but over the long term, should the debt burden continue to grow.
Addressing the challenges

Fiscal challenges relate not just to current stimulus spending but also to the longer term trajectory of deficit spending. Deficit spending in and of itself is not necessarily problematic, especially if GDP grows at a faster rate than deficit growth. Under such a scenario, debt and deficits shrink on a relative basis over time. Unfortunately, it appears that the U.S. is on a different trajectory as our population ages and mandatory spending requirements, such as Medicare and Social Security, are projected to grow at a faster rate over time.

It is unlikely, in our opinion, that the government will make any near-term changes to curtail spending or increase revenue, and such changes are ill advised during periods of economic contraction. It is more likely that additional stimulus in response to the current crisis will add even more to the federal debt. Only once the economy recovers would an opportunity exist to address the long term sustainability of deficit trends. However, these decisions are politically challenging, and given the choice between taking potentially unpopular action or “kicking the can down the road,” Congress has historically opted for the latter.

When, if ever, our lawmakers do act, there are several schools of thought for them to debate regarding debt management and appropriate fiscal policies.

Table 1: U.S. government alternatives for paying for the stimulus over time

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<tr>
<th>Alternatives</th>
<th>Potential implications</th>
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<td>Spending cuts</td>
<td>Given the federal budget’s makeup, a significant portion of any cuts would likely need to come from popular social programs, which would be politically challenging.</td>
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<tr>
<td>Tax increases</td>
<td>Much like spending cuts, tax increases would likely be unpopular—at least with some segments of the population. In addition, this would run counter to recent policy, which has been to simplify the tax code and reduce rates.</td>
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<td>Higher economic growth</td>
<td>Arguably the best way to reduce debt-to-GDP is to grow GDP. This approach, however, can be challenging, as systemic facts point to lower average growth rates in the years ahead.</td>
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<td>Negative real rates</td>
<td>Despite low inflation rates, even lower yields currently allow the government to finance debt at negative real rates. While the Fed can help manage interest rates, there is no guarantee that rates will remain low.</td>
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<tr>
<td>Inflation or debt renegotiation</td>
<td>Printing dollars to pay off maturing debt or renegotiating outstanding bonds would destroy investors’ and citizens’ savings and make it difficult to borrow again and, in our view, should be used only as a last resort.</td>
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Implications for investors

We think investors’ worst fears of runaway inflation and a jump in interest rates as a result of significant government spending are unlikely to materialize. While worst-case concerns are unlikely, we do see three potential investment and economic impacts as a result of fiscal stimulus spending.

- **Lower longer term growth rates.** High debt levels restrict policymakers’ ability to respond to unexpected future events. Future shocks may have a more significant negative economic impact, as lawmakers might lack flexibility to deal with them fiscally. Significant government debt levels 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.

- **Lower inflation.** High government debt levels have a deflationary effect. Funds that may have otherwise been directed toward investment and consumption must be diverted to service a growing debt burden.

- **Lower yield and returns.** As the population ages, demand for income securities is expected to increase. Fiscal trends and an aging demographic make it more likely that asset-class return expectations will be lower in the future than we have experienced historically.
Risks 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. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.

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