Cougar Global Viewpoints

The investment implications of the ballooning U.S. budget deficit

OCTOBER | 2023

- The U.S. budget deficit and federal debt are expected to grow continuously.
- Rising deficits, debt burdens and political gridlocks could limit lawmakers' ability to respond if the economy stumbles.
- While there are not signs of an imminent crisis, the United States faces the risk of an erosion in confidence.
- Investors are ready to demand higher compensation for holding longer-term U.S. bonds.

After briefly narrowing to **$1.4 trillion** in 2022, or about 5.5% of the U.S. gross domestic product (GDP), the U.S. budget deficit for fiscal year 2023 widened to **$1.7 trillion**, or about 6.5% of GDP, according to the U.S. Congressional Budget Office (CBO). However, even without the $330 billion reduction in outlays for President Biden's student-debt forgiveness plan that the U.S. Supreme Court invalidated with a decision in August 2023, the true deficit for 2023 is about **$2 trillion**, or more than 7% of GDP. At a time when unemployment is below 4%, that's a very high budget deficit to run and a sign that something is wrong with U.S. fiscal policy. Typically, the budget deficit tends to narrow at the later stages of the business cycle, as tax revenues are strong and the government is not actively providing stimulus to the economy. Fiscal year 2023 is unusual in this respect, as the U.S. Treasury is dealing with providing funding for the administration's programs and support for the war in Ukraine while also dealing with a significant increase in interest expenses because of the rise in rates over the past two years. **Particularly alarming are the CBO forecasts that the sizeable U.S. budget deficit and debt are on course to rise continuously over the next decade and beyond.**

Why does a budget deficit matter? Persistently larger deficits add substantially to federal debt and increase interest payments on the debt. According to the CBO, federal debt held by the public will rise from 97% of GDP in 2022 to 98% in 2023. By 2029, debt is projected to climb to 107% of GDP, exceeding the historical peak of 106% reached in 1946, immediately after World War II. In 2053, the debt-to-GDP ratio is projected to soar to 181% and keep rising higher. These are very alarming numbers.

Governments cannot run high budget deficits and escape any negative repercussions. Fitch Ratings downgraded the long-term U.S. Treasury debt rating from AAA+ to AA+ in August, citing the widening fiscal deficits, growing debt burden, and the debt-limit political standoffs as reasons for the downgrade. The downgrade followed the debt-ceiling standoff two months prior that brought the United States close to a technical default. Fitch is the second ratings agency to remove the United States' top AAA rating, after Standard & Poor's did so in 2011, following a similar standoff.

The Treasury Department has been on a borrowing binge this year. To finance its deficit, it has issued a large amount of Treasury bills and coupon bonds throughout the 2023 fiscal year at a much higher rate than it has historically. This is happening at a time when the U.S. Federal Reserve is letting bonds run off its balance sheet as part of quantitative tightening. In addition, as the U.S. deficit continues to grow, a large amount of supply will likely be coming in the next few years and at rates higher than historical levels and also amid waning foreign demand.

So, deficits don't matter, until they do. However, there are no signs of an imminent crisis, and U.S. Treasuries are still generally considered to be the safest government debt in the world. **But reining in the deficit requires bipartisan compromise, which is increasingly important for a country like the United States that controls the world's reserve currency and has a strong global standing.** Continuously increasing budget deficits, accompanied by domestic political gridlocks, rattle the confidence investors have in a country's ability to manage its long-term fiscal challenges. **As a further complication, lawmakers might also feel their policy options will be more constrained if the economy stumbles.**

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Concerns about the U.S. fiscal outlook do threaten markets and the economy and prompt investors to demand higher term premia, that is, the additional compensation for the risk of holding long-term debt, even with U.S. debt, historically regarded as the safest. Both the term premium and low expectations for policy decisions have driven up yields this year. As a result, while Treasury bonds can continue to provide solid income, their ability to provide strong capital gains could be limited for a considerable period, barring an exogenous shock or a recession.

Final word: Rising budget deficits, debt burdens and political standoffs underscore the U.S. long-term fiscal challenges. That could prompt investors to settle on a higher term premium over time for the risk of holding long-term government debt.

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DEFINITIONS

The business cycle is the periodic growth and decline of a nation's economy, measured mainly by its GDP. It has four main phases: expansion, peak, contraction, and trough.

Coupon bonds are bond that pay interest – the "coupon" – at regular intervals based on their stated interest rate during the years before the bond matures. At their maturity dates, the bond's also return to investors their principal value. There are bonds – zero coupon bonds – that don't pay any income during the life of the bond. Instead, all their returns, as well as their principal value, are delivered to investors at maturity date.

The debt-to-GDP ratio is the metric comparing a country's public debt to its gross domestic product (GDP). By comparing what a country owes with what it produces, the debt-to-GDP ratio reliably indicates that particular country's ability to pay back its debts.

Default occurs when the issuer of a bond fails to make interest or principal payments to bondholders within the period specified for those payments.

Fiscal policy is a term used to describe the use of government spending and taxation to influence the economy, particularly macroeconomic conditions such as inflation, employment, economic growth and aggregate demand for goods and services. Fiscal policy is often used to stabilize the business cycle and regulate economic output by adjusting spending and tax policies to make up for the shortfalls of the private sector.

Gross Domestic Product (GDP) is the total value of goods and services provided in a country during one year.

Quantitative tightening, also known as quantitative tapering, refers to the attempt by central bankers to reverse the effects of quantitative easing (QE), which is a form of unconventional monetary policy in which a central bank purchases longer-term securities from the open market to increase the money supply and encourage lending and investment. In quantitative easing, buying securities adds new money to the economy, and also serves to lower interest rates by bidding up fixed-income securities. It also expands the central bank's balance sheet. In quantitative tightening, reducing those purchases is a policy primarily aimed at interest rates and at influencing investor perceptions of the future direction of interest rates.

A reserve currency is a foreign currency that is held in significant quantities by central banks or other monetary authorities as part of their foreign exchange reserves. The reserve currency can be used in international transactions, international investments and all aspects of the global economy. It is often considered a safe-haven currency.

The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

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Cougar Global Investments is a global macroeconomic asset allocation manager that believes the goal of investing is to achieve compound annualized returns for clients. We use a disciplined portfolio construction methodology combining post-modern portfolio theory and risk management to pursue our clients' objectives.

ABOUT RAYMOND JAMES INVESTMENT MANAGEMENT

Raymond James Investment Management is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our boutique investment managers – Chartwell Investment Partners, ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. We believe providing a lineup of seasoned, committed portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

To learn more about Cougar Global's strategies, philosophy and capabilities visit cougarglobal.com or call 1.800.521.1195.

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