BARINGS INVESTMENT INSTITUTE

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LEADING THOUGHTS

How Long Can This Go On?

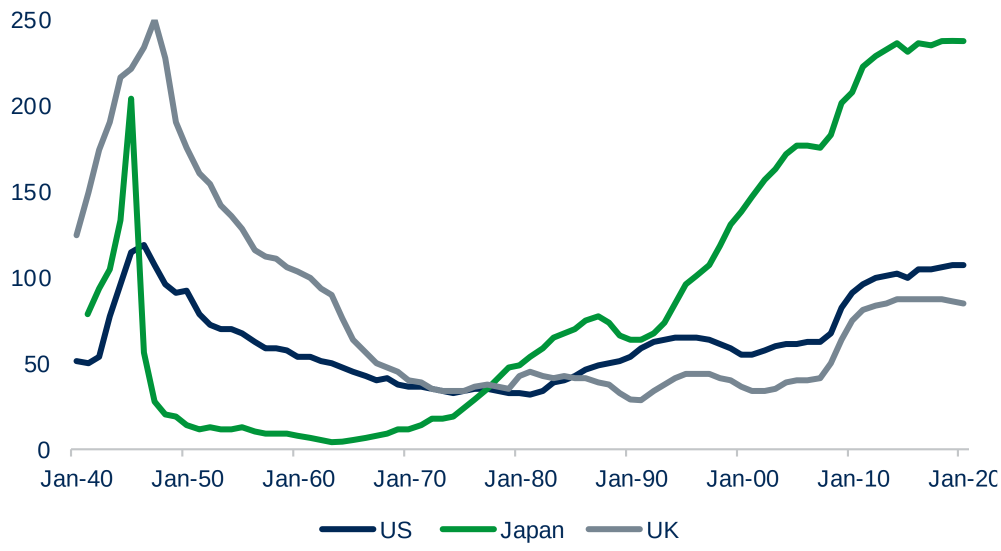
U.S. government debts may set new records, but investors should focus more on borrowing costs and growth rates.

There is no good time for a pandemic, but for the U.S. economy there are bad times and there are *really* bad times. If you want to feel a chill down your spine, just imagine "COVID-2008," with a housing meltdown and a banking crisis on top of the lockdown and recession. Or consider the terror of "COVID-1980," with inflation hitting 14% and the Fed's tools severely restricted.

These are more than haunting visions that trigger an investor's cold sweat; they are useful reminders of why even a few years of large U.S. deficits should—*should*—still be affordable. As any banker will confirm, the levels of a borrower's debt are less important than the affordability of the debt. And affordability for the world's largest economy depends as much on interest rates staying low as it does on America's business model delivering more growth and innovation than its advanced economy peers.

First, some numbers. The federal budget deficit may hit 25% of GDP this year depending on the size of the next stimulus packages to get through Congress, rivaling the levels during World War II. Overall debt held by the public may jump another 20%, also matching wartime highs.

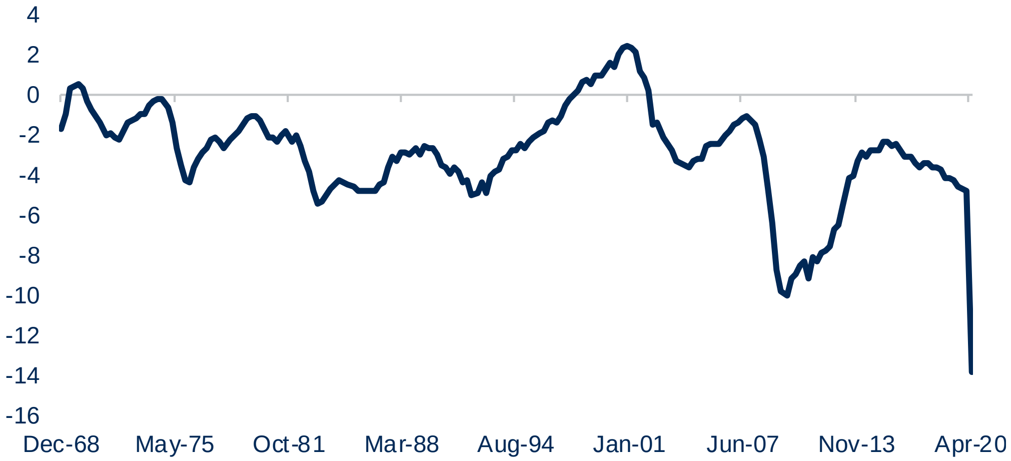
DEBT TO GDP (%)



Source: Bloomberg and Bank of England and IMF. As of July 23, 2020.

But debt as a share of the economy will not drop nearly as fast as it did in the 1950s and 1960s because growth will be slower and budgets won't balance. We also entered this crisis with a structural budget deficit near 5% of GDP, and neither Republicans nor Democrats are running on reducing it anytime soon. Even after pandemic costs are addressed, the United States faces large bills over the next decade to rebuild creaking infrastructure, cover health and retirement costs of an ageing population and mitigate the effects of climate change.

U.S. DEFICIT TO GDP (%)



Source: Bloomberg. As of July 23, 2020.

An investor holding U.S. bonds may reasonably ask, "how long can this go on?" The base case should be that the United States may well sustain these debt levels for a long time. There may be higher risks and a drag on growth, but the chance of ignominious defaults or cascading bankruptcies is likely low.

Some prominent economists have warned that countries face a potential crisis when debt exceeds 90% of GDP, citing "eight centuries" of case studies. Others point to Japan, where debt surpassed the size of the economy in the mid-1990s and is now closing in on 250% of GDP, as an example of what is possible in a country with large domestic savings.

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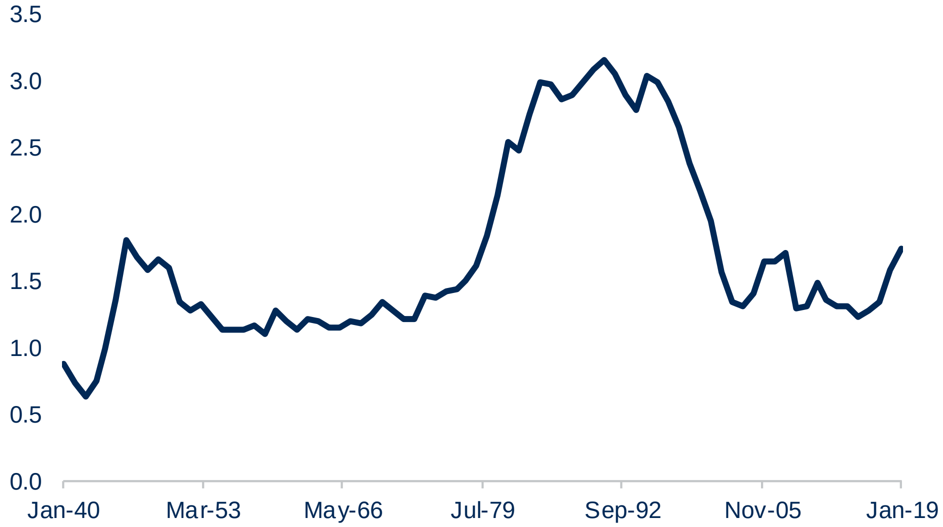
Most important for sustainability, of course, are low borrowing costs. In fact, for all its new borrowing through the crisis, the federal government's interest payments were actually lower in the first nine months of this fiscal year (October 2019 through June 2020) than they were a year earlier as bond yields fell.

Rates will rise as the economy recovers, but there is little reason to believe they will spike sharply. This is the silver lining to "secular stagnation" from the combined headwinds of technology, globalization, demographics and more. Low growth and low returns have delivered what Sebastian Mallaby of the Council on Foreign Relations calls the "Age of Magic Money," in which some large governments and their central banks can spend their way out of crises with little fear of inflation taking root.

DEBT SERVICE COSTS (NSA)



Source: Fred Data. As of July 23, 2020.

Note: Data only extends to December 31, 2019.

But it's not just the cost of the debt that must remain low over the next decade. Crucially, it is trust in the borrower's ability to repay. The math is not that challenging. If the economy gets back to just 1.5% growth, which is the low end of most forecasts, and the Fed delivers inflation close to its 2% target, nominal GDP growth would be 3.5%. If net borrowing costs remain at 1.5%, the debt ratio should shrink by about 2% per year.

If borrowing costs rise a little, then nominal growth will be higher, too. The greater immediate risk is that the Fed and Congress take their feet off the pedal before growth is firmly entrenched, but for now we'll have to take Jay Powell at his word that he is "not thinking about thinking about" raising rates.

Beyond ability to repay, of course, America's willingness to repay remains crucial, too. This may sound far-fetched after yet another crisis during which global investors flocked into dollar assets as the safest port in the storm. Amid the increasingly polarized election debate, it's often easy to overlook the trustworthiness of boring legal and regulatory institutions. It's also easy to forget the U.S. record of dynamism and innovation continue to deliver better long-term results than other advanced economies.

Recall that the United States lost its AAA rating from Standard & Poor's in 2011 largely because of political dysfunction. Market confidence may be far more vulnerable to legal and regulatory institutions becoming politicized, election results that look tainted and a political class that ignores global responsibilities.

These are the trends that should worry investors far more than the size of this year's deficit or next year's debt.

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*As of March 31, 2020

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