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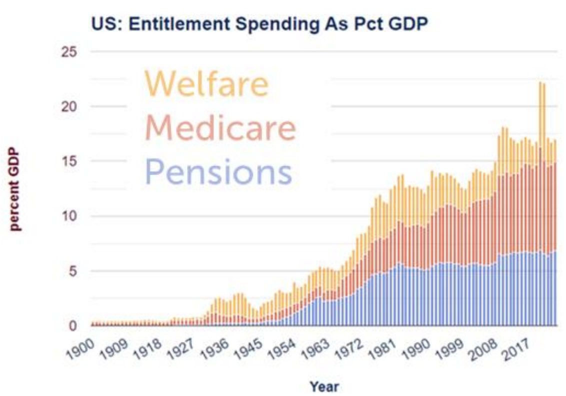
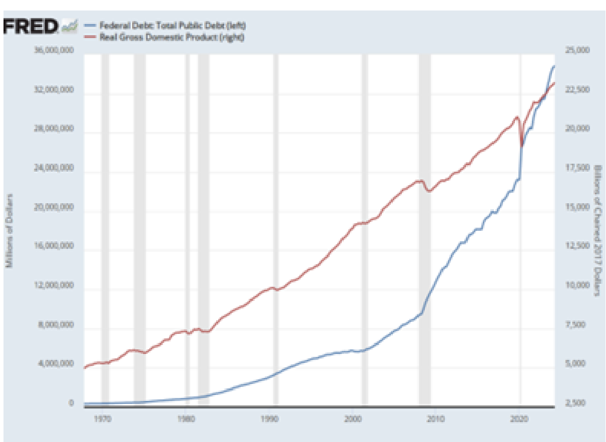
The Coming Debt Crisis — and what to do about it

"How did you go bankrupt? Two ways. Gradually, then suddenly." – Ernest Hemingway, *The Sun Also Rises*

Celebrating a Milestone

The US celebrated a milestone this summer – but not a good one. The National Debt surpassed $35 Trillion – That's $35,000,000,000,000, or more than $100,000 per citizen. Even more scary, it works out to $271,000 per US taxpayer![i] How did that happen? How will this affect the future? And what can we do about it?



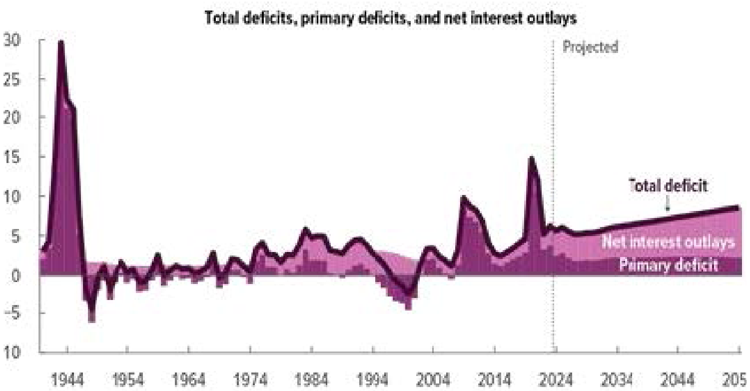


First, let's look at what we're spending all that money on: The answer is "entitlements" which consist of Social Security, Medicare, and welfare programs[ii]. The creation of welfare spending to ease the Great Depression was followed by massive pension spending after WWII. After that, though, the programs simply kept growing. Two key catalysts caused significant acceleration in the growth of government debt – the Global Financial Crisis of 2008 and the 2020 pandemic[iii]. Government debt (the blue line) shot up during both crises to support the economy while GDP (the red line) declined. But what jumps out when looking at the chart below is this: the trajectory never settled down after either crisis ended; the government has just kept spending and spending. You might say the US Government is addicted to spending.

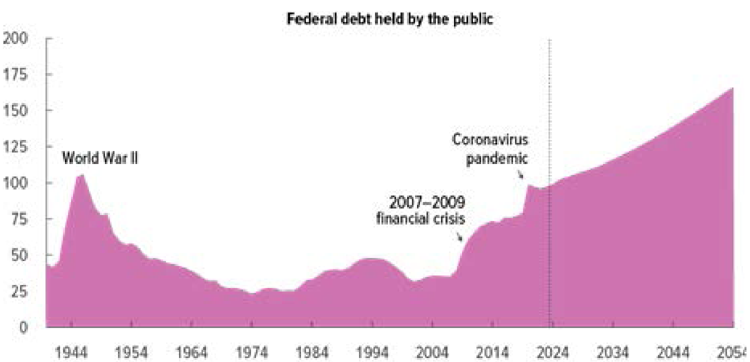
In fact, since the end of WWII, federal tax revenue has grown 15% faster than national income, but federal spending has grown 50% faster than that.[iv] These trends show no signs of slowing.

The result of all this is that we have been running bigger and bigger budget deficits each time there has been a need for government support. As you can see from the chart below, the 2023 budget deficit was 6% of GDP, this illustrates the stark change in our fiscal situation.

Outside of a crisis - World War II, the 2008 crisis, or the Pandemic - the deficit never got as high as it is today – a period of strong growth. The deficit grew as high as 5.7% of GDP in 1983 but exploded to 10% during the 2008 GFC, only to mushroom further, to almost 15% of GDP, during the Pandemic. Deficits normally occur during a recession; looking at the chart, though, you would assume we're still in a recession, not a 2% growth environment, as the Federal Reserve predicts[v].



Our profligate spending is expected to catch up with us as interest expense continues to grow – in fact the CBO suggests that net interest outlays will be larger than the primary deficit over the next decades[vi]. This leads to the key problem in this scenario – The US debt burden.



The CBO expects the debt held by the public to rise each year going forward, from 99% of GDP in 2024 to 122% in 2034 and 166% of GDP in 2054 – higher than any point in US history, including in the aftermath of World War II.

Why does this matter? Higher debt levels create many problems: a lack of fiscal flexibility, crowding out of private investment, slower growth, and higher inflation, all of which may lead to reduced confidence in the US financial system.

The Problem with Excessive Debt

Just as with our personal finances, governments cannot borrow forever – money needs to be paid back sometime. Think of your mortgage as the Federal debt: if you tripled your mortgage but your income stayed the same, eventually you'd run out of money. That's exactly what's expected to happen to the US – government debt is projected to go from less than 50% of GDP to over 150% - tripling the size of our debt, relative to our country's income. Could this cause America to collapse?

The US happens to have a printing press, so the negative consequences would be a bit different, and may include some of the following:

- Lack of flexibility, leaving us vulnerable, unable to respond to a financial crisis.
- Higher government borrowing can crowd out the more efficient borrowings of the private sector.
- Higher debt burdens may require higher interest rates, leading to higher borrowing costs – for everyone, not just the government.
- Higher borrowing costs may lead to slower economic growth and higher inflation.
- These factors are likely to lead to reduced confidence in the US financial system, as other countries and investors worry about our ability to repay, making the US a less attractive destination for investment.

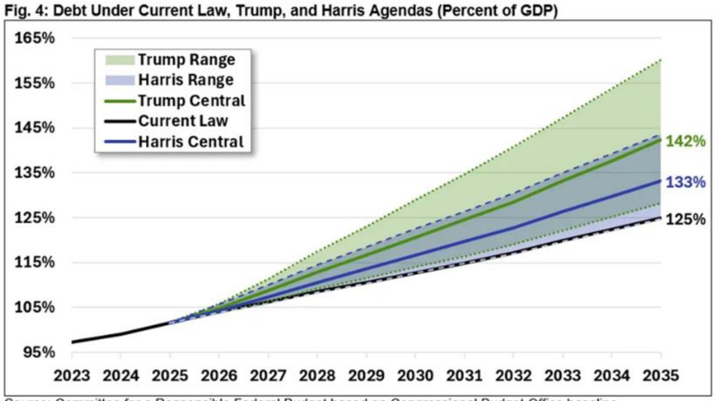
What can be done?

Can the problem be fixed?

There are four ways out of excessive debt:

- A country can devalue its currency, but that's not feasible when you are the world's reserve currency, like the US Dollar.
- A country can allow inflation to increase, thereby reducing the value of borrowed dollars. As we have seen in recent years, this causes many other problems and is not a great solution.
- A country can grow its way out of the problem like the US did after World War II. This is the hope.
- Fiscal austerity is technically a fourth solution, but that does not appear to be realistic in today's political environment! As can be seen in the chart to the right, Trump will likely leave the country's balance sheet worse than it is today and there is no other politician that is, truly, advocating for a fiscally sustainable budget.

Fig. 4: Debt Under Current Law, Trump, and Harris Agendas (Percent of GDP)



Source: Committee for a Responsible Federal Budget based on Congressional Budget Office baseline.

The However, if the government does manage to instill a greater sense of fiscal responsibility, the deficit might decline, like it did after the technology boom – the charts above show that the deficit and outstanding debt situations both improved during the late 1990s and early 2000s. Could Artificial Intelligence play a similar role today that the internet boom did in the 1990s? It's certainly possible, but the government must also put its fiscal house in order. How, you ask? There is a very interesting tool that will help you think through these issues and their impact:

Debt Fixer | Committee for a Responsible Federal Budget [vii]

The key limitation to this tool is the term economists love to use: "All else being equal". Each change is modeled without the context of other changes, but it is a start in thinking through the issues and in seeking out politicians that will do the same.

In the meantime, we must think about how the deficit might affect our portfolios.

How should this change my portfolio?

Potential consequences of higher deficits and debt would include the following: a) Lower growth, b) higher inflation and interest rates c) more geopolitical and market volatility. Here are some portfolio implications:

- Stocks
  - Returns may be lower than recent returns; prepare yourself to take advantage of equity market volatility.
  - Pay close attention to the price you pay – valuation matters greatly in the long-run, particularly if growth is slower in the coming decades.
- Bonds
  Invest in bonds that have a higher yield, like corporate bonds, that can compensate you for what inflation steals.
  Consider investing in floating-rate and shorter maturity bonds.
- Alternatives
  - Think about alternative investments to diversify stock and bond risk.
  - Consider investing in private markets, as the illiquidity premium may compensate for lower public market returns.

To finish on an optimistic note, I share a quote attributed to Winston Churchill: "you can always count on the Americans to do the right things, after they have exhausted all other possibilities"[viii].

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Nathan Willis is Director of Portfolio Strategy for OneAscent Investment Solutions and has 25 years of investment experience, including 20 years investing in illiquid strategies.

Nathan holds a bachelor's degree in Business Administration with a concentration in Information Systems and a minor in Economics from Taylor University. He is a holder of the CFA Charter and CAIA designation. Nathan started his career at NationsBank where he spent several years managing institutional bond portfolios and an equity mutual fund.

Prior to joining OneAscent, Nathan served as Chief Investment Officer of Greenhawk Corporation, a single-family office. At Greenhawk, Nathan was responsible for portfolio strategy and manager diligence. During his time at Greenhawk Nathan developed the allocation, sourcing, and diligence strategy for the private equity portfolio.

Prior to Greenhawk, Nathan spent almost 15 years with GenSpring Family Offices, a unit of SunTrust Banks, where he constructed portfolios for multi-generational families. While at GenSpring, Nathan served on the Investment committee and manager selection committee and served developed programs to mentor junior investment staff. Prior to GenSpring, Nathan spent four years with the family office group of Wachovia Bank.

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Sources

[i] Source: US Debt Clock U.S. National Debt Clock : Real Time (usdebtclock.org)
[ii] Source: US Government Entitlement Spending History with Charts - a usgovernmentspending.com briefing
[iii] Source: Federal Reserve Bank of St Louis
[iv] Source: Wall Street Journal Why America Is Going Broke - WSJ
[v] Source: Congressional Budget Office, Federal Reserve System Federal Surplus or Deficit [-] as Percent of Gross Domestic Product (FYFSGDA188S) | FRED | St. Louis Fed (stlouisfed.org)
[vi] Source: Congressional Budget Office An Update to the Budget and Economic Outlook: 2024 to 2034 | Congressional Budget Office (cbo.gov)
[vii] Source: Committee for a responsible budget Debt Fixer | Committee for a Responsible Federal Budget
[viii] Source: Hillsdale College – this quote is a 'supposed' quote "Americans Will Always Do the Right Thing..." - The Churchill Project - Hillsdale College