The recent tax cuts for individuals and businesses, combined with the early 2018 budget agreement, are likely to boost economic growth over the next few years, brightening the outlook for investors. After several years when the deficit was shrinking, higher government spending is expected to increase federal budget deficits and debt. As a result, some worry that the debt is too big or could trigger another financial crisis. We don’t think either is true.

Deficits and Debt Don’t Trouble Markets Today
The total U.S. debt has reached $20.5 trillion, including about $5.7 trillion the government owes itself. While the numbers are large, remember the U.S. is a large, wealthy country and can afford it. National income is also more than $20 trillion, but a more useful comparison is to the net wealth of the country, which rose to a record $98.7 trillion at the end of 2017.

We don’t think the debt is likely to become a worrisome issue for financial markets unless Congress delays raising the debt ceiling, which has been suspended until 2020. But the debt is essentially the sum of past deficits, and deficits are projected to grow rapidly. Many people worry that we can’t afford our federal debt, but we can. Here’s why:

- **Faster economic growth helps.** Faster growth generally increases tax revenue without a similar hike in spending, reducing the deficit. And when the economy grows faster than the deficit, it’s easier to afford long term.
- **Keep a long-term perspective.** Most of the time, the debt is compared to national income or gross domestic product (GDP), and the percentage of GDP has varied over time without any relationship to financial markets, as the chart shows. Just after World War II, net debt was more than 100% of GDP. More recently, net debt has totaled about $14.8 trillion, or 76% of GDP.

Stocks Have Increased with Rising and Falling Debt

![Chart showing correlation between debt as % of GDP and S&P 500 index]

Source: FRED, 12/31/2017.
• The debt is not as overwhelming as it seems. When it comes to the government, all the numbers are big. Although the U.S. debt is large compared to the government debts of many other countries, our economy is big, too. Japan, China and the United Kingdom all have government debt that is a higher percentage of GDP than the U.S. And today’s still-low interest rates and foreign holdings indicate global investors are confident the U.S. is financially sound and will make timely payments.

• Higher deficits may push interest rates higher. Although history doesn’t show a strong tie between interest rates and the size of the federal deficit, higher government borrowing could be a reason to expect higher rates. Other factors may include the impacts of solid economic growth, tight labor markets and the Federal Reserve’s plans to keep slowly raising short-term interest rates.

Crunching the Growing Deficit Numbers
As the chart shows, in 2017 the federal deficit (borrowing) was $615 billion, or 3.5% of GDP. Rapidly increasing spending on mandatory federal programs – especially Medicare, Medicaid and Social Security – means the deficit rises as more baby boomers retire. Those three categories – plus other mandatory spending, such as government retirement and health obligations – are almost two-thirds of total federal government spending.

2017 U.S. Government Spending vs. Revenue and Borrowing

2017 Government Spending = $4.0 Trillion

Sources of Financing

2017 Inflows

<table>
<thead>
<tr>
<th>Spending</th>
<th>Sources of Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medicare &amp; Medicaid: $966</td>
<td>Borrowing: $615</td>
</tr>
<tr>
<td>Social Security: $939</td>
<td>Revenue: $3,367</td>
</tr>
<tr>
<td>Defense: $590</td>
<td></td>
</tr>
<tr>
<td>Other: $459</td>
<td></td>
</tr>
<tr>
<td>Non-defense: $610</td>
<td></td>
</tr>
<tr>
<td>Net Interest: $263</td>
<td></td>
</tr>
</tbody>
</table>

Interest expense was just 6.6% of total spending, reflecting recent low interest rates. The Congressional Budget Office projects that interest expense will rise to 12.4% of total spending over the next 10 years as rates rise. Interest payments increase more slowly than the payments from the three mandatory programs. Keep in mind that the growing deficits in this chart don’t include the impact of the 2018 budget agreement, which increased federal government spending by $300 billion over the next two years. That’s why we think the budget deficit will likely exceed $1 trillion starting next year, depending on the timing of the additional government spending.

Rising Deficits Over Time

Annual Federal Budget Deficit

Source: Congressional Budget Office.
Will Deficits Ever Be Reduced?
The tax cuts enacted at the end of 2017 and the early 2018 budget agreement were designed to boost economic growth, but even with that impact, federal deficits are likely to rise quickly. That's why we think eventually the U.S. will address its rising debt and deficit through a combination of tax increases and benefit cuts, but if the past is a guide, only when it has to - and that mix of increases and cuts is impossible to guess. While today, many are enjoying the recent tax cuts, be prepared to pay more for benefits such as Medicare, as well as the possible impact of higher taxes. We think it makes sense to consider tax-advantaged and tax-deferred investments such as:

- Municipal bonds
- Roth and traditional IRAs
- 401(k) accounts
- Education savings accounts

Ways to Prepare Today
Don't let concerns about the government's finances keep you from making important decisions that affect your financial future. You may need to:

- Rebalance to an appropriate mix of stocks, bonds and international investments so your portfolio has the right combination based on your comfort with volatility, current situation and long-term financial goals.
- Improve your portfolio's diversification by adding a wider variety of asset classes.
- Prepare emotionally for the possibility of more volatile markets ahead, as faster economic growth, a tight job market, slightly higher inflation and steady short-term interest rate increases could trigger more market volatility.

As federal deficits and the debt rise over the next few years, calls to address them are likely to become louder. That's why we think it's smart to consider the possibility of higher taxes and/or fewer benefits ahead, even though changes aren't likely for several years. Your financial strategy needs to address longer-term trends and possibilities as well as the short-term positive benefits of tax cuts and higher federal spending.

Deficit vs. Debt: What's the Difference?
A budget deficit occurs when the federal government spends more than it takes in. The debt is essentially the sum of the government's past deficits. The federal government has run a budget deficit for most of its history. As a result, Congress must raise the debt ceiling periodically.