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By Invitation - In a debtor's prison

America's debt cannot keep stacking up, says Jeffrey Gundlach

The "King of Bonds" sees the risk of a debt restructuring with global repercussions

ILLUSTRATION: DAN WILLIAMS

IN "THE SUN ALSO RISES", Ernest Hemingway's first novel, Mike Campbell, a jaded war veteran and inveterate drunk, is asked how he went bankrupt. "Two ways," he replies. "Gradually and then suddenly". America's government—like Mike, no stranger to serial binges and futile wars—is on its own way to bankruptcy. We have lived through the gradual part. Under the next few presidential administrations, the national debt will mushroom beyond the government's ability to service it, perhaps even beyond the credulity of the country's creditors. In the coming years expect dollar debasement, debt restructuring or both.

America's sovereign-debt spiral has been building since Washington embarked on large budget deficits in the 1980s. As the tab rose from about 30% of GDP towards 100% in the 21st century, the Treasury continued to find willing creditors. The dollar still rules as the world's reserve currency. Inflation and bond yields tracked lower for decades. And since 2008, under the anaesthetic appellation "quantitative easing", the Federal Reserve has shown its readiness to print more dollars to monetise away government debt. So why can't the band play on?

An interplay of forces is going to break the bank. Yields on Treasury bonds fell and fell for nearly 40 years, with the 10-year yield hitting all-time lows in 2020. America has since entered a secular environment of rising interest rates, so the costs of servicing the national debt are rising rapidly. As securities issued at interest rates as low as 0.5% mature, the principal is being rolled into the higher rates of the spot market, at the moment 3.7 percentage points higher. Higher interest expenses feed into deeper deficits, sparking more borrowing, driving heavier debt loads. This is how the debt spiral spirals—unless, that is, lower rates are engineered by the Federal Reserve, which would cause inflation. There will be no road left to kick the can down.

A recession would propel this debt spiral into crisis. The government is running annual deficits approaching $2trn, more than 6% of GDP, even with positive growth and four years of low unemployment. This breaks with the Keynesian bargain which prevailed from the end of the second world war until the middle of the past decade: run large deficits to offset economic weakness, shrink them in times of robust growth. With the deficit at recessionary levels already, the hit to tax revenues in an actual recession would drive America yet further into the red.

As in the past, a recession—or fear of it—should drive investors towards perceived safe havens, including Treasury bonds: a rate-lowering movement that may already have played out. Once confronted with a recessionary decline in tax revenue, the government's probable reflex would be a return to money-printing. Politicians would borrow more to fund the wider gap, taking for granted debt monetisation by their central bank. The scale of money-printing, however, would dwarf that of past bouts of Fed bond buying. Yields would rise to discount repayment in a depreciated currency.

Let's run the numbers. Projections to 2034 from the Congressional Budget Office (CBO) assume no recessions, an average primary deficit of 2.6% of GDP, plus 3.6% from debt expense (the latter assuming an effective interest rate on government debt of 3.5%). In the next ten years, under those assumptions, America's debt-to-GDP ratio would rise from 99% to 122%.

But those assumptions are optimistic. America's economic expansions after the second world war have lasted an average of 21.8 quarters; the current one has spanned

17. Timing economic cycles is difficult but for the sake of argument, let us accept the CBO's recession-free outlook. The 2.6% primary-deficit premise, though, is another matter. Since the financial crisis of 2007-2009, it has averaged 4.9%. As for the effective rate, consider 3.5% a rosy view. Rates of 6% are certainly within the experience of the past 30 years; for a world breaking with past inflation norms, 9% is not unimaginable.

In either case our debt-spiral model, assuming nominal growth stays the same, shows this situation compounding into fiscal catastrophe. By 2034 debt service at 6% rates would consume 45% of all tax revenue; at 9% rates it would eat up 83%. The budget deficit would balloon from 6% of GDP to 11% or 18%, respectively. These numbers imply debt-to-GDP ratios of 147-184%. The Penn Wharton Budget Model has shown that debt loads of 175-200% would be sustainable only under the most favourable assumptions, and a belief that Washington will prevent the debt burden from rising further. "Once financial markets believe otherwise," says the research group, "financial markets can unravel at smaller debt-GDP ratios."

Something will surely give before such hypothetical nightmares play out. Earlier this year, the CBO itself and the International Monetary Fund issued their own explicit warnings. Phillip Swagel, the head of the CBO, even warned that the "unprecedented" escalation of America's debt bender risked a kind of market reckoning that curtailed the government of Liz Truss, briefly Britain's prime minister.

President-elect Donald Trump's plan for a Department of Government Efficiency (DOGE) led by Elon Musk and Vivek Ramaswamy is the most encouraging sign I have seen of a fiscal awakening in Washington. I doubt DOGE will touch the entitlements, where much of the imbalance lies, but let us hope this begins a trend in the right direction.

When external pressure at last forces America's leadership into hard choices, I believe the first move will be dollar debasement. Congress may one day impose taxes on assets—ineffective but gratifying to some. And there is the real possibility of a quasi-default by the Treasury, through debt restructuring beyond what today's consensus would dare to contemplate. In the upheaval to come, few are likely to be spared. ■

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