Citi Global Wealth Investments

CIO Strategy Bulletin

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Debt and Consequences: Will Debt and Deficits Derail the US Recovery?

Key Takeaways

U.S. Debt and Deficits are Unlikely to Derail the Recovery: Is the pace of US Federal borrowing long-run sustainable? No. But will the US have an economic crisis and trigger a global economic crisis in the next decade because of Federal borrowing? We think it's unlikely. This dual view does not mean debt and government spending is "insignificant." Focusing resources on servicing the debt is an inefficient economic use. That does not mean that the US Treasury will be unable to refinance and grow its borrowing or that real interest rates will surge.

Global Confidence in US Bonds Remains High: Many long-run Federal debt metrics looked worse in 2020 when short-run US borrowing was also at its peak pace. Rates plummeted to record lows despite this. Then and now, the US dollar was strong and foreign confidence in US bonds high. Even after the Fed's strong tightening measures, US debt servicing costs are below 1990s levels. As such, the US is not at serious risk of default.

Do Not Wait for Household Debt to Sink This Recovery: The experience of 2007-2008 has observers on high alert for signs of excessive consumer borrowing. While components of US household debt have surged, broad private debt and household debt have been restrained, falling relative to GDP in recent years. Those looking for an economy-wide debt crisis may be distracted and waiting in vain.

Potential Portfolio Implications

For those seeking to stabilize portfolios, hedging costs in equity and credit markets remain historically inexpensive. For those that are under-exposed to equity and bond market investments, we'd look for pullbacks to consider reasonably-priced growth and income opportunities highlighted in our asset allocation (please see our latest Quadrant).

January CPI: More than a "Blip"

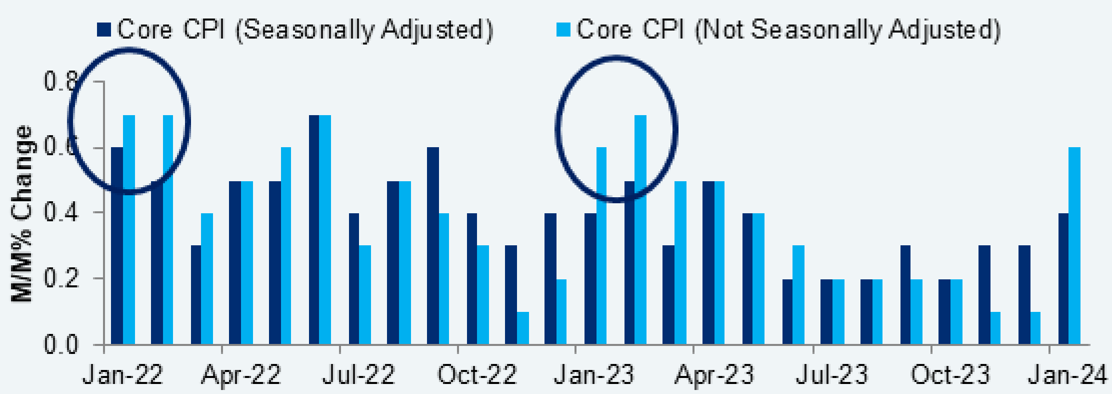
January's CPI report was "custom made" to interrupt the current bullish market narrative. The January CPI report was +0.3%, +0.1% above expectations for both headline and core inflation.

At the January 31, 2024, Federal Open Market Committee meeting, Jerome Powell said that the Fed needed "more good data" on the inflation front to gather enough comfort to ease monetary policy in coming months[1]. While one can exaggerate the impact of a single data point, the January CPI news doesn't fit his criteria. Current bond market optimism and policy context suggest we should treat it as more than a "blip" and that inflation progress will not be a straight line to 2.5% by year-end.

We think that the February CPI report to be released in March probably won't fit the criteria either. Seasonal patterns evolve through time. One that seems to be emerging are large, discrete, early-year price increases. In each of the last two years, core inflation measures matched their largest gains of the year in *both* January and February (**FIGURE 1**).

We would also not assume that inflation data will immediately resume slowing and give the "required comfort" to the Fed. In recent months, there were components of slowing inflation in the data that seemed excessive. For example, medical care services costs have been falling outright, likely because of distortions in the reporting of healthcare insurance costs.

FIGURE 1: US CPI Core Monthly % Change (before seasonal adjustment)



Source: Haver Analytics as of February 14, 2024. Seasonal adjustment is a statistical technique that measures and removes the influences of seasonal patterns and flows to reveal how economic data change from month to month. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Remaining Confident Inflation Will Decline in 2024

There are still large factors suggesting that 2024 will be a year of disinflation. In fact, we can easily imagine ***downside risk*** to our forecast for a 2.5% rise in the CPI by year end. Inflation could be less than expected. Known lags in US housing cost data are an upward distortion to current inflation measures. The lagged impact of tightening monetary policy and reduced loan demand on money supply correctly pointed to the disinflation in 2023. The same data suggests much more to come in 2024.

It is possible that another month of "hot data" will be ignored if markets believe corporate profits are rising even as inflation ebbs. But bullish markets are not known for patience. US Treasury yields have already risen about 40 basis points in the year-to-date. "Fear of missing out" in the equity market may, for a time, give way to plain fear.

[1] Source:. [Transcript of Chair Powell's Press Conference -- January 31, 2024 (federalreserve.gov)]

U.S. Debt and Deficits are Unlikely to Derail the Recovery

"I place economy among the first and foremost of virtues, and the public debt as the greatest dangers to be feared...To preserve our independence, we must not let our leaders load us with perpetual debt." Thomas Jefferson, 1816[2]

Long before there were concerns about climate change, pollution or nuclear proliferation, **debt** has served as the predominant worry stone for investors and voters.

Employment and profits may be growing, but "what about the debt?!"

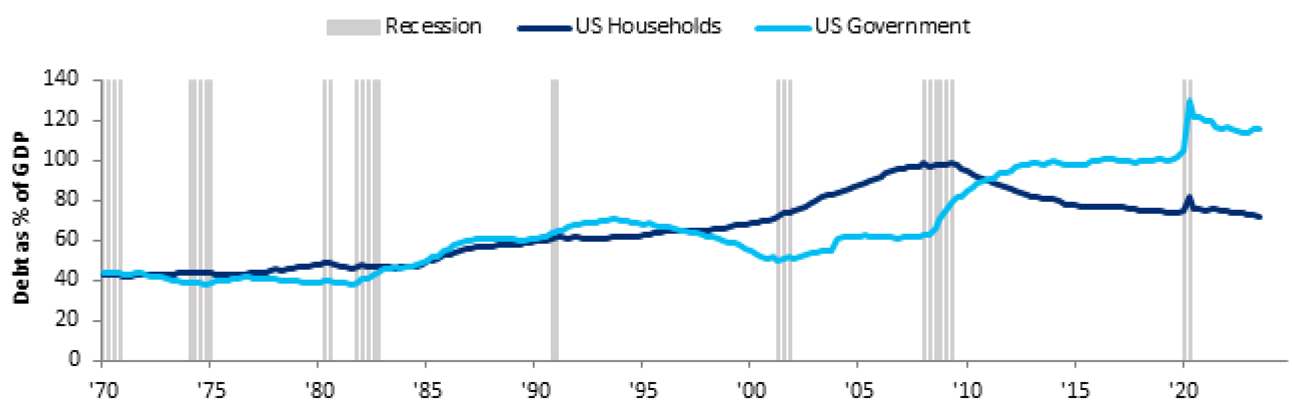
Can America afford to run deficits like this?

Debt crises do occur. There have been many sovereign defaults, generally among smaller economies borrowing in foreign currencies they don't control (most often the US dollar). In the US itself, the events of 2008 were undoubtedly a "debt crisis", but not at a federal level. Very poor lending standards for home mortgage borrowers unable to repay shaky housing investments plus highly leveraged bank balance sheets combined to crush the economy (see **FIGURE 2 & 3**).

There are many ways to look at debt issues. One is through the lens of households. Household debt has been falling as a share of GDP (**FIGURE 2**). One can cherry pick among weaker household debtors or components of borrowing that are rising quickly. As discussed below, the overall household balance sheet does not look particularly stretched.

Another lens if from a federal point of view. US government debt has been rising rapidly since 2008. The US Treasury is the world's largest debtor; however, it sources the predominant amount of funds domestically (77%) and the US Dollar serves as the world's reserve currency.

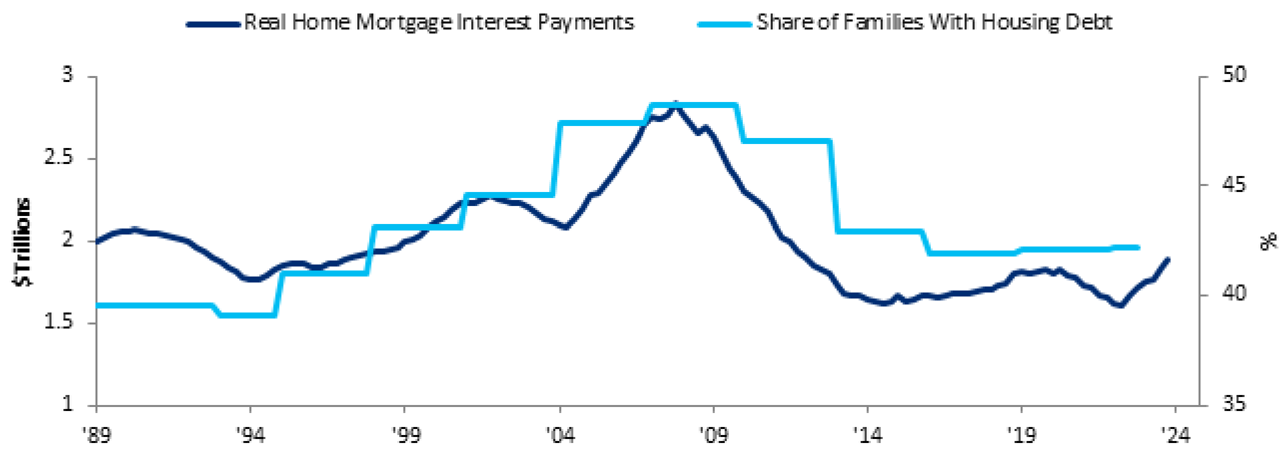
FIGURE 2: US Government and Household Debt as % of GDP



Source: Haver Analytics as of February 14, 2024.

[2] Source: Monticello, The Threat of Debt. https://www.monticello.org/the-art-of-citizenship/the-threat-of-debt/

FIGURE 3: Real Household Mortgage Interest Payments and share of US Households with Housing Debt.



Source: Haver Analytics as of February 14, 2023.

What drives debt? In the US, it is getting older.

Asked by members of Congress if the US Federal Debt is on a sustainable path, successive Fed Chairmen have answered definitively "no" since the time of Alan Greenspan. Official forecasts for federal liabilities show an increase faster than the economy is projected to grow over most of the 21st century. In that context, they answered correctly.

Over the last decade, the share of the US population over the age of 65 rose by 3.5 percentage points. In the next two decades, that share is projected to rise another 4.3 percentage points[3]. Nonetheless, the primary age trigger at which US healthcare benefits are paid has not changed since the Medicare System was established in 1965. That age is 65.

An aging population has a larger impact on US debt creation than other economies which generally cover or insure healthcare spending from birth. In the US, unlike other developed economies, the bulk of government support for healthcare spending is *age-triggered* rather than *birth-triggered.*

Driven by the world's most expensive healthcare costs per unit (according to The Organization for Economic Cooperation and Development[4]) and limited direct revenue collections for Medicare spending, the direction of spending for an aging US population has been "always up." Of course, we do not know what rising life expectancies will do for labor force participation and income tax collections. We also cannot predict if or when there will be changes in government policies.

A second major contributor to rising debt are pension expenses. Pension costs and the so-called "dependency ratio" of workers to retirees is a generalized global problem amid aging. The US has partially addressed this with adjustments to Social Security program age triggers. US federal healthcare spending is different. It is a *special US problem.*

Future debts are important to economic performance because Federal borrowing to pay for retiree healthcare and other costs compete for scarce savings. Real resources in the economy will be needed for healthcare consumption, military spending, and other priorities. Rather than debt finance future Medicare spending, savings might instead be used more productively by the private sector to grow the capacity of the economy.

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[3] Source is Bureau of the Census and Haver Analytics as of February 16, 2024.

[4] Source: The Organization for Economic Cooperation and Development, Health Care Prices, May 2020, https://www.oecd.org/health/health-systems/Health-Care-Prices-Brief-May-2020.pdf

Global Confidence in U.S. Bonds Remains High

What determines the cost of US borrowing? Interestingly, the periods of the largest immediate debt issuance – to support economic stabilization – generally occur during recessions. Therefore, short-term, and even long-term interest rates are *negatively correlated* with US budget deficits. Periods of economic weakness tend to be times when savers are risk averse and gladly add to low-risk fixed income holdings rather than allocate more to risk assets, pushing down yields.

In 2020, when US borrowing rose a record $4.3 trillion, US 10-year Treasury yields fell to a record low 0.5%. As the economy recovered, net borrowing fell to $2.4 trillion last year, while 10-year US Treasury yields rising to about 4% by year end.

This may seem like the magic of central banks, which do have enormous influence on yields. The Bank of Japan has been able to hold Japanese 10-year government bond yields below 2% since 1999. The experience of Japan highlights there is no threshold that is unsustainable for a government debt-to-GDP ratio. In example, Japan's government debt has nearly double the level of the US since 2000 (see **FIGURE 4).** This is not without economic cost; high levels of government debt can crowd out private investment and slow growth.

The Power of the Dollar

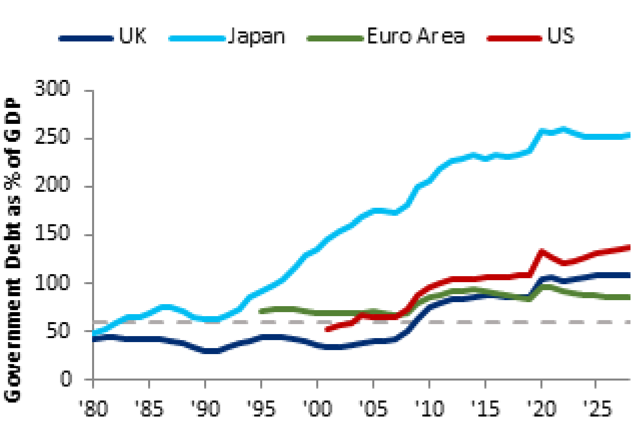
Having a high share of government financing from domestic lenders can be important. The foreign share of US Treasury debt financing has plunged as the Federal Reserve has held more debt on its own balance sheet for the past 15 years (**FIGURE 5**). However, the dollar's use as the world's reserve currency – with by far the largest share of global trade invoicing – is even more important. The US Trade Weighted dollar has remained close to a record high level. While the dollar has many challenges which we expect to build over time, its dominance is unrivaled.

History suggests that the Fed is limiting future borrowing costs for the US Treasury by maintaining the dollar's credibility. This is why servicing today's US Treasury borrowing – even after recent record issuance levels and higher interest rates – still falls below 1990s highs of Federal Revenue or GDP (see **FIGURE 6**).

One of the US dollar's great strengths is the Federal Reserve's commitment to low inflation. This is why the Fed is willing to periodically raise rates, force up government borrowing costs and mark down the value of the Fed's own bond portfolio. Higher inflation expectations would make real interest rates even higher, as experienced in the 1980s.

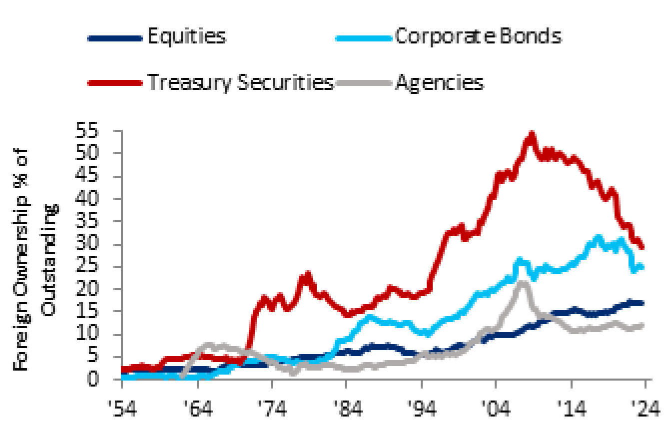
How the US Congress determines to spend, tax, and borrow in the future is an open question. Current law would leave a trajectory of rising spending and deficits relative to GDP in the decade ahead. However, **US budget projections that embed long-term interest rate expectations close to current levels seem plausible**.

FIGURE 4: Government Debt as % of GDP (Major Economies)



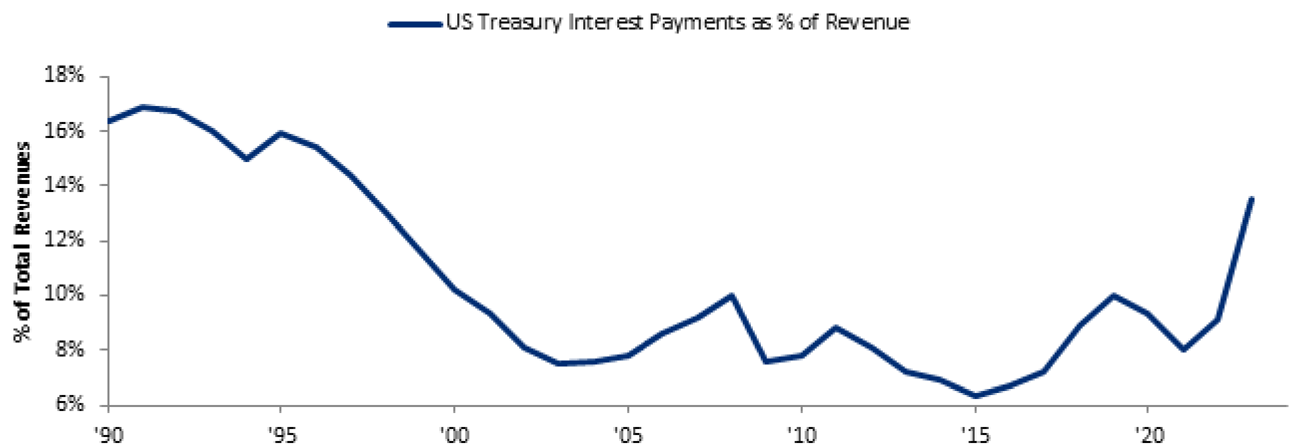
Source: Haver Analytics as of February 14, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

FIGURE 5: Foreign Ownership Share of US Securities



Source: Haver Analytics as of February 14, 2023 based on data from the Board of Governors of the Federal Reserve System.

FIGURE 6: US Treasury Interest Payments as % of Revenue



Source: Haver Analytics as of February 14, 2023.

A Remote Risk: The Debt Ceiling

Another unique feature of US borrowing is the existence of a statutory "debt ceiling." Enacted at the time of World War I, Congress must ratify its borrowing plans – including servicing existing debt – *after* making decisions to tax and spend. On occasion, a few US policymakers have threatened *intentional default* rather than raise the debt ceiling which has increased almost annually since the early 20th century. The threat of intentional default is political rather than a result of market forces. As such, it should be considered a remote risk to the world economy and financial markets.

Do Not Wait for Household Debt to Sink This Recovery

After hearing that the Federal Budget will not be an immediate catastrophe, we often hear fear about the buildup of credit card debt, and the risk of another consumer debt crisis. It is only natural with the memory of 2008 still relatively fresh, to fear growth in high-rate debt, but the consumer balance sheet is fundamentally healthier post pandemic than it was before.

Post housing crisis consumers have retrenched significantly and, with high inflation deflating debts, a generationally important reset of debt levels has occurred. The reality - in aggregate and from a balance sheet perspective - is that the pandemic, massive government cash infusions, and inflation were a gift to consumers balance sheets. High inflation and a stalled housing market and consumers' tendency to hold floating assets but fixed interest debts have driven up their net worth while driving debt to income ratios to the lowest level in 20 years (see **FIGURE 7**).

Real Estate Powers Household Balance Sheets Higher

For U.S. households, per the Federal Reserve, 70% of all debt is mortgage related. The combination of the frozen real estate market which has kept households from buying homes and tapping equity in current homes with large pandemic era increases in home values mixed with fixed (and on average very low) rates has driven the real estate backed debt to disposable income ratio to around 61%, down from 92% in 2008.

In aggregate households now have an over 70% equity stake in their homes, up from 46% in 2009. We tend to see this as forced savings, and likely not the equilibrium level of equity in housing. Once interest rates start declining and the mortgage market improves, it seems highly likely that households will increase their leverage in real estate, both taking cash to pay off high interest rate credit cards and simply purchasing more housing than is possible at today's available mortgage rates.

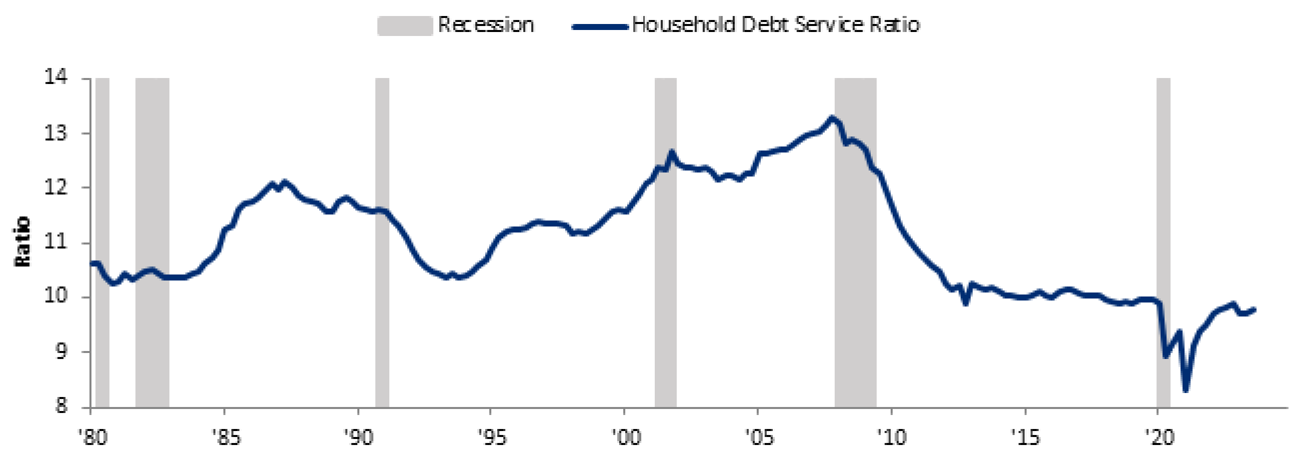
Watching Credit Card Debt

Consumer debt fears are not without basis. Credit card balances rose above $1 trillion in aggregate in 2023 for the first time ever while interest rates on credit cards have soared to above 22% a year (see **FIGURE 8**). Likewise, it is undoubtedly true that there are households who are struggling to make debt payments if their personal incomes have not kept pace with inflation more broadly. But these lower income households are not the core of consumer balance sheets that will drive economic performance and consumption in the years ahead.

There are pockets of debt which may have challenges, especially auto loans with used vehicle prices falling (-3.5% year-to-year in the January CPI release). But at just over 10% of consumer debt outstanding, these are likely of limited systemic importance. Finally, student loan balances have long been a scare point for the future consumption path of younger generations. But outstanding balances were eroded sharply by the combination of the temporary holiday on interest during the pandemic and high inflation, allowing the real debt outstanding to fall nearly 15% since 1Q 2021.

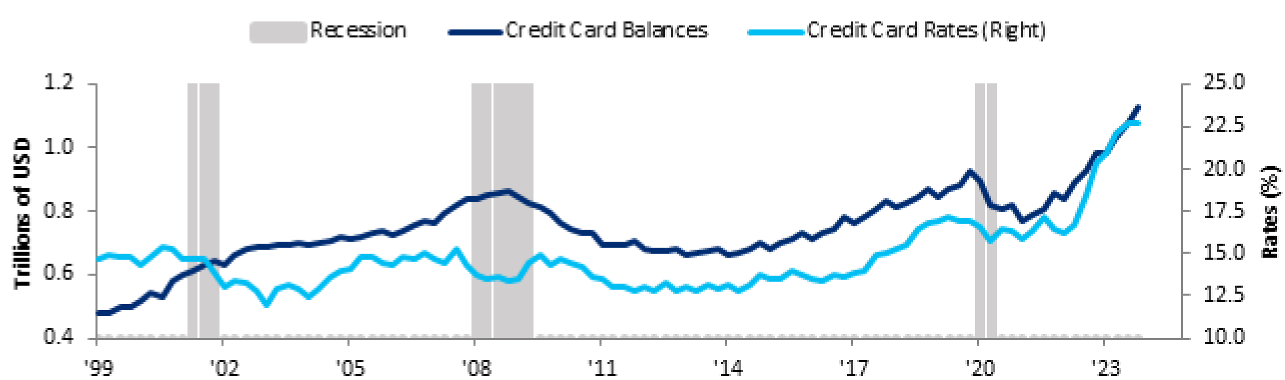
With inflation falling and the unlikelihood that mortgage rates hit their early pandemic lows again, it is likely that consumers will start to build leverage again in balance sheets. But that is fundamentally a sign of health and not a threat to the outlook from household balance sheets.

FIGURE 7: Household debt service ratio



Source: Haver Analytics as of February 14, 2024.

FIGURE 8: Credit card debt surpassed $1 Trillion for the first time in 2023



Source: Haver Analytics as of February 14, 2024.

No Near Term Threat

We can only touch on the vast subject of “debt and deficits” in this Bulletin.

It is quite clear that US policymakers and the public demand more from government than they are willing to give up in current resources. Yet, given the critical role the US plays in world finance, it allows the US government to grow debt further and shift the burden of financing to future generations of taxpayers. The cost of the debt in the coming decade is not likely to rise to extreme levels unless another, more credible borrower or borrowers competes more successfully for US and global savings.

The Fed is also a potent source of US credibility as evidenced by the US dollar’s enduring strength. Many other government borrowers would likely default before the US does.

With inflation falling and the unlikelihood that mortgage rates hit their early pandemic lows again, it is likely that consumers will start to build leverage again in balance sheets. But that is fundamentally a sign of health and not a threat to the outlook from household balance sheets.

It is inevitable for us all to see shadows of the last crisis everywhere, the 2008 financial crisis highlighted the dangers of excessive leverage and unsustainable debt payments in the household sector and there is a full cottage industry dedicated to building fear of the Federal debt situation. Ironically, there is much less energy spent on demonstrating the much more concrete and real risk to portfolios of overreacting to fears and missing the returns following the rare double reset in the stock and bond market in 2022.

While all events and risks cannot be anticipated far into the future, we believe a US government debt crisis is unlikely in the coming decade. As noted, this is not without economic cost; high levels of government debt can crowd out private investment and slow growth.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Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal rating are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Rating[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)			
Low grade (speculative)	Ba	BB	BB
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
2 The rating from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standings within the category.

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