Points to Ponder

May 19, 2023

The First Tee...

Near Sighted…financial markets are closely watching developments in the debt ceiling negotiations…but this is a short-term issue, the bigger problem is the long-term fiscal outlook:

- The Congressional Budget Office CBO) recently released some startling data…forecasting the government debt held by the public will increase by over 48% during the next ten years to $46 trillion:
  - Warning signs appear when debt is growing faster than the economy…the U.S. has been on this trajectory for quite some time, propelled primarily by an aging population and the rising cost of healthcare *(I can relate to that!)*
  - The ratio of public debt to GDP is on track to reach 98% this year, and rise to 118% in 2033:
    - The CBO projections could be understated, as there are assumptions built into the numbers that may not pan-out:
      - These include the economy growing at an annual rate of 2%, and unemployment remaining under 5% for the next decade:
        - Also, some of the tax-cuts passed in 2017 will expire (as required by law) in 2025, and not be renewed.
- **Bombs Away**…the U.S. debt keeps moving the country closer to a "debt bomb" scenario:
  - A debt bomb occurs when a country's obligations become so large it must borrow just to service the debt and interest payments…in theory, resulting in interest rates increasing and more government debt accumulation:
    - **The dept pain train**…the only way to break-out of the debt spiral is a sharp increase in taxes, with equal decline in spending:
      - Higher revenues could help alleviate the debt problem, but history has shown a boost in tax receipts is unsustainable:
        - The CBO estimates that federal revenues averaged 17.4% of GDP from 1974 to 2022…2022 saw a surge in cash flows into government coffers with receipts totaling 19.6% of GDP, as asset prices and corporate profits posted large gains in a post pandemic surge:
          - Estimates for federal revenues over the next decade are targeting an average of 18.1% of GDP by 2032…well behind the pace of debt appreciation.
        - Closing the deficit gap with revenues alone would require an unprecedented increase in tax receipts.
      - The other unsavory alternative devolves into the government defaulting…*which amazingly, some in Congress are currently considering.*
  - In 2022, federal interest payments amounted to 1.87% of GDP…the highest level in the past 20 years:
    - The inflation spike over the past year has raised new challenges for the government to service its expanding debt:
      - Federal interest payments are on track to reach 3.6% of GDP in 2033 and 6.2% in 2044…twice as high as the historical peak.
  - In 2001, federal government spending as a percentage of GDP stood at 17.7% (down from peak of 22.9% in 1983):
    - Despite two decades of low inflation growth, government outlays to GDP have steadily risen…**projected at 23.7% this year**:
      - CBO forecasts the spending to GDP ratio at 25.3% in 2023, and 29% in 2044 (which are conservative estimates versus other predictions):
        - If the forecast is close to accurate, the U.S. will become vulnerable to a debt-bomb scenario with-in the next 10 to 20 years.
- **Reality Check**…the current debt ceiling confrontation is not focused on fiscal sustainability:
  - Both parties have their agendas…the Democrat's platform is for unlimited public spending, but without a desire to raise taxes for a majority of the populous…while Republicans embrace spending cuts, but not a reduction in budget deficits:
    - The higher level of inflation increases the cost of entitlement programs and debt service more than revenue adds:
      - Certainly, continuing to kick-the-can down the road on the rising costs of entitlement programs is unsustainable.
  - The premise that a sovereign debt crisis is not an issue for the U.S. because it is the world's reserve currency and we print our own money, overlooks the collateral damage from a government default:
    - Besides the economic risks of higher inflation and interest rates, the country becomes increasing vulnerable to geopolitical pressures as we depend on other nations to finance our debt (the dollar would lose its standing as the global standard):
      - The fallout in the financial markets would undoubtedly be on a cataclysmic scale…asset values could be depressed for extended periods
- **Thanks for Nothing**…in the long run, the lack of fiscal discipline will be most costly to the younger generations:
  - Standard of living levels will be lower as large personal debt loads limit ability to borrow:
    - The cost to borrow and the impact to discretionary spending will be negative due to high inflation and a weak dollar
  - When government debt is discussed, and trillions of dollars are mentioned, it is hard for most to grasp the value and size of the deficit…and the hardships it could cause in the future:
    - In 2007, the government debt totaled $9 trillion (62% of GDP), in just 15 years it has increased by 244% *(that's reality!*
      - The Debt Ceiling was originally established to insure congress remained fiscally responsible…obviously, that has not worked.

At the turn...

The Back Nine…

Trading Places…to shore-up the liquidity metrics in the $24 trillion U.S. debt market the Treasury Department will start to buy back its own bonds ***(taking from the left hand and giving to the right)***

- The ease of Treasury trades being executed are at their worst level since the pandemic
  - The recent banking crisis has pushed Treasury bond market swings to their largest in 40 years:
    - In mid-March, trading in Treasury securities surged to a record $1.5 trillion in one day (SVB declared bankruptcy on 3/17).
  - Market volatility has surged due to the impact of inflation and higher interest rates on bond values:
    - Large buyers of longer maturity Treasuries, commercial banks, foreign governments, and life insurance companies, have huge losses in the market value of their investment portfolio holdings…causing them to back away from Treasuries
      - Although the security losses were only paper (not realized), commercial banks are required by the Fed's supplementary leverage ratio (SLR) to set aside capital for mark-to-market Treasury values…banks with deposit runs, had to sell bond holdings to cover:
        - The Federal Reserve has also been reducing its Treasury holdings by $60 billion a month, part of its quantitative tightening program.
  - **The Fed is still the largest owner of U.S. government debt, with about $6 trillion in current balances.**
- **Old for New**…starting next year, the Treasury is planning to begin conducting regular buyback operations for liquidity support and cash management…with the intent to ease liquidity pressure in the market:
  - The program will purchase older securities and replacing them with larger current issues:
    - The action will retire some of the out of market coupon issues (large premiums and discounts) but is not intended to change the overall maturity profile of the marketable debt outstanding…**current duration profile is a record high 74 months**
      - The Treasury is currently proposing about $250 billion a year as the amount of securities designated to be swapped:
        - **Nothing New**…the Treasury has conducted buyback operations in the past, between 2000 and 2002 the purchases were undertaken to allow for the sale of new bonds to maintain market access when the federal government was running a rare budget surplus.
- **Wish List**…the Treasury has two main goals they are trying to achieve with the buyback program:
  - The first, is to support liquidity, which in-turn should help reduce market volatility.
  - The second, the employment of cash management strategies help balance the distribution of debt:
    - Such as during major tax collection dates where instead of slashing T-Bill supply, buybacks are executed instead.
- The action is hoped to incentivize traditional Treasury buyers back into the market.

19th Hole...

He that lives upon hope will die fasting.

Benjamin Franklin

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