

Rising federal deficits and debt: What you need to know

Investment Strategy Team



After several years of the deficit shrinking, higher government spending is expected to increase federal budget deficits and debt. As a result, some worry the debt is too big or could trigger another financial crisis. We understand you might have this reaction as well, but we don't think either is true.

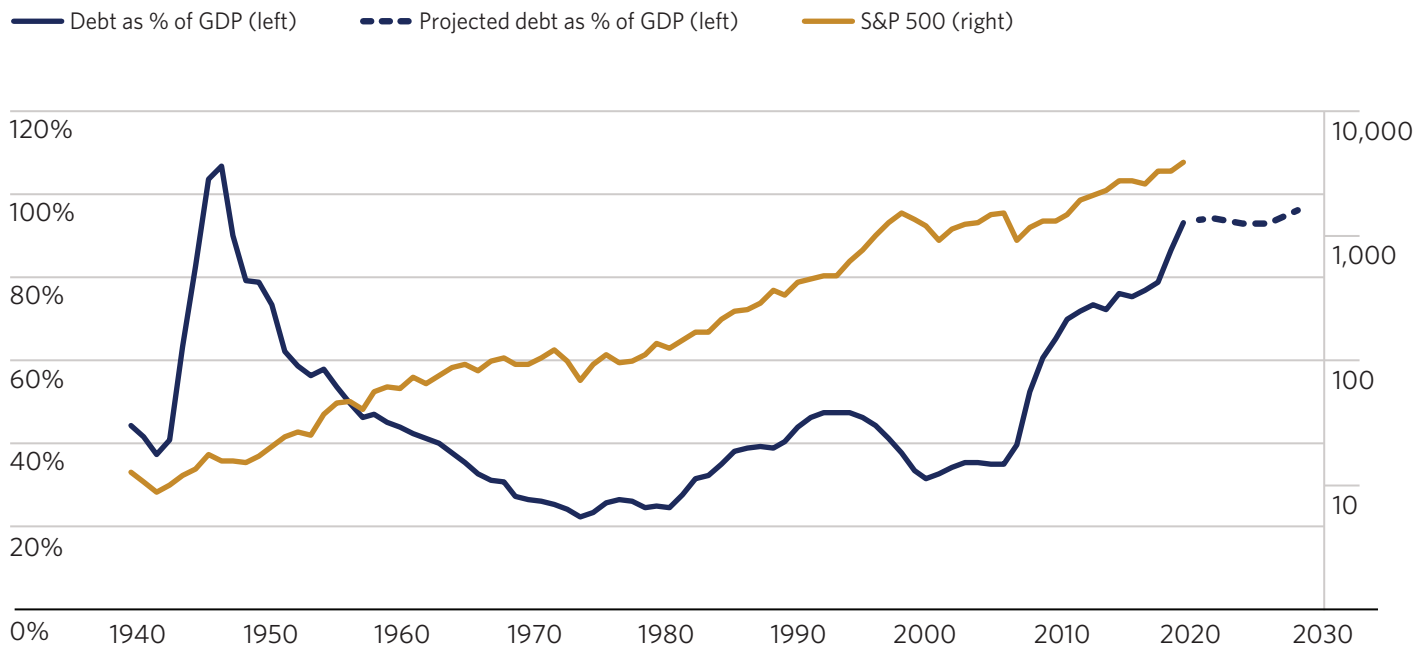
Deficits and debt don't trouble markets today

Total U.S. debt reached over \$27 trillion, with a deficit of over \$3 trillion or 31% of total GDP, as the government provided fiscal stimulus to combat the effects of the coronavirus. 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 \$109 trillion at the end of 2018.

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, and we're here to explain it.

- **Economic recovery will help.** As cities and states ease social isolation policies, economic activity should start to pick up and could turn into a strong and swift recovery. As the economy gets back on track, the government deficit should shrink as support for businesses and the unemployed is reduced.
- **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 on Page 2 shows. Just after World War II, net debt was more than 100% of GDP. More recently, net debt has seen a sharp rise due to the increased deficit, which is projected to rise to 93% of GDP in 2021.

Stocks have increased with rising and falling debt



Source: Bloomberg, CBO, February 2021. The S&P 500 is an unmanaged index and is not available for direct investment. Past performance does not guarantee future results.

- **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.

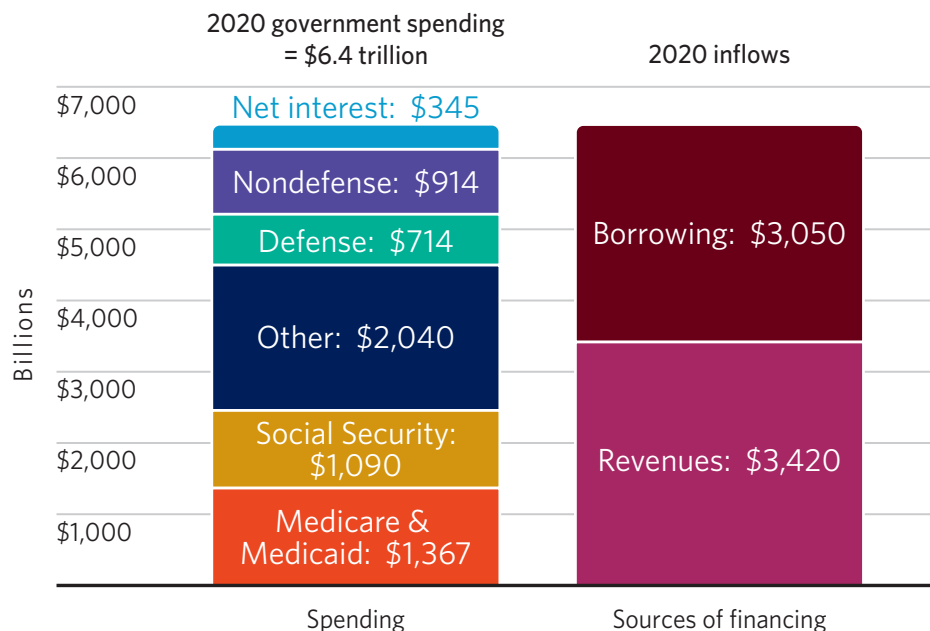
- **Higher deficits may push interest rates higher.**

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 interest rate trajectory.

Crunching the growing deficit numbers

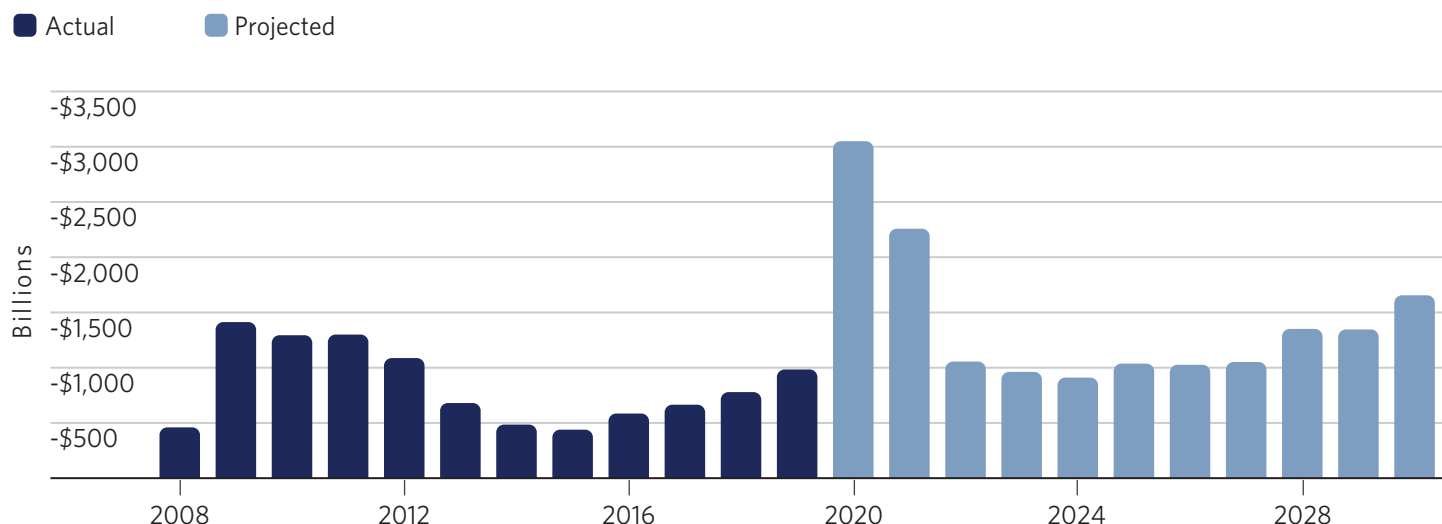
As the chart shows, in 2020 the federal deficit (borrowing) was \$3 trillion, or 14% of GDP. Rapidly increasing spending on mandatory federal programs – especially Medicare, Medicaid and Social Security – means the deficit rises as more baby boomers retire. Those three categories – plus other mandatory spending, such as government retirement and health obligations – are almost two-thirds of total federal government spending.

2020 U.S. government spending vs. revenue and borrowing



Interest expense was just 5% of total spending, reflecting recent low interest rates. The Congressional Budget Office projects that interest expense will rise to 11.5% of total spending over the next 10 years as rates rise. Interest payments will rise to \$807 billion in 2029, compared with projected spending of \$4.5 trillion on the three mandatory programs.

Rising deficits over time - annual federal government deficit



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.

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 the coronavirus has brought on a slew of new deficit increase measures and slowed the anticipated growth. 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 many are relying on recent tax cuts, government loans and subsidies, and bailout packages, 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.

Past performance does not guarantee future results. Diversification does not guarantee a profit or protect against loss in declining markets. Special risks are inherent in international investing, including those related to currency fluctuations and foreign political and economic events. Investors should understand the risks involved in owning investments, including interest rate risk, credit risk and market risk. The value of investments fluctuates, and investors can lose some or all of their principal.