Rising federal deficits and debt

What you need to know

Investment Strategy Team

After rising sharply in 2020 and 2021 in response to the COVID-19 pandemic, government spending is expected to continue to rise over the coming years, increasing the federal budget deficit and debt. As a result, some worry the debt is too big or could trigger another financial crisis.

While we acknowledge that the U.S. debt situation could create tough fiscal decisions down the road, we don't believe it poses a near-term threat to the economy.

Deficits and debt not a near-term threat

Total U.S. debt reached over $32 trillion and government spending reached 36% of total GDP in 2023, as the government provided fiscal stimulus to boost semiconductor research and clean energy production through the CHIPS and Science Act and the Inflation Reduction Act. These more recent stimulus measures were in addition to large amounts of fiscal stimulus in 2020 and 2021 to combat the coronavirus pandemic.

While the numbers are large, remember the U.S. is a large, wealthy country and can afford it. National income is also more than $22 trillion, but a more useful comparison is to the net wealth of the country, which rose to a record $135 trillion at the end of 2022.

The debt is essentially the sum of past deficits, and deficits are projected to grow rapidly. While it may require tough fiscal decisions down the road, we don't foresee the U.S. debt situation posing a near-term risk to the economy, and we're here to explain why.

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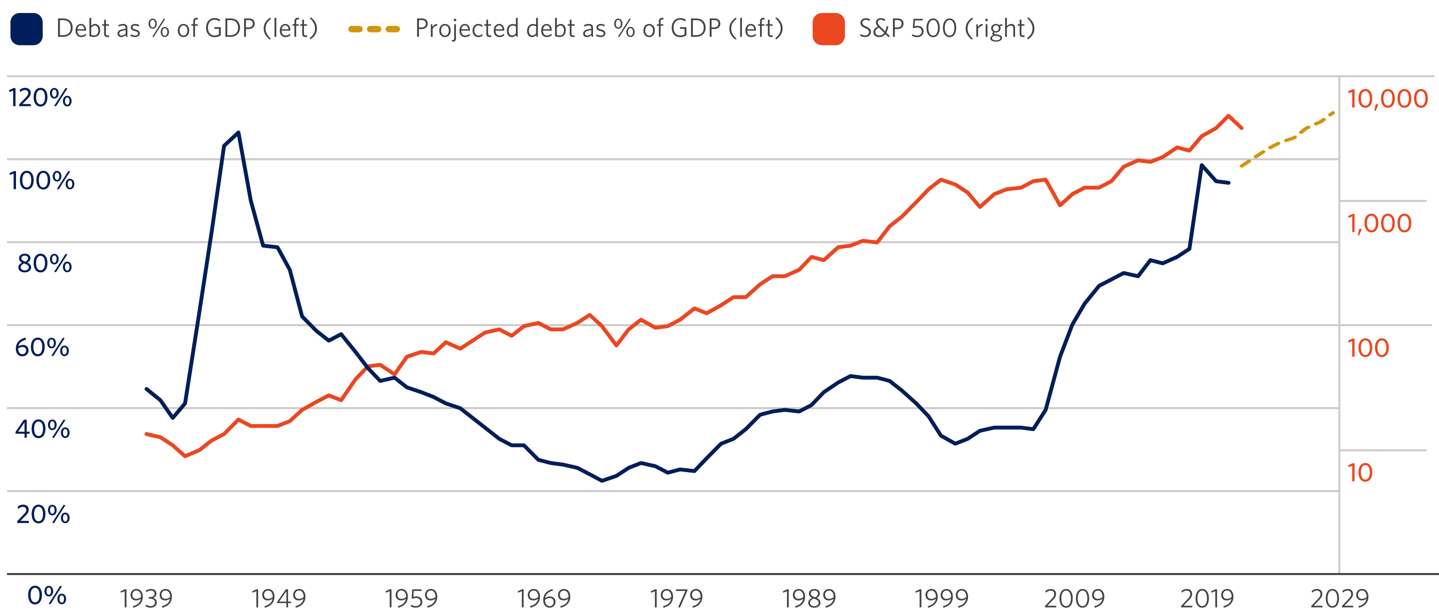
- **A resilient economy could help.** Despite calls for a U.S. recession to emerge in 2023, the U.S. economy has remained resilient, fueled by a resilient consumer and tight labor market. While we anticipate near-term growth to slow from above-trend levels, we don't foresee a deep economic downturn or recession.

  Modestly rising economic activity can reduce the prevalence of automatic stabilizers such as unemployment insurance, which in turn could lower government spending.

- **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 below 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 100% of GDP in 2024.

Stocks have increased with rising and falling debt



Source: FactSet, Federal Reserve Bank of St. Louis, Congressional Budget Office long-term budget projections, June 2023. The S&P 500 is an unmanaged index and is unavailable for direct investment.

- **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 also big. In 2022, net interest payments as a percentage of GDP were less than 2%.

  While this figure is projected to rise over the coming years, we don't believe the current U.S. debt situation creates a near-term risk for the economy. We would, however, acknowledge that if left unaddressed, rising federal budget deficits and debt could create problems further down the road.

- **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. Offsetting factors could be lower inflation and slowing economic growth. We expect inflation to continue lower toward the Feds 2% target and economic growth to slow from above-trend levels, which could support lower rates.

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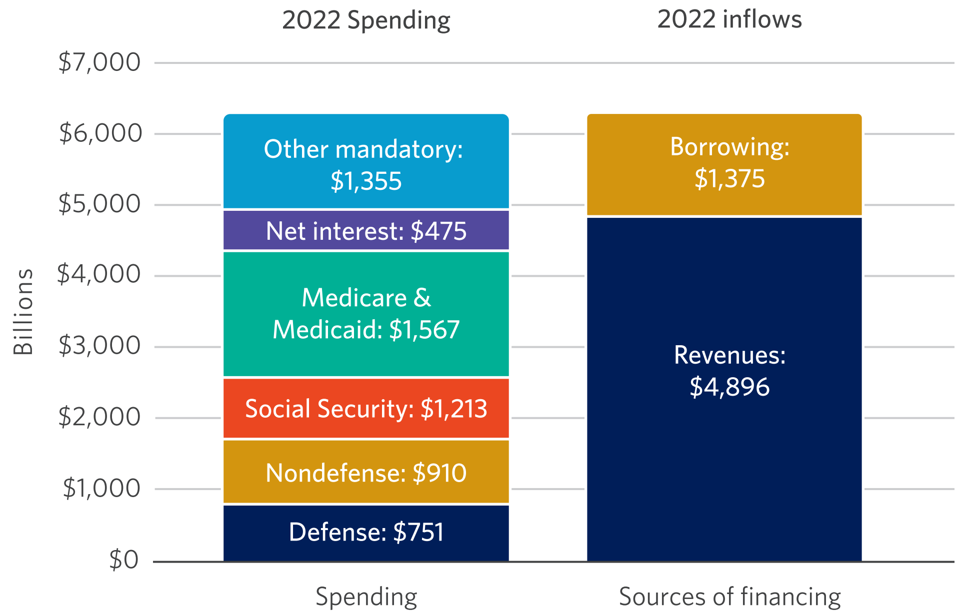
Crunching the growing deficit numbers

As this table shows, in 2022 the federal deficit (borrowing) was $1.4 trillion, or 5.5% 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.

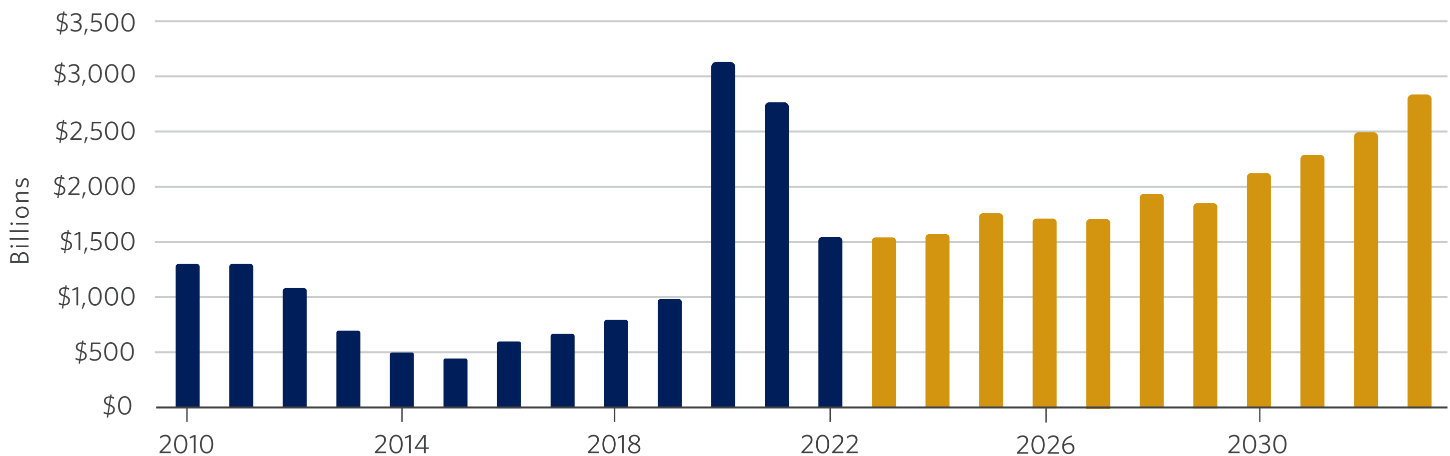
2022 U.S. government spending vs. revenue and borrowing



Source: Congressional Budget Office.

Interest expense was 7% of total spending and could continue to rise over the coming years as interest rates normalize after more than a decade of historically low rates. The Congressional Budget Office projects that interest expense will rise to 14.5% of total spending over the next 10 years. Interest payments are projected to rise to $1.4 trillion in 2033, compared with projected spending of $6.1 trillion on the three mandatory programs.

Rising deficits over time — Annual federal government deficit



Source: Congressional Budget Office.

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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?

Total federal debt surpassed $32 trillion in 2023 and is expected to continue to rise for the foreseeable future. While we don't believe the current debt situation creates a near-term threat to the U.S. economy, we do believe it will require difficult fiscal decisions down the road.

This could include adjustments to taxes and government spending, along with changes to entitlement programs such as Social Security, Medicaid and Medicare, though likely not for another decade or two.

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 economic growth potentially slows from above- to below-trend growth, the Fed enters the "last mile" of lowering inflation to its 2% target, and labor market conditions ease from historically strong levels.

As federal deficits and the debt rise over the next few years, calls to address them are likely to become louder, particularly with 2024 being an election year. 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 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.

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