The COVID-19 pandemic threw the world into convulsions and forced almost every government to aid its populace. In the U.S., three COVID relief bills (the $2.3 trillion CARES Act in March 2020, the $900 billion Consolidated Appropriations Act in December 2020, and the $1.9 trillion American Rescue Plan in March 2021) added over $5 trillion in fiscal expenditures over an eleven-month period. From February 2020, prior to the pandemic-related lockdowns to June 2021, a month of nearly full reopening, the U.S. Treasury increased its public borrowing by about $5.0 trillion. Total government debt (including $6.2 trillion of intragovernmental debt) stood at $28.5 trillion as of the end of June 2021. After the final revision, U.S. first quarter 2021 GDP stood at $22.1 trillion. At 129% of GDP, U.S. fiscal obligations may be attaining "vicious cycle" levels.

Some government officials and economists believe there is no problem with high levels of debt. Supportive arguments include insistence principal does not have to be paid back, interest rates are low and elevated debt is temporary. In our opinion, all of these fail to recognize a confluence of factors that enabled the debt splurge in the first place. In addition, on current trajectory, the government will likely be further increasing its debt load leading to two potentially catastrophic outcomes: 1) a loss of confidence from investors who will reduce their ownership of U.S. government bonds, and 2) a debt trap that perpetually burdens the U.S. economy, causing stagnation and deteriorating living conditions.

Federal Reserve's Role

Since the 2008-2009 recession, the Fed aided and abetted the federal government in the expansion of its debt. During most of the last thirteen years, the Fed provided some level of stimulus, led by accommodative short-term rates and complemented by quantitative easing. Prior to the economic crisis that commenced in 2008, the Fed's total assets were under $900 billion. After initiating quantitative easing in 2009, the balance sheet grew steadily through the end of 2014, when it reached $4.5 trillion. That growth phase included the famous "taper tantrum" in the first half of 2013 when the Fed unexpectedly announced a QE pause which led long term rates to spike higher. After 2014, the central bank's assets held relatively steady for a couple of years and began a gradual decline, leading to a low of $3.76 trillion in August 2019. As of the end of February 2020, the Fed's assets totaled $4.2 trillion. At the end of June 2021, the figure had nearly doubled to $8.1 trillion.

In essence, the central bank monetized the federal government's debt and financed around 70% of the government's pandemic-related incremental borrowing. The COVID-19 lockdowns necessitated extraordinary measures but, by definition, as extraordinary measures they should be of limited duration and followed by a plan for retraction. Thus far, away from assistance provided in the form of loans, little from the pandemic relief packages is expected to be paid back or recouped by future revenues. Adding to this, the current administration proposed another $4+ trillion in expenditures related to infrastructure and new entitlements. Infrastructure spending traditionally involves one-time spending and may on occasion produce revenues, while entitlements are evergreen and tend to expand leaving a permanent call on government resources. If all of the proposed spending comes to fruition, government debt will be on trajectory to exceed 140% of GDP within a few years.

Defenders of "new" economic thinking believe government resources should be used extensively to boost economic activity. Part of the logic places no limits on the central bank monetizing deficits. An ignored side-effect of these theories revolves around "moral hazard." A problem with subsidies and entitlement spending is that it is difficult, if not impossible, to withdraw. Quantitative Easing suffers from the same problem. Financial markets come to rely on the central bank's presence thereby internalizing levels of interest rates that conform with the Fed's targets. Any indication that the subsidies will end are met with increased volatility. In 2013's "taper tantrum," long interest rates rose about 70 basis points in a few weeks. Severe bond and equity market reactions generally affect financing conditions and quickly reverberate through the economy with negative consequences. It is instructive to observe the Fed never fully reversed its post-2009 government bond build-up, suggesting extraordinary policy measures were more permanent than advertised. These novel policy tools were then aggressively restored in the face of a new economic threat.

Excessive Government Spending

In a May 28, 2021 editorial, The Wall Street Journal chided the Biden Administration for a highly inflated $6 trillion budget that was proposed for fiscal 2021. The editorial mentioned that, if approved, the proposed level of expenditures will become the norm going forward. Spending of that magnitude would bring the federal government's share of the economy close to 25% from a more normal pre-Covid average of 19.4%. Such an outcome would be extremely troublesome from a debt level perspective, and a damaging constraint on the economy's dynamism.

To finance its desired expenditure extravaganza, the Administration proposes an array of tax increases. Should these materialize, they would have a deleterious effect on growth. Perhaps the more concerning effect on the economy in our opinion would be the transfer of decision-making on resource deployment from the private sector to the public sector. Governments are notoriously ineffective stewards of capital and infrequent leaders in innovation. By shifting over 5% of GDP to government bureaucracies, the Administration would likely initiate a lengthy period of economic stagnation.

A review of European governance may be instructive. In most Euro area countries, government expenditures as a share of GDP exceed 40%. Over the decade ending 2019, the average Euro area real growth rate was about 1.4%. For the U.S., the average was 2.3% even though that decade brought one of the slowest post-recession ten-year growth rates in history. For the decade ending in 2007, the U.S. grew at an average of 3.1% per annum, including the 2001 recession.

A widely held view posits that U.S. government securities will always enjoy global demand because, by comparison to European or Japanese government debt, the U.S. offers higher yields and security. Leaving aside the unhealthy role of the European Central Bank in the interest rate relationship, we should not forget the disruption bond markets experienced in 2011 when S&P downgraded the U.S.'s sovereign rating. With unchecked government spending and mounting debt, we think the assumption of U.S. supremacy in the government bond market may be questioned.

In a recent Wall Street Journal article, authors Marcus Walker and Peter Landers wrote about record amounts of debt issuance by global governments. The article included graphs citing IMF data which showed public debt of the 20 largest economies as a share of GDP at a record 125%. A separate picture showed average government bond yields at record lows. The article mentioned the new economic reasoning related to higher debts and deficits, especially in relation to perceived underspending after the severe 2008-2009 recession. Governments' ability to borrow is appropriately associated to excess savings linked primarily to aging populations. Limited connection was made to either the savings build-up from pandemic-related expenditure curtailments or the massive monetization of debt by lax central banks. The irony is that looking longer term, none of these sources of liquidity has the permanence needed to ensure a smooth retirement of the emergency borrowing.

Demographics and Fertility

Perhaps the most frightening concern related to the explosion of debt is demographic. The last time developed country debt reached current levels was during World War II. The culmination of the war brought with it needed reparations, a demographic explosion and an end to the armament related debt build up. The end of the pandemic is occurring under very different conditions, including a demographic retracement, slower longer term growth forecasts and debt permanence related to growing entitlements.

In a front-page article on May 23, 2021, the New York Times wrote about the world's demographic shifts. The first paragraph encapsulates the challenges, "All over the world, countries are confronting population stagnation and a fertility bust, a dizzying reversal unmatched in recorded history that will make first-birthday parties a rarer sight than funerals, and empty homes a common eyesore." The article goes on to discuss aging populations in China, Europe and the U.S. alongside continuously declining fertility rates in developed economies. These changes have meaningful implications for policy makers, including, on the positive side, reduced natural resource usage, more limited strain on the environment and more manageable child rearing and educational obligations. On the negative side, the ability of younger generations to "fund" the retirement of older ones diminishes. This is where the debt burden can become a serious problem.

Countries with older demographics tend to have slower growth rates. Logically, the burden of the elderly on healthcare, social security and family care tend to be larger and more resource intensive than child care. In addition, with fewer people making up the workforce, aggregate production falls. According to the article, on current trends, demographers expect a period of sustained reduction in global population by the middle of this century. It is hard to envision an economic dynamic by which smaller population cohorts can take care of both the requirements of the older generations and mountains of debt accumulated at a time of more favorable demographic composition.

Tax Policy

Prior to the pandemic, the U.S. was running deficits around 3% of GDP with a growing economy and near-record low unemployment. In part, the solid economic performance came from reductions in corporate taxes that made the U.S. a highly desirable business jurisdiction. Pandemic relief spending upended the modest deficits likely necessitating a search for revenues. With sizeable spending proposals, the current administration has focused its tax proposals on "the wealthy" and corporations.

While detailed tax proposals are not yet available, a central focus of the Secretary of the Treasury has been on global minimum taxes for corporations. Leaving aside the foolishness of all nations agreeing to cede a major economic policy lever to highly indebted developed nations, a successful outcome is not likely to raise significant revenues. In addition, the proposal to raise domestic tax rates will erode the competitive benefits the 2017 reduction gave U.S. corporations.

A cursory review of proposed tax rates illustrates the challenges and likely ineffectiveness of the corporate tax plan. Acknowledging corporations have sophisticated tax departments that allocate revenues in accordance with business objectives, we can look at four rates: The current and proposed U.S. federal corporate rates 21% and 28%, the proposed global minimum tax 15% and Ireland's corporate tax rate of 12.5% (one of the lowest globally). If domestic rates rise by 7%, corporations may transfer business to Ireland where they pay 12.5%. The global minimum tax would cost an additional 2.5%. Depending on how taxes were allocated, the effect of the domestic increase on government revenues would likely not be the full 7%. In fact, revenues to the IRS could conceivably decline. Large corporations are dutybound to minimize their taxes which might be a reason governments should focus their revenue-raising targets elsewhere.

Addressing the pandemic was necessary for governments around the world. However, taking advantage of emergency circumstances to implement a massive expenditure program may yield counterproductive results over the long term. The theory debts do not have to be paid back assumes the economy continues to grow at a healthy pace and government revenues remain strong. Also, debt levels in excess of GPD assume interest rates will remain low permanently. Adopting that assumption when the central bank is monetizing the debt will likely be challenged by markets. Should inflation remain high, economic activity fade and borrowing continues to grow, the U.S. economy could be in for a few challenging years.

July 15, 2021

GIA Partners, LLC

At GIA Partners, credit is in our DNA. We are a bottom-up credit manager who has managed credit portfolios in virtually every part of the world's fixed income markets as well as through some of the most severe credit events in history. Additionally, our investment team has the distinction of being among the first to recognize and actively invest in global high yield and emerging markets debt.

We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

Gloria Carlson
Director, Sales and Marketing
212 893-7835
gcarlson@giallc.com

Arnold West
Director, Institutional Sales
212 893-7815
awest@giallc.com

Important Information