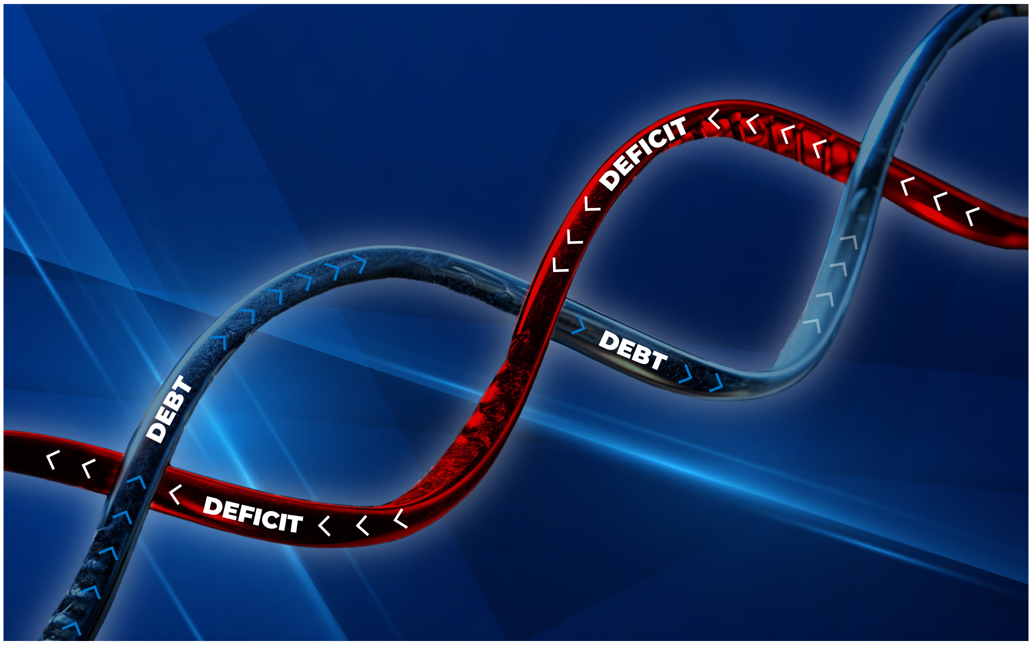
U.S. Debt Spiral Watch:

A Scenario Survey as Washington Drifts Toward a Reckoning

Ryan Kimmel, Analyst, Macro Asset Allocation | July 2024



In the first half of 2024, two prominent public financial institutions – the nonpartisan budget analytical center of the U.S. Congress and the world's largest lender to sovereign governments – publicly aired concerns over the fiscal health of the United States and the sustainability of its sovereign debt. DoubleLine, which tracks the evolution of America's debt and deficit spirals, last year began publicly sharing alternative scenarios under which these imbalances exceed critical thresholds. In light of recent rumblings at the Congressional Budget Office (CBO) and International Monetary Fund (IMF), Ryan Kimmel, Macro Asset Allocation Analyst at DoubleLine, shares the firm's latest thinking on the U.S. fiscal dilemma.

In the first half of 2024, two prominent public financial institutions – the nonpartisan budget analytical center of the U.S. Congress and the largest lender to sovereign governments – publicly aired concerns over the fiscal health of the United States and the sustainability of its sovereign debt. DoubleLine, which tracks the evolution of America's debt and deficit spirals, last year began publicly sharing alternative scenarios under which these imbalances exceed critical thresholds.[1] In light of recent rumblings at the Congressional Budget Office (CBO) and International Monetary Fund (IMF), this strikes me as a timely juncture to share DoubleLine's latest thinking on the U.S. debt dilemma.

The first major watchdog to bark was the CBO. In an update released March 20 to its long-term budget outlook, the CBO warns that the U.S. government is presiding over deficit and debt spirals that, unchecked, "would slow economic growth, push up interest payments to foreign holders of U.S. debt, and pose significant risks to the fiscal and economic outlook."[2] In case anyone missed the point, a few days later, CBO Director Phillip Swagel told the Financial Times that the "unprecedented" trajectory of the U.S. debt binge risked the kind of reckoning in the currency and debt markets that toppled the Truss government of the United Kingdom in 2022.[3]

On June 27, the International Monetary Fund (IMF) weighed in. In the organization's annual assessment of the U.S. economy, IMF staff warns, "The fiscal deficit is too large, creating a sustained upward trajectory for the public debt-GDP ratio. The ongoing expansion of trade restrictions and insufficient progress in addressing the vulnerabilities highlighted by the 2023 bank failures both pose important downside risks."[4] One news report at the time notes the "unusually harsh criticism" by the IMF "toward the U.S., its biggest shareholder."[5]

Notwithstanding these shots across Washington's bow from ordinarily collegial authorities, no echoes, let alone reform proposals, have come from America's leadership. No calls to action from the senior-most members of the House or Senate, Cabinet members or the presidential contenders in the Democratic and Republican parties. Investors, however, cannot afford complacency. It behooves risk managers to keep a weather eye on the U.S. deficit and debt spirals, and their possible trajectories toward thresholds that, if crossed, could force even Washington's hand to take draconian measures.

Keynesian Crossroads

Since its foundations were laid in the Great Depression in the 1930s and at the United Nations Monetary and Financial Conference held in Bretton Woods, N.H., in July 1944, the Keynesian school of economics has largely guided U.S. fiscal and monetary policy. As the IMF itself has worded it, Keynesian policy has employed "countercyclical fiscal policies that act against the direction of the business cycle." The U.S. government has alternately expanded deficit spending relative to gross domestic product (GDP) to stimulate employment and growth in economic downturns, and throttled back deficits "to cool the economy and prevent inflation when there is abundant demand-side growth."[6]

True to orthodox Keynesian form, the federal budget balance and unemployment rate moved inversely to each other into the middle of the last decade. The budget balance and labor market, however, have parted ways. *(Figure 1)* Since 2016, the federal government has run deep, persistent budget deficits despite robust economic expansion and low unemployment. As of late, the budget deficit hovers around 6% of GDP, a substantial figure, considering the U.S. economy expanded the past four years. *(Figure 2)* Not only do large deficits during growth periods reflect a troubling trend of government spending outpacing revenue generation, their persistence raises the danger of much deeper debt-funded deficits in the next and future recessions.

Federal Budget Balance and Unemployment Rate (Inverted)
As of June 2024

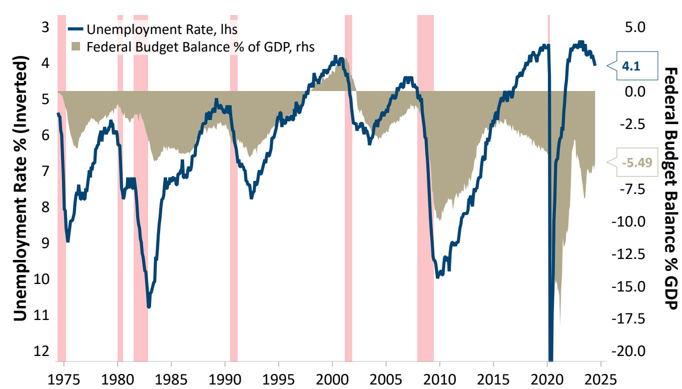


Figure 1
Source: DoubleLine, U.S. Bureau of Labor Statistics (BLS), Macrobond
Red shaded areas represent NBER U.S. recessions.

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Federal Budget Balance % GDP in Economic Expansion Since 1954 | As of July 2024

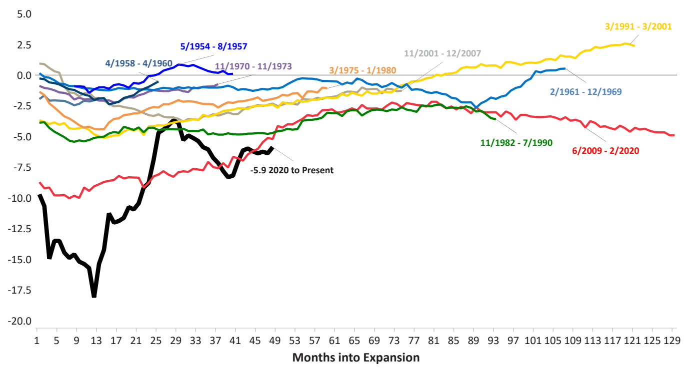

Figure 2
Source: DoubleLine, U.S. Treasury, BEA, Macrobond

Federal Budget Debt Held by Public and 10-year U.S. Treasury Yield | As of June 2024

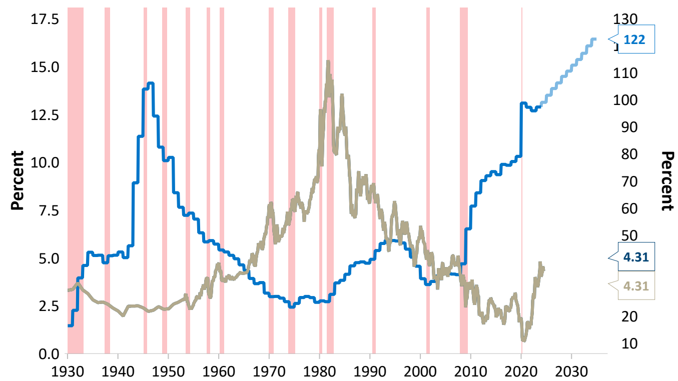

Figure 3
Source: DoubleLine, CBO, U.S. Treasury, Macrobond
Red shaded areas indicate recessionary periods.

Impact of Rising Interest Rates

One of the key challenges facing the U.S. fiscal landscape is the prospect of higher interest rates. In the aftermath of the Second World War, the U.S. faced similar debt levels as today. America, however, was able to work down its debt load thanks to low interest rates, averaging just above 3% from 1945 to 1965. With the combination of low interest rates and strong nominal GDP growth, averaging around 6% during the period, the U.S. was able to take the debt load from a peak of 106% of GDP in 1946 down to 37% in 1965 without recourse to painful restructuring. *(Figure 3)*

In contrast to the stable rate environment in 1945-65, interest rates have been on the rise since bottoming in 2020. Notwithstanding its enlivened concerns about the federal deficit and debt trajectories, the CBO seems optimistic on the outlook for borrowing costs. The CBO projects the average interest rate on outstanding federal debt to remain steady around 3.5% for the next 10 years with debt to GDP climbing to 122%. This benign interest-rate assumption would not be my base-case scenario. As of July 30, 2024, the entire U.S. Treasury yield curve is currently above 4%, and the Federal Reserve policy rate is above 5%. As in my previous public presentation on the federal debt dilemma,[7] in the present update I play out a simple exercise of taking the CBO's baseline budget projections and applying different and arguably more likely interest-rate scenarios. *(Figure 4)* I model hypothetical scenarios for the average interest rate on government debt of 4%, 5% and 6% over the 10 years ending 2034. This thought experiment projects U.S. debt-to-GDP levels to around 126% at 4% interest, 136% at 5% and 147% at 6% by 2034.

U.S. Federal Debt as Share of GDP | As of July 2024

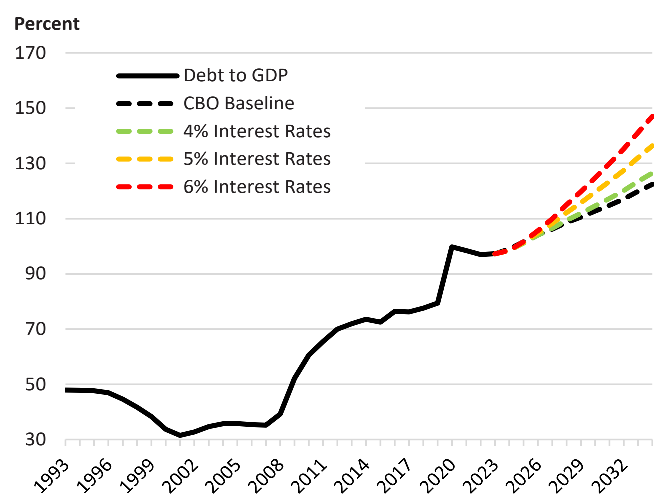

Figure 4
Source: DoubleLine, U.S. Treasury, BEA, Macrobond
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As interest rates increase, so does the burden of servicing the government's substantial debt. The CBO projects interest expense on the national debt will rise to 23% of federal tax revenue. Under my higher-rates scenarios, the interest expense climbs to terminal levels of 26% of federal tax revenues at 4% interest, 35% at 5% and 45% at 6%. *(Figure 5)* Neither the CBO projections nor mine, I should add, assume economic recession over the next 10 years. A recession would trigger higher deficits due to "automatic stabilizers," exacerbating the fiscal strain.[8] Modeling for the timing and severity of a future recession is beyond the ability of armies of economists, but it's safe to say, an unbroken expansion over the next decade is unlikely. After the end of the Second World War, U.S. expansions have averaged 64 months.[9]

U.S. Government Interest Expense as % Tax Revenue
As of July 2024

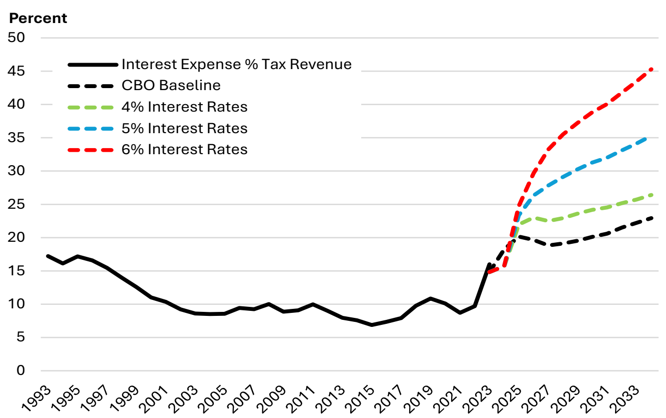

Figure 5
Source: DoubleLine, Bloomberg
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Negative Feedback Loop

The implications of higher government debt loads extend beyond fiscal metrics alone. Increased borrowing by the government can crowd out private investment, reducing the availability of capital for businesses to expand and innovate. The CBO estimates that for every additional dollar of deficit-financed spending, private investment decreases by 33 cents.[10] This decline in private investment would diminish the stock of private capital over time, suppressing economic output.

Reduced economic output, in turn, would lead to lower government revenues, compounding the deficit. Such a negative feedback loop further strains fiscal sustainability, perpetuating a cycle of increasing debt and reduced economic growth potential. Moreover, diminished private investment decreases the amount of capital available, pushing up the return on capital required by investors – potentially leading to higher interest rates on both private and government debt.

Paths to Fiscal Improvement

Amid these daunting fiscal realities, several potential avenues exist to mitigate the U.S. government's unsustainable fiscal trajectory:

Stronger Economic Growth: Enhanced productivity and sustained economic expansion could bolster revenue streams, alleviating some pressure on the federal budget. Policies aimed at fostering innovation, such as artificial intelligence, and increasing workforce productivity could yield long-term fiscal benefits. But this might be more of a hope than reality.

Federal Reserve Intervention: The Fed could consider implementing yield curve control measures akin to strategies deployed in the 1940s and 1950s. By manipulating interest rates across various maturities, the Fed could curb rising borrowing costs for the government, tempering the escalation of interest expenses. Recently, the Bank of Japan (BOJ) has deployed a similar tactic, with the central bank holding around 50% of total Japanese Government Bonds outstanding, indirectly monetizing Japan's exorbitant debt, which has ballooned to 250% of GDP. By comparison, the Fed holds around 17% of U.S. Treasuries outstanding. *(Figure 6)* However, it's unclear how this will end for Japan, and the Japanese yen has depreciated materially since the BOJ started implementing such an extreme policy.

Federal Reserve and Bank of Japan Holdings of Sovereign Debt as Share of National Debt Outstanding | As of June 2024

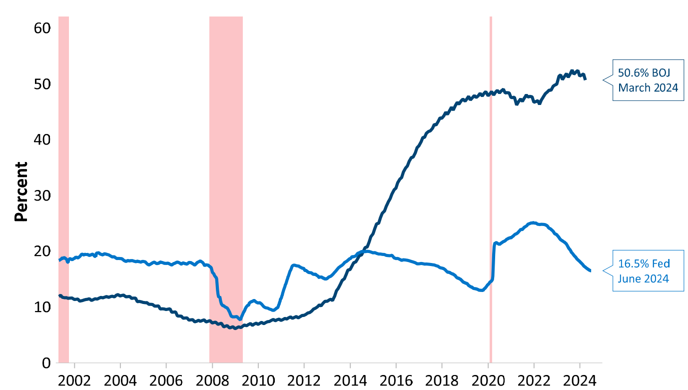

Figure 6
Source: DoubleLine, Fed, U.S. Treasury, BOJ, MOF, Macrobond
Red shaded areas indicate recessionary periods.

Fiscal Restraint: While politically challenging, exercising fiscal restraint remains a viable option. Restraint could entail reducing discretionary spending, reforming entitlement programs and increasing tax revenues through broad tax reform. Unpalatable though they might be, such measures are the sine qua non for restoring fiscal balance and safeguarding the nation's long-term economic stability. A key question is, will politicians act before U.S. debt dynamics unravel into an unsustainable condition for the economy?[11]

Financial Market Implications

The unsustainable fiscal trajectory of the U.S. government carries profound implications for global financial markets:

Higher Interest Rates: As Washington faces mounting debt service costs, higher interest rates could become a reality. This shift is likely to ripple through financial markets, potentially forcing bond yields and borrowing costs higher across various sectors of the economy. In fall 2023, we saw a flare-up of interest volatility stemming from fiscal concerns and market indigestion from absorbing elevated Treasury issuance. *(Figure 7)* The Fed at least is not oblivious to the connection. In remarks before the New York Economic Club on Oct. 19, 2023, Fed Chair Jerome H. Powell ascribed the recent spike in yields to a variety of factors, including high deficits.[12] The U.S. Treasury Department, however, was loath at the time to acknowledge a link between surging Treasury issuance and the rising term premium on government securities. With high yields persisting into the following week, Treasury Secretary Janet Yellen pushed back on market concerns that surging Treasury yields were driven by increased government borrowing to paper over the widening fiscal deficit. Speaking to Bloomberg News on Oct. 26, Yellen ascribed the surge in longer-term bond yields to a strong U.S. economy, not increased government borrowing.[13]

Weaker U.S. Dollar: Persistently high deficits and rising debt levels could exert downward pressure on the U.S. dollar. If the Fed were to embark on yield curve control, this could exacerbate the dollar's weakness, a similar dynamic we have seen play out in Japan with a weak Japanese yen as a byproduct. *(Figure 8)*

Stronger Gold: Historically, gold has served as a hedge against inflation and currency fluctuations. Heightened concerns over fiscal sustainability and potential currency devaluation could drive investors toward safe-haven assets like gold, boosting its price in the global market. We have already seen gold prices break out to all-time highs. *(Figure 9)*

U.S. Treasury 6-Month Net Issuances | As of July 2024

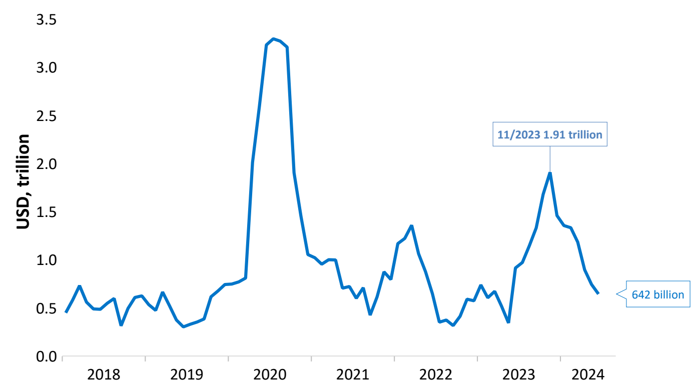

Figure 7
Source: DoubleLine, SIFMA, Macrobond

Bank of Japan JGB Holdings as Share of JGB Outstanding and USD/JPY (inverted) | As of July 2024

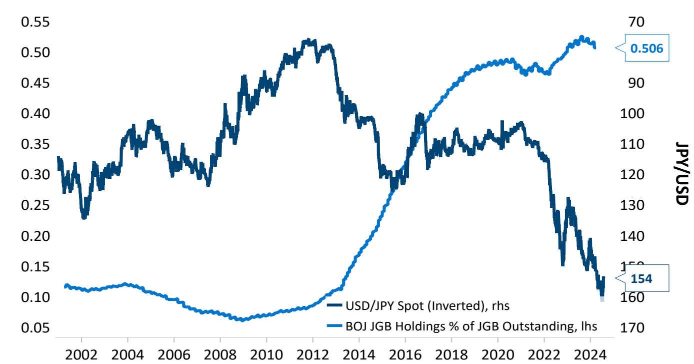

Figure 8
Source: DoubleLine, BOJ, MOF, Macrobond

COMEX Gold Future Price | As of July 2024

Figure 9
Source: DoubleLine, CME Group, Macrobond

Conclusion

The unsustainable fiscal trajectory of the U.S. government poses material risks to America's economic stability and long-term prosperity. With mounting deficits and escalating debt levels, timely action is needed to steer the nation onto a sustainable fiscal path. Consensus, however, is a rarity today in Washington, and serious acknowledgment by the political and policy leaders of the country's fiscal peril is almost nowhere in sight, let alone proposals for meaningful reform.

Financial markets are likely to react to these fiscal challenges, with potential implications for interest rates, exchange rates and asset prices. While we will hope for decision-makers to one day move to safeguard the U.S. economy, in the absence of such a day dawning, it is incumbent on asset managers to track the building storm signs and prepare for turbulence ahead. ■

About the Author

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Mr. Kimmel joined DoubleLine in 2013. He is an Analyst for the firm's Multi-Asset Growth Strategy. Prior to DoubleLine, Mr. Kimmel was a Proprietary Trader at The Gelber Group, trading currencies for the Foreign Currency Group. Prior to that, he was an Investment Banking Analyst in Morgan Stanley's Mergers and Acquisitions Group. Mr. Kimmel holds a B.A. in Business Economics from the University of California, Los Angeles, and holds an MBA from the Anderson School of Management at the University of California, Los Angeles.

Endnotes

1 The present paper, "U.S. Debt Spiral Briefing: July 2024" by DoubleLine Analyst Ryan Kimmel, is an update of prior outlooks on the U.S. deficit and debt spirals. See: "Rates Can Never Rise (Redux)," a presentation by DoubleLine CEO, Chief Investment Officer and Founder Jeffrey Gundlach at the Grant's Interest Rate Observer 40th anniversary fall investment conference, Oct. 18, 2023, https://doubleline.com/markets-insights/grants-40th-anniv-rates-can-never-rise-redux-10-3-23/, and "The Federal Debt Spiral," a presentation by Ryan Kimmel, Nov. 14, 2023, https://doubleline.com/markets-insights/the-federal-debt-spiral/. For another notable warning from the private sector, see "Central bank spending is like 'heroin' for households, says Jamie: JP Morgan boss says US economy is addicted to debt," The Telegraph, November 27, 2023. https://www.telegraph.co.uk/business/2023/11/27/central-bank-spending-heroin-jamie-dimon/ From academia, see "When Does Federal Debt Reach Unsustainable Levels?". Penn Wharton Budget, Oct. 6, 2023. https://budgetmodel.wharton.upenn.edu/issues/2023/10/6/when-does-federal-debt-reach-unsustainable-levels

2 "The Long-Term Budget Outlook: 2024 to 2054," Congressional Budget Office, March 2024. https://www.cbo.gov/system/files/2024-03/59711-Long-Term-Outlook-2024.pdf

3 Claire Jones, "US faces Liz Truss-style market shock as debt soars, warns watchdog: Fiscal burden on 'unprecedented' path, says independent Congressional Budget Office head," Financial Times, March 25, 2024. https://www.ft.com/content/c43cf841-174a-457f-92de-be2c44dbb440

4 For further insight into the unfolding regime change confronting developed market countries' decades-long dependence on debt-financed deficits, please see "Debt, currency and inflation crises – the U.K.'s object lesson for the G-7," an Oct. 18, 2022, Pensions & Investments guest column by my colleague Bill Campbell, head of DoubleLine's Global Sovereign Debt team. https://doubleline.com/wp-content/up loads/2022/10/UKs-Object-Lessons-for-the-G-7_Campbell-10-18-22.pdf

5 "United States of America Staff Concluding Statement of the 2024 Article IV Mission," International Monetary Fund, June 27, 2024. https://www.imf.org/en/News/Articles/2024/06/27/cs62724-united-states-concluding-statement-of-the-2024-article-iv

6 Eric Martin, "IMF Blasts US for Risky Deficits, Debt, Trade and Bank Rules," Bloomberg News, June 27, 2024. https://www.bloomberg.com/news/articles/2024-06-27/imf-blasts-us-over-risky-deficits-debt-trade-rules-and-banks

7 Sarwat Jahan, Ahmed Saber Mahmud, and Chris Papageorgiou, "What Is Keynesian Economics?," International Monetary Fund, Finance & Development, September 2014, Vol. 51, No. 3. https://www.imf.org/external/pubs/ft/fandd/2014/09/basics.htm

8 See "Economic Downturns: Effects of Automatic Spending Programs and Taxes," U.S. General Accountability Office, Nov. 16, 2023. https://www.gao.gov/assets/d24106056.pdf Excerpt: "The federal budget contains mechanisms—known as automatic stabilizers— that alter tax and spending levels in response to changes in economic conditions without direct intervention by policymakers. For example, in an economic downturn—when incomes and the employment level fall—tax liabilities may decrease, and more people may become eligible for certain government benefits, such as unemployment insurance and food assistance. Conversely, when incomes and the employment level rise, tax liabilities may rise, and fewer people may be eligible for government benefits."

9 US Business Cycle Expansions and Contractions, National Bureau of Economic Research. https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions.

10 "The Long-Term Budget Outlook Under Alternative Scenarios for the Economy and the Budget," p.6, Congressional Budget Office, May 21, 2024. https://www.cbo.gov/system/files/2024-05/60169-scenarios.pdf

11 In a 2023 study produced by Jagadeesh Gokhale and Kent Smetters, the Penn Wharton Budget Model found that sovereign debt loads of 170% to 200% of GDP have collapsed national economies. See "When Does Federal Debt Reach Unsustainable Levels?" Oct. 6, 2023. https://budgetmodel.wharton.upenn.edu/issues/2023/10/6/when-does-federal-debt-reach-unsustainable-levels

12 Jeanna Smialek, "Strong Economic Data 'Could Warrant' Higher Rates, Fed Chair Says," The New York Times, Oct. 19, 2023. Excerpt: "Mr. Powell pointed to several possible reasons behind the recent increase in long-term rates: Higher growth, high deficits, the Fed's decision to shrink its own security holdings and technical market factors could all be contributing factors." https://www.nytimes.com/2023/10/19/business/economy/powell-fed-interest-rates.html US Business Cycle Expansions and Contractions, National Bureau of Economic Research. https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions

13 Viktoria Dendrinou, Christopher Condon and Margaret Collins, "Yellen Says Yield Surge Is Due to Strong Economy, Not Deficits," Bloomberg News, Oct. 26, 2023. https://www.bloomberg.com/news/articles/2023-10-26/yellen-says-increase-in-yields-reflects-higher-for-longer-rates