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The long-term consequences of U.S. deficit spending

Narrowing deficits and subdued interest rates should keep Federal debt payments manageable over the next 10-15 years, accompanied, however, by more modest investment returns.

Deeper analysis of investment trends and topics **April 1, 2021**

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Key takeaways

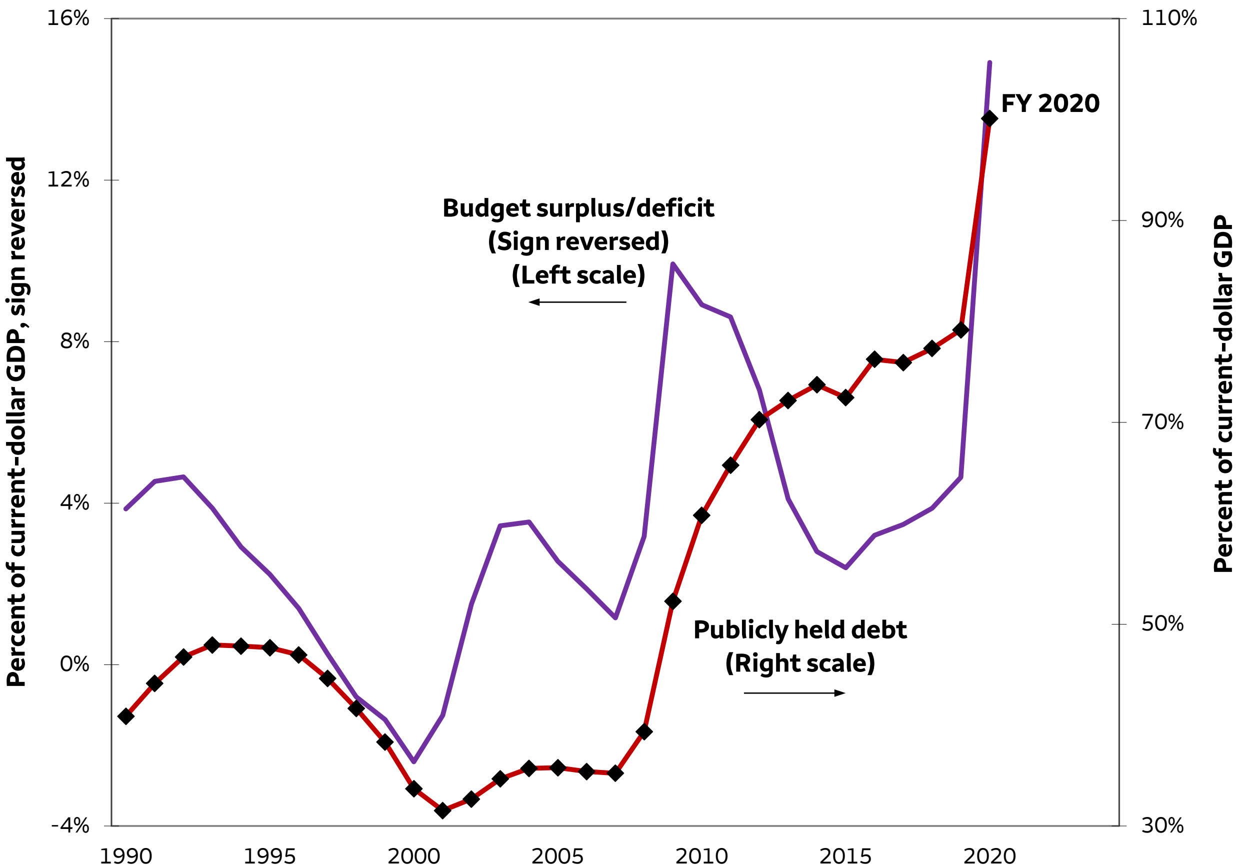
- Currently at $26 trillion, the federal debt load is staggering, and its long-term prospects are troubling.
- We believe it unlikely that investors will face the most damaging effects of the U.S. fiscal threats anytime soon. Moreover, extrapolating current trends ignores other factors that should blunt the worst outcomes over the next 10 to 15 years.
- More likely, in our view, is that federal debt levels remain high but moderate their growth rate. Our long-term expected returns for fixed income and equities account for a scenario of somewhat lower investment returns and greater market volatility than long term historical averages. In turn, these assumptions influence the strategic allocations in our long-term portfolio models.

Explaining budget complacency

Rising budget deficits are resurfacing as a high-profile economic issue after a decade of near-neglect. The recent $1.9 trillion pandemic-relief package epitomized the attitude toward budget deficits — a crowning achievement in a year-long effort to get the economy back on its feet, but one that overshadowed worries over fiscal complacency. Chart 1 shows that even before the deficit ballooned in response to last year's pandemic-related spending, the budget gap was widening at a time late in an economic growth cycle when it normally is narrowing. The ratio of debt to gross domestic product (GDP) was approaching 80% in 2019, a level that hadn't been seen since the start of the Korean War in 1950. That ratio has since breached 100%, and the Congressional Budget Office expects it to remain there through mid-decade.[1]

[1] "The 2021 Long-Term Budget Outlook," Congressional Budget Office, March 4, 2021.

Chart 1. Temperature's rising on federal budget deficits and debt (fiscal years)

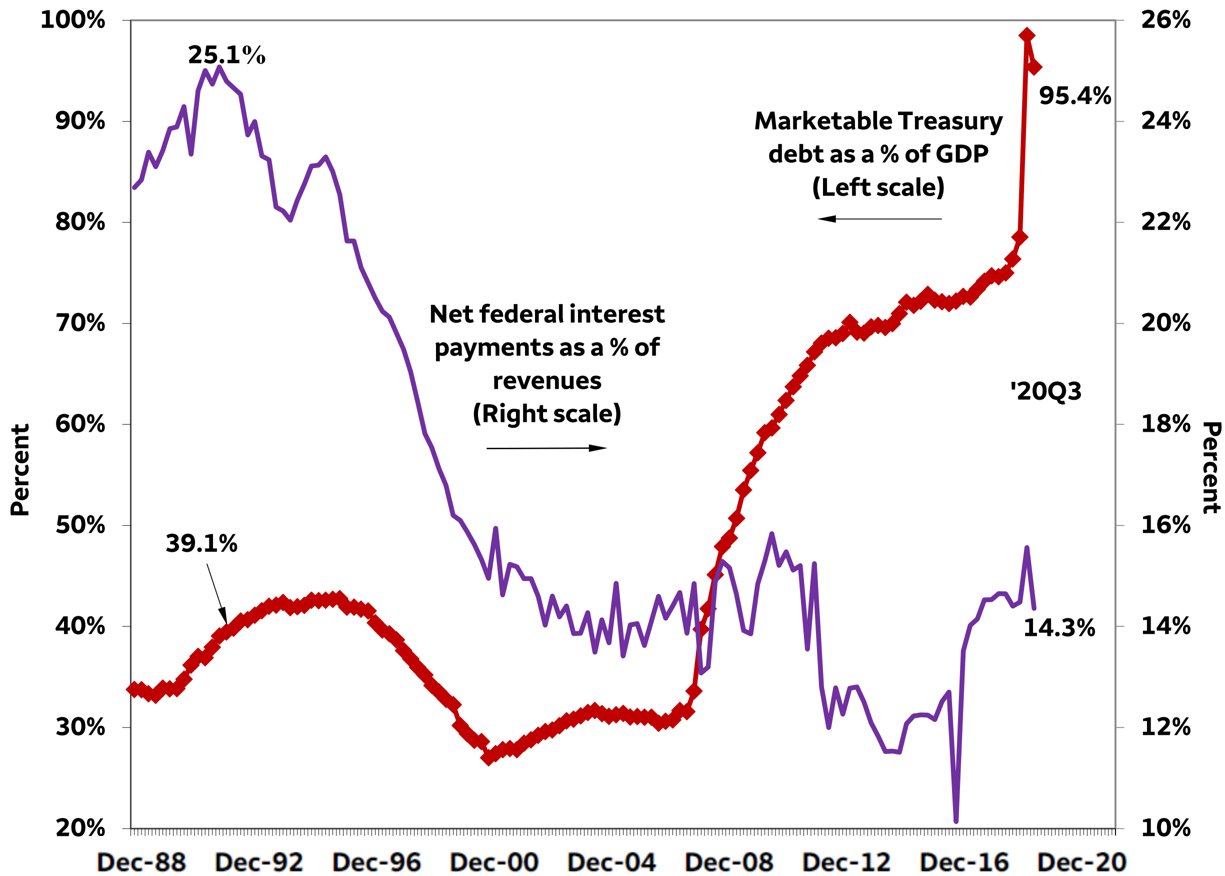


Sources: Congressional Budget Office, U.S. Treasury Department, Wells Fargo Investment Institute, March 2021. Data through September 30, 2020.

Why so little thought about the implications of mounting federal deficits and debt? We think that economic growth, or the lack of it, offers one explanation. The focus during the past decade was less on government finances than on jump-starting growth during a weak economic recovery from a deep recession in 2008 – 2009. Those efforts intensified beginning with an economic free fall during last year's pandemic, which worsened income and wealth inequality while lifting unemployment to Depression-era levels.

Second, worries have been suppressed by historically low interest rates countering increased debt in keeping the government's financing burden at an unusually low level. Budget deficits were a bigger issue in the late 1980s and early 1990s, when higher interest rates lifted federal debt financing payments to over 25% of revenues on debt equivalent to less than 40% of GDP. (See Chart 2.) There's a good deal less concern over borrowing and debt now, with low interest rates keeping the payment burden at less than 15% of revenues.

Chart 2. Low financing costs ease investor concerns over federal deficits and higher debt

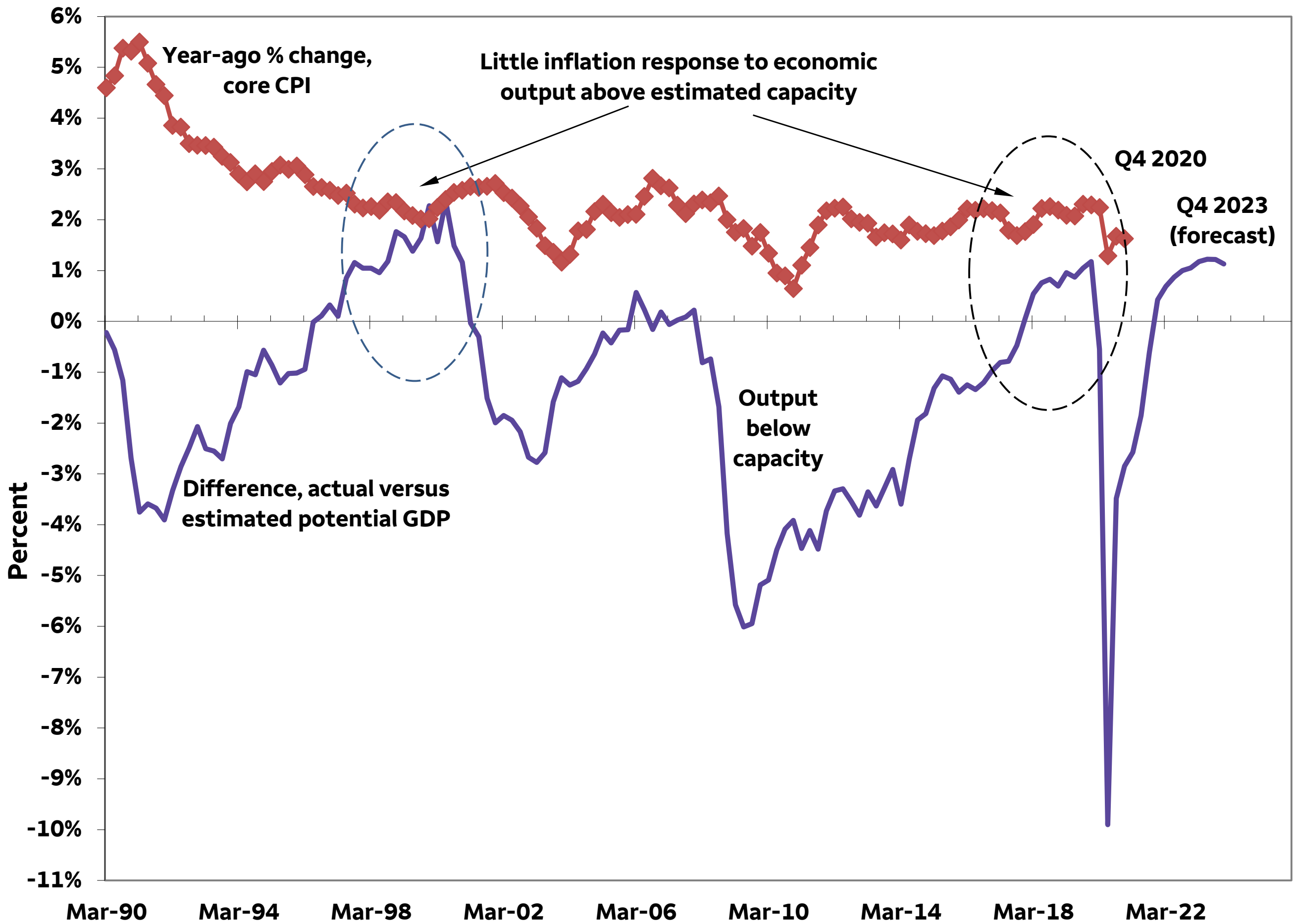


Sources: U.S. Treasury Department, Wells Fargo Investment Institute, March 2021.

The economy's recent success in absorbing increased deficit financing is not a free pass for even more rapid spending and borrowing. We believe that the threat of widening budget deficits and mounting federal debt increase over time. However, other economic trends have muted the impact, so far:

- Ample financing, low interest rates, and weak credit demand during much of the previous growth cycle have prevented the private sector crowding out from federal borrowing feared by many.
- Inflation's structural restraints have helped prevent 1960s-style demand-pull inflation even as the economy has operated near — and, at times, above — its long-term potential. Inflation's restraint during such periods is illustrated in Chart 3. Structural restraints have included globalization, or the migration of manufacturing to low-cost countries; an aging workforce; labor's weakened bargaining power; and technological change, including the rapid growth of more transparent online shopping.

Chart 3. Economic overheating not always an inflationary event

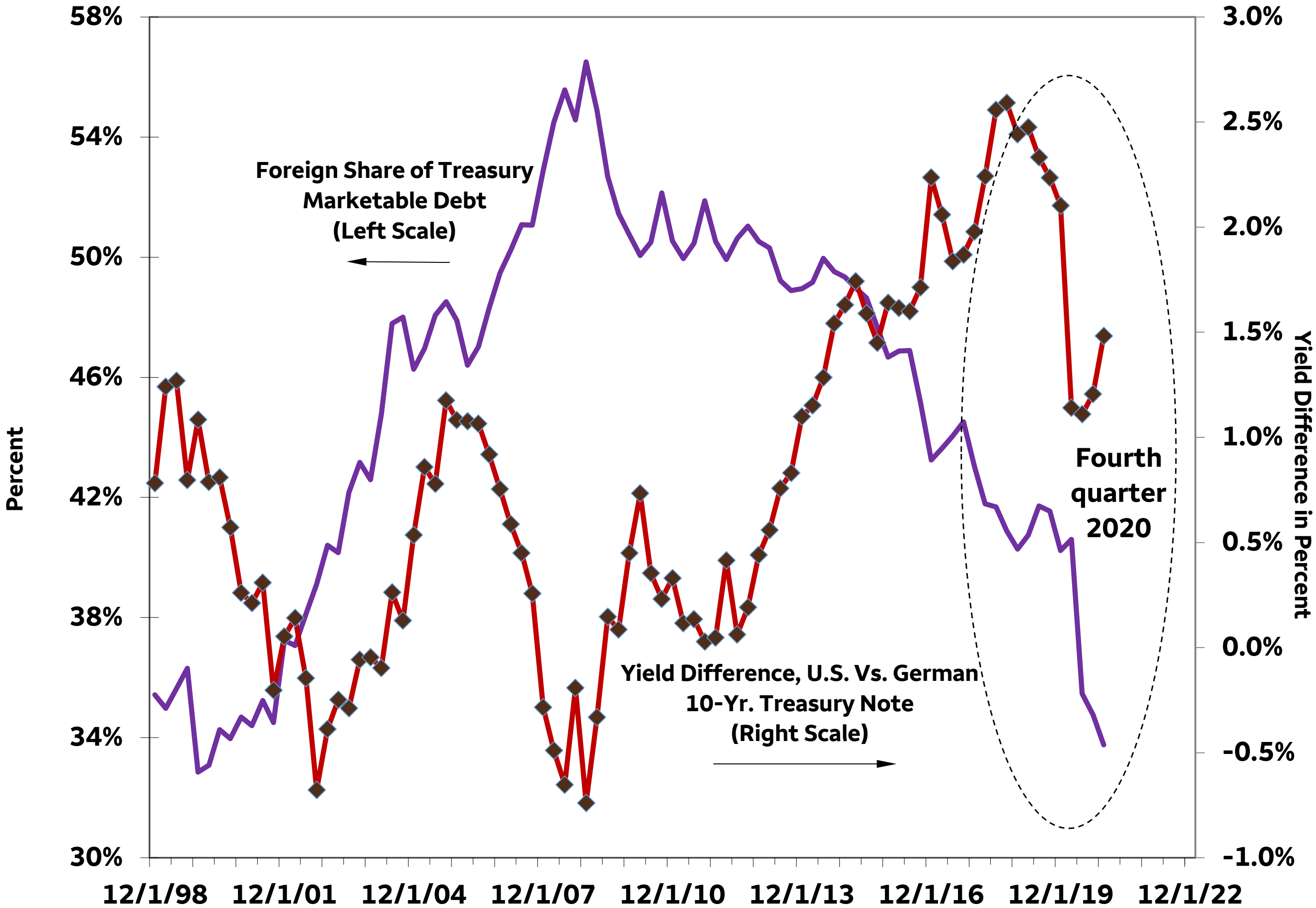


Sources: Congressional Budget Office, U.S. Commerce Department, U.S. Labor Department, Wells Fargo Investment Institute, March 2021. Chart shows CPI inflation, actual vs. potential real GDP in percent. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

- A loosened historical link between money growth and spending also helps explain why inflation hasn't climbed with budget deficits. For example, Federal Reserve (Fed) data show that increased cash created as a by-product of the Fed's Treasury debt purchases is being hoarded rather than spent by businesses and consumers, judging from low and declining money velocity, or the ratio of transactions to the money used to finance it.[2]
- Reduced dependency on sometimes volatile foreign capital has provided a measure of stability to deficit financing even as federal borrowing has increased. As indicated in Chart 4, the foreign share of U.S. Treasury marketable debt fell to a 20-year low of a little more than a third by the fourth quarter of last year, bucking unusually attractive yield premiums on U.S. debt in 2018 – 2019.

[2] An intuitive way to understand money velocity is the average number of times that private individuals spend each dollar. The hoarding of cash we are seeing may be due to gloomy economic prospects since 2008 (compared to other economic recoveries) and very low interest rates, which lead investors to hold cash instead of interest-bearing assets, such as bonds.

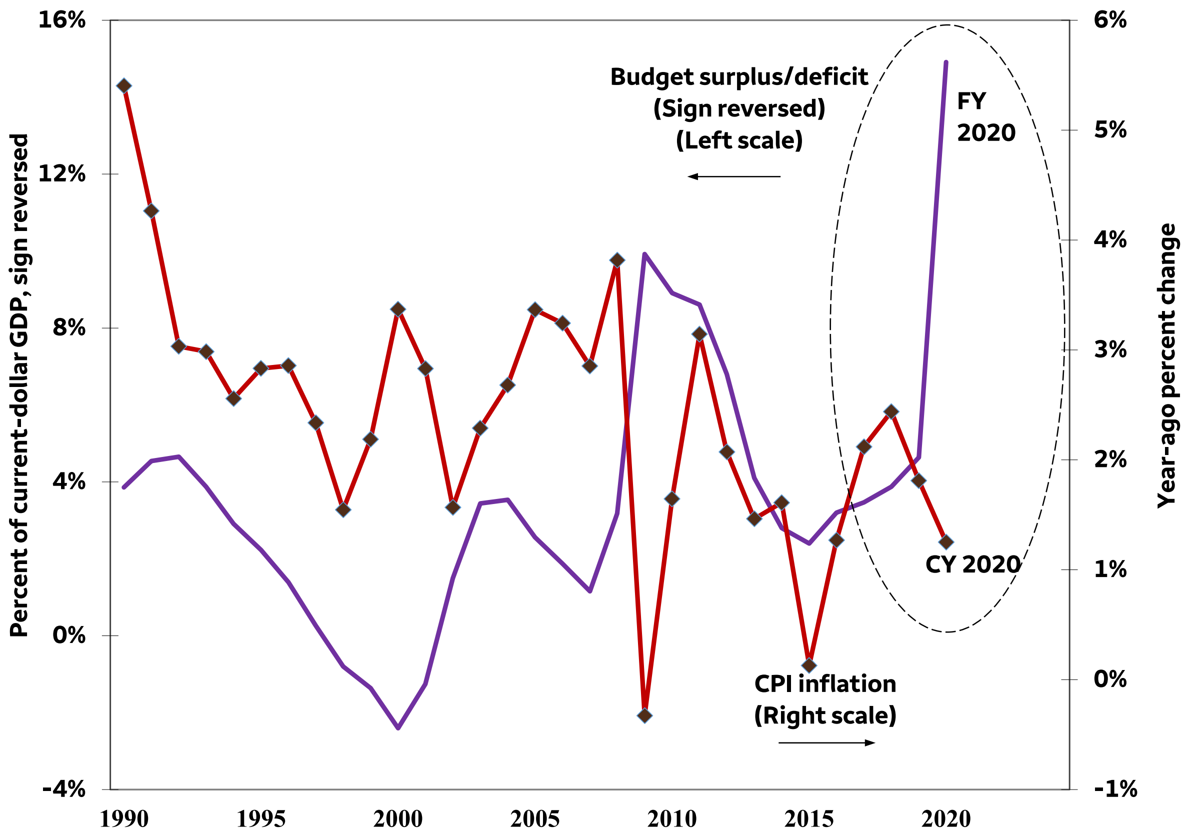
Chart 4. A dwindling share of Treasury debt held by non-U.S. investors



Sources: U.S. Federal Reserve Board, Wells Fargo Investment Institute, March 2021. Data through Q4 2020.

- Pandemic-related borrowing in the past year may have been viewed by investors as a one-time emergency affecting the level of debt but not its long-term trajectory.
- Perhaps most notable has been the failure of increased deficits and, at times, rapid money growth to ignite inflation. In other words, Chart 5 reveals that federal deficits are not in themselves inflationary.

Chart 5. Inflation largely unresponsive to rising budget deficits



Sources: Congressional Budget Office, U.S. Labor Department, Wells Fargo Investment Institute, March 2021. Data through September 30, 2020.

Our outlook for the federal debt impact on the U.S. economy and capital markets

The pandemic occasioned the recent increase in spending, deficits, and debt. The U.S. fiscal deficit rose from 4.6% of GDP in 2019 to 14.9% in 2020, while debt as a share of GDP rose from 79% to just over 100% of GDP. Even prior to 2020, the federal debt had accelerated as a share of the economy (see Chart 2).

The point is that we should evaluate a variety of relevant trends to consider the impact of the deficit and debt on the economy. The main factors and capital market implications we expect include:

- **Crowding out reduces the federal government's ability to respond to crises**: Rising interest payments on the federal debt, among the most uncontrollable of the spending categories, risk what amounts to an internal crowding out of other spending categories.[3] We expect fiscal policy to become less flexible in its ability to stabilize the economy in the event of another recession or international political or economic shock. Impact on capital markets: more volatility, especially in the equity markets.
- **Heavy debt loads suggest higher future taxes and a slower economy:** Household and business incomes risk being diverted from spending to saving ahead of a potential decline in after-tax earnings, lowering economic growth. Households also could be encouraged to pivot from spending if deficit-related increases in interest rates encourage greater saving. Impact on capital markets: Slower economic growth means lower inflation and a lower-for-longer trend in interest rates.

[3] For an extensive study of the composition of federal taxes and spending, please see our report, *Paying America's Bills*, Wells Fargo Investment Institute, October 2020.

- **Demographics work against economic growth:** Consumer-spending growth, two-thirds of total GDP is expected to slow as the population continues to age. Impact on capital markets: slower economic growth, lower inflation, and a lower-for-longer trend in interest rates.

- **Foreign investors taking a smaller share of U.S. Treasury debt means a weaker dollar:** The increasing Fed holdings of U.S. Treasuries means a lower share held by international investors. Implicitly, this means that the supply of dollars is increasing faster than the international demand for the dollar. Over time, the greenback should depreciate further. Historically, this has also meant higher interest rates, but even lower European and Japanese interest rates in coming years may restrain the dollar's depreciation. As long as U.S. investors are still willing to hold U.S. Treasuries, the rate differential favoring the U.S. implies that any dollar depreciation or increase in interest rates is moderate. A modestly weaker U.S. dollar should be favorable for U.S. multinationals that repatriate foreign earnings.

- **Political and market pressure should constrain Congress:** Considering the low level of inflation and the high level of debt, the economy could be very sensitive to even modest increases in long-term interest rates once yields return to their pre-pandemic levels. As market-based interest rates move even higher, Fed policymakers should be inclined to raise short-term rates from zero. The large amount of public and private debt should make borrowers — including the Federal government — more sensitive to even moderate increases in financing costs. Implications for capital markets: Volatility in equity and bond markets is more likely to come from even small changes in expected inflation and interest rates.

We believe that these points from our long-term outlook outweigh the biggest concern about deficits and the government's mounting liabilities — namely, a devaluation or repudiation of the debt. One route to a catastrophe takes a slow pace. If inflation rises and remains above the level of interest rates, then those who hold U.S. Treasury debt over time would see their interest and principal payments fail to keep up with inflation in the prices of goods and services. In this way, bond investors will lose purchasing power over time.

Another, faster path is a deliberate push by monetary policymakers to fund government spending directly by printing money to pay the debts. Historically, such a policy has driven inflation so high that investors would simply stop buying U.S. Treasuries.[4] Alternatively, Congress could simply demand to renegotiate all or some portion of the outstanding debt, which would also undermine investor confidence.

We find both scenarios to be possible but unlikely, in that they fail to take account of other trends also at work in the economy. High levels of public and private debt already work to increase the sensitivity of all borrowers to any increase in inflation or interest rates. Meanwhile, the same high debt levels — as well as other trends, such as demographics, globalization, and new technologies — work against large increases in inflation.

Investment implications

For the next year or two, deficit spending and monetary policy that accommodate further borrowing should have a strongly positive effect on the economy and on risk-taking in financial markets. We favor equities and have turned defensive on fixed income.[5] In equity markets, we prefer those asset classes and sectors that should outperform as economic growth exceeds its 40-year average of 2.5% but with interest rates and inflation that are only slowly rebounding to

[4] This is the policy suggested by Modern Monetary Theory (MMT). MMT effectively favors a subordinate role for the central bank in printing money to support full employment and other government programs. We view such an acceleration in federal debt as an unlikely future policy. Only Congress has the authority to reduce the Fed's independence, and failed past attempts to change mandated independence under the Federal Reserve Act show how politically difficult it is to execute change. For another perspective on why MMT seems neither imminent nor inevitable, please see Mark Thoma, "Why the Federal Reserve Needs to Be Independent," CBS News MoneyWatch," November 12, 2009.

[5] For a complete set of our current short-term allocation preferences, please see "Adjusting Guidance for a Stronger 2021 Growth Outlook," Wells Fargo Investment Institute, March 5, 2021.

pre-pandemic levels. Internationally, we favor emerging market equities but are broadly unfavorable on equity markets in Europe, Japan, and other ex-U.S. developed markets.

Beyond the next few years, our long-term (10 to 15 years) capital market assumptions account for the expected effects of higher debt levels but slower debt growth on the economy and financial markets. Federal debt, while unsustainable at the recent pace, is likely to slow but stay at a high level. We believe long-term economic growth, interest rates, and inflation should recover to their pre-pandemic levels but remain subdued compared with prior decades. Moderate long-term economic growth, along with subdued inflation and interest rates, will leave the financial markets susceptible to lower investment returns and higher volatility than what we've experienced over the past decade whenever government starts discussing tax and spending changes. In this way, elevated debt risks weighing on asset prices going forward, especially compared to the decade just passed. While that low-rate, low-inflation environment continues, however, we believe the federal debt will remain manageable.

As higher debt levels continue to suppress economic growth, and as the population ages, we expect slower private spending growth and, therefore, continued low inflation and interest rates despite additional U.S. Treasury debt issuance. Equities are likely to remain volatile around federal tax and spending changes. However, earnings growth should remain positive while corporate managers take advantage of low interest rates, slowly developing improvements in worker productivity, and technological changes that increase supply-chain flexibility and enhance corporate cost control.

In such an environment, fixed-income returns may remain low by historical standards, but corporate bonds and preferred securities should continue to offer premiums over U.S. Treasuries. Moving down the credit spectrum may be a viable strategy, especially during economic recoveries from recessions, but we favor adding credit risk only with the assistance of active management. Equities may continue to be a primary source of portfolio income, and equity investors may find price appreciation opportunities in sectors of the economy that receive increased government support. (Over a horizon of the next year or two, for example, we have been expecting near-term government spending in infrastructure and health care.)

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Definitions

The Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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