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Market Memo

Research and Insights

The Impact of a Rising US Deficit and Over $30 Trillion in Government Debt

For years, we have heard that the US needs to be careful regarding its debt levels, with a key contributor being an ever-increasing deficit. How will we know when a country is nearing the end of its long-term debt cycle? How do countries, over time, find themselves in a debt crisis? In 2018, I was researching how to overcome the correlation problem apparent in traditional asset allocation theory. (I have detailed the correlation problem in previous memos.) I was reading anything and everything related to economic history, such as “Why Empires Fall” by Peter Heather and John Rapley, and “This Time is Different” by Ragoff and Reinhart. During this time, a new three-book series called, “Principles For Navigating Big Debt Crises” was released by Ray Dalio. Ray retired from Bridgewater Associates, the largest and one of the most successful hedge funds in the world, last year. When I first entered the Financial industry, I heard Dalio give a talk at an economic forum where he shared what he believed was the reason for his firm's success, which boiled down to studying history and working toward understanding how the “Economic Machine” works. He believes in identifying principles that are timeless and universal. From that point on, I adopted this philosophy and continue to work toward identifying cause-and-effect relationships between economic variables, many of which I have shared with you through market memos. I went back through my research files on short- and long-term debt cycles and thought sharing this framework with you was timely.

A Step-by-Step Framework for Understanding the Long-Term Debt Cycle

1. **Short-Term Debt Cycles Build Up Over Time**
   Economic activity ebbs and flows in short-term debt cycles (typically called the business cycle and lasts around 7-10 years on average). Borrowing and lending expand in booms and contracts in recessions. These cycles are manageable, but their cumulative effects lay the groundwork for the long-term debt cycle.

2. **The Accumulation of Debt**
   Over decades, governments, businesses, and individuals have accumulated debt, often outpacing the ability to service it sustainably. Debt grows relative to income and GDP, signaling the early stages of a potential long-term issue. A key measure to help identify this issue is monitoring the growth rate of debt versus the growth rate of income. If debt grows faster than income, eventually, your ability to pay back what is owed becomes difficult, and you must spend less to pay what is owed.

3. **Debt Saturation**
   Debt levels reach a tipping point where servicing the debt consumes a significant portion of income, crowding out other economic activities. This constriction stifles growth and amplifies financial instability. (Deficit to GDP ratio chart below)

4. **Decreased Investor Appetite for Debt**
   Governments must sell bonds to finance deficits, but when investor demand declines, bond prices drop, and interest rates rise. This creates a feedback loop of increasing costs for new debt issuance.

5. **Central Bank Intervention**
   To stabilize the system, central banks often resort to printing money. This increases liquidity but risks devaluing the currency and sparking inflation.

6. **The Crisis Point**
   A "financial heart attack" occurs when debt service obligations overwhelm an economy, leading to drastic measures such as debt restructuring, currency devaluation, or implementing extraordinary taxes and capital controls.

7. **Deleveraging**
   Economies enter a phase of deleveraging, where debt levels are reduced through a combination of inflationary policies (money printing) and deflationary measures (spending cuts or defaults). This process is painful but necessary for restoring balance.

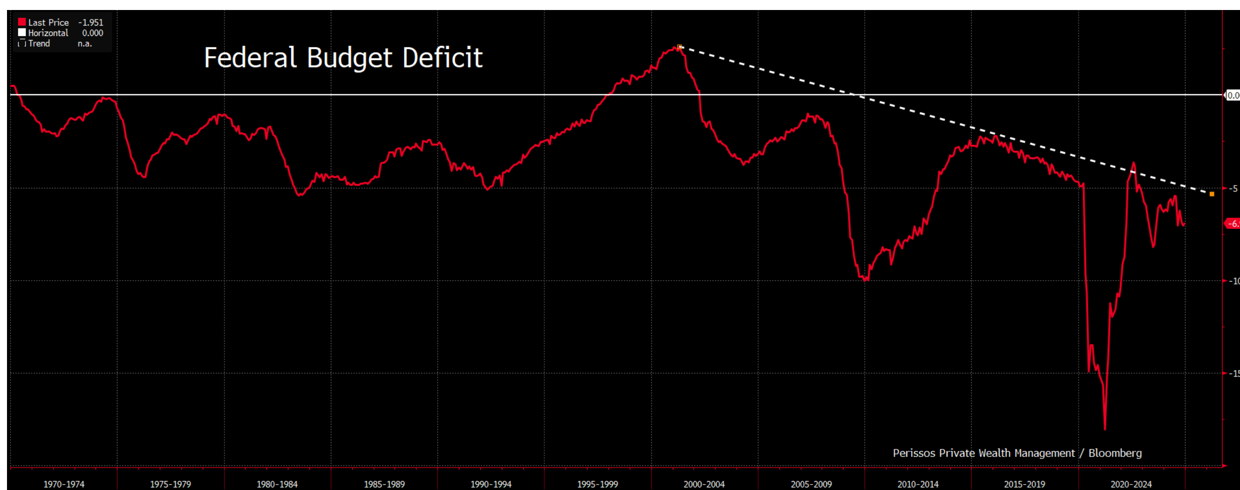
8. **Restructuring and Rebalancing**
   Countries restructure their debt, adjust fiscal policies, and implement reforms to regain investor confidence and stabilize their economies.

9. **Recovery or Stagnation**
   Successful deleveraging leads to economic recovery and the start of a new cycle. Failure results in prolonged stagnation or systemic collapse.

The Current Situation in the USA

Accumulation of Debt

The U.S. federal debt has ballooned, with the Congressional Budget Office (CBO) projecting deficits of 6% to 7.5% of GDP in coming years. High deficits are occurring even during favorable economic conditions, leaving little room for maneuvering during downturns. Below is a chart showing the Deficit as a percentage of GDP. The white line represents a balanced budget, and anything below the white line represents how big the deficit is compared to GDP. We currently sit at about -7%, which means the deficit is consuming roughly 7% of GDP. A deficit this large is unsustainable and needs to be cut roughly in half.



Debt Saturation and Service Costs

Rising interest rates exacerbate the cost of servicing debt. With interest payments consuming a growing share of government revenue, critical investments in infrastructure, defense, and social programs are being squeezed.

Decreased Global Appetite for U.S. Debt

Foreign holders of U.S. Treasuries, already wary due to geopolitical tensions and monetary policies, are showing declining interest in U.S. bonds. This trend threatens to destabilize the Treasury market, the backbone of global finance. When deficits grow too large, and investors feel they will be paid back in a depreciated currency, they start selling their bonds. What happens is that the supply (the amount of debt/bonds that need to be issued) is greater than the demand for those bonds. In order to increase demand for the bonds, interest rates must rise.

Central Bank Challenges

The Federal Reserve faces a difficult balancing act. Tightening monetary policy to combat inflation risks exacerbating a debt crisis, while loosening it could devalue the dollar and undermine investor confidence. As mentioned above, interest rates rise when supply is greater than demand. If interest rates rise fast, Central Banks could be forced to step in and purchase bonds in the open market to keep interest rates from rising too high. This can create a situation where the Central Bank's purchase of bonds increases the amount of money in the economy, which is inflationary, creating a spiral of higher rates and higher inflation. When this occurs, Central Banks face the same issues as commercial banks: the interest rate they must pay out is higher than the interest rate they earn on the bonds they purchased. This creates a large negative net worth on the Central Bank's balance sheet. When the Central Banks buy a lot of debt, it lowers the value of the debt because it lowers the value of the money that the debt is promised to receive. This is where keeping an eye on the Central Bank's balance sheet gives insight into whether a country is struggling with too much debt. **Currently, the Fed has brought inflation down near its target, but if the demand for US debt diminishes, the Fed may be faced with a tough choice between keeping inflation in check or letting interest rates rise sharply. That is why getting the deficit down is so important.**

Signs of a Tipping Point

Indicators such as rising yields on long-term U.S. Treasuries, political gridlock over fiscal reforms, and reduced foreign demand for bonds suggest the U.S. is nearing a critical stage in the long-term debt cycle. **Keep in mind the long-term debt cycle is measured in decades, not years. This framework is not meant to suggest that a debt crisis is imminent. The average long-term debt cycle is typically around 70-80 years, give or take a decade.** There is still time for the government to correct the situation and reduce the deficit to a more reasonable level. We will discuss what can be done next.

Pathways Forward

- **Reduce the Deficit:** A target of reducing the deficit to 3% of GDP is essential for stabilizing the debt-to-GDP ratio. This would require a mix of spending cuts, tax increases, and possibly new revenue streams such as tariffs. I have not been a fan of blanket tariffs, but I can see where targeted tariffs can help reduce the government deficit. Adding tariffs to China's steel imports, where they are known to have been dumping massive amounts into the US, has been shown to be beneficial.
- **Monetary and Fiscal Coordination:** Cooperation between the Federal Reserve and Treasury is needed to balance fiscal tightening with monetary easing. Historical examples, like U.S. policies in the 1990s, demonstrate the potential for success. **From about 1992 to 1998, the balance between fiscal policy, which is deflationary as the government spends less, and monetary policy, which is inflationary due to lower interest rates, kept the economy humming along as the deficit was reduced at the same time.**
- **Encourage Economic Growth:** Policies fostering innovation, education, and infrastructure investment can expand the GDP base, making the debt burden more manageable. Debt is only bad when it is used for unproductive uses. Lavishly funding entitlement programs is not a good use of Government resources. The people receiving money from the government who are capable of work are unproductive and provide no value to the economy. If you sit at home on the couch but are able to consume, your consumption must be paid by someone else; right now, that is tax dollars and government debt.
- **Address Political Instability:** Bipartisan agreements are necessary to restore confidence in U.S. governance and reduce fiscal risks.

While this may sound a bit doom and gloom, that is not the intention. The intention is that this is the reality of how cycles work, not just for the US but for all countries. How they are handled makes all the difference. As of now, that seems to be a top priority with the current administration. One of the reasons for DOGE is to reduce government spending and

inefficiencies. There are many theories as to what lowering taxes or increasing tariffs will do to an economy. Much of it depends on balancing inflationary decisions versus deflationary decisions. **To be clear, a US debt crisis is not on the horizon as of now. The US has the privilege of being the world's reserve currency, giving it more lenient with its deficit. However, if debt and deficit growth continue at their current pace, the US will face a "come to Jesus" moment at some point in the future.**

We will continue to monitor the indicators to determine how well the government and central bank are handling the debt/deficit problem, and this will guide us in determining the appropriate asset allocation for portfolios. If debt continues to grow at its current pace, bonds become riskier to own. If the dollar begins to depreciate, real assets such as gold and commodities typically provide a hedge. As of now, the economy and employment are still strong, and while the new administration settles in, we can expect more market volatility as investors adjust to policy changes.

All my best,

Footnote & Disclosures

This framework draws upon the principles outlined by Ray Dalio, founder of Bridgewater Associates, in his extensive study of debt crises.

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