Special Commentary

National Debt, Deficits & Inflation: No Worries for Now

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National Debt & Deficits: No Worries for Now

The burgeoning US national debt has long been a concern. Within the past decade, the debt has ballooned from roughly $15 trillion to almost $27 trillion today, with about $4 trillion added in response to the coronavirus pandemic and debt-to-gross domestic product now at roughly 100% (See slide 3). Indeed, the level of US federal debt is a concern that must be addressed over time. We are not panicked nor is this a sign of impending doom.

Is the US in Trouble from a National Debt Perspective: Could the US Default?

Ultimately, this is the crux of the national debt issue. In our view, the answer is emphatically no—the US is not a credit risk at present. There are three key reasons underpinning our view. First, the US can afford to pay its debts and can easily service the interest on its debt (See slide 5). Moreover, the US has an incredible trove of multitrillion-dollar assets that could be sold or privatized to raise funds. Obvious examples include the 640 million acres of land in the United States owned by the federal government, the mortgage portfolios within Fannie Mae and Freddie Mac, or student loans, etc. Or Congress could use its taxing authority to raise revenue to make debt-service payments. While these are not appealing options, they are levers that could be pulled if needed.

What About Federal Deficits?

Deficits and debt fit hand-in-glove; they are related, but different. Fiscal deficits—budget shortfalls—are a primary cause of increased debt. Again, the reason for the recent dramatic increase in fiscal deficits was the aforementioned pandemic response (See slide 6). But this isn't just a US problem, all of the key economies have pushed their fiscal deficits higher by roughly similar relative amounts (See slide 7). Thus, the US's fiscal deficit in relative terms has remained in-step with peers in the near term.

Moreover, these deficits are likely temporary (See slide 6). We are not suggesting that deficits don't matter; however, there will be plenty of time to address the budget deficit in the coming years. Specifically, we believe that deficits need to be balanced over an entire economic cycle, but there are legitimate reasons to temporarily overshoot, such as Great Financial Crisis, and the COVID-19 pandemic.

Rising interest rates, which push up the interest expense to service the debt, are another cause for fiscal deficits. But, there are few reasons to see that situation changing anytime soon, especially given historically low interest rates globally at present, including negative interest rates in several key regions such as Europe and Japan.

(Continued on next page)

Inflation and the Bottom Line

Doesn't Huge Federal Deficits and the Federal Reserve "Printing Money" Cause Inflation?

Nobel laureate Milton Friedman rightly warned that "inflation is always and everywhere a monetary phenomenon," and was caused by "too much money chasing too few goods."

Indeed, there has been a dramatic increase in the size of the Federal Reserve's balance sheet (See slide 4, left chart) in the past decade, first to address the Great Financial Crisis and now to help markets function properly amidst the COVID-19 pandemic. This has greatly expanded the money supply.

Yet, despite the increase in the money supply, inflation has consistently been markedly lower for the past 20 years. The Federal Reserve's preferred inflation metric—the annual change in PCE prices—has averaged just 1.5% in the past decade and 1.8% since 1999. The lack of inflation over this span coincides with a sharp decline in the velocity of money, which is the number of times a US dollar is spent to buy goods or services. This is due to individuals and businesses holding more cash, which we believe is warranted due to uncertainty.

Furthermore, that excess cash is held with banks, which have historically had a strong incentive to put those reserves to work by lending it out. But, with individuals and businesses already flush with cash, there has been less demand for new loans. Thus, there is less "chasing" of goods, as Dr. Friedman put it, and lower inflation generally.

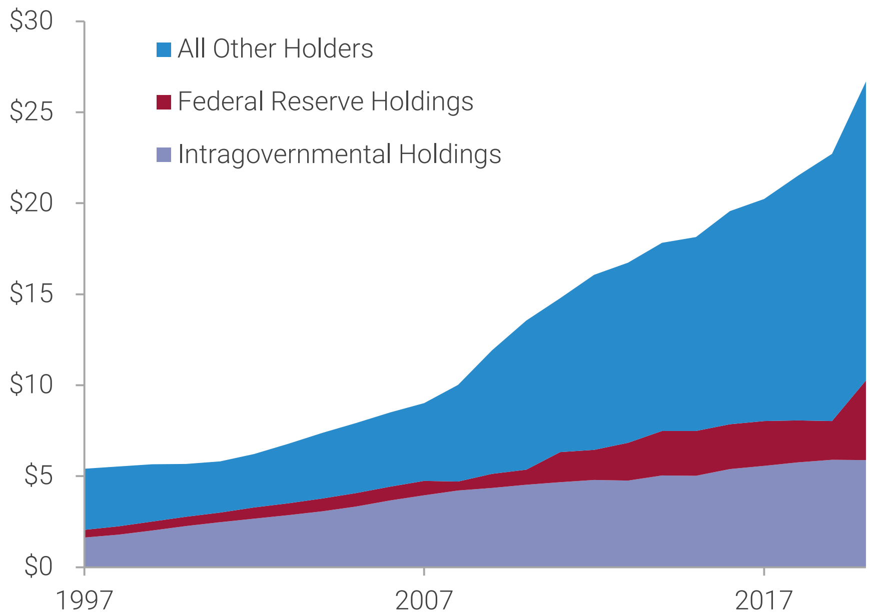
Bottom Line

While it might be politically unpalatable, Congress and the White House could reprioritize paying down the national debt or, at the very least, not adding to it. Again, unlike other countries—such as the recent examples of Argentina, Greece and Italy—the US can manage its debt load. While we believe debt levels are not a concern in the near-term, the topic does merit attention over the longer-term. Additionally, inflation is less of an issue in turbulent times, especially as individuals and businesses are holding more cash.

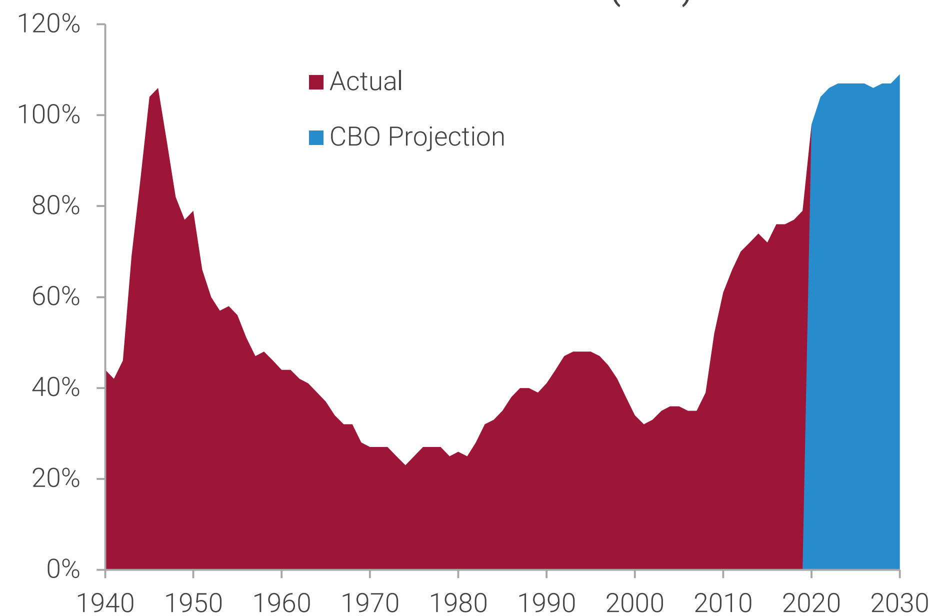
National Debt:
Total Amount vs. Percentage of GDP

The total national debt outstanding is now $26.7 trillion†, nearly 39% of which is owed to federal agencies—such as the Social Security trust fund—as well as the Federal Reserve. Relative to the size of the US economic base using gross domestic product (GDP), the total national debt is currently at 98% of GDP and projected to reach 110% in the next decade.

Total National Debt Outstanding (in Trillions)



National Debt as a Percentage of Gross Domestic Product (GDP)



Source: SunTrust IAG. Data Sources: Left Chart: US Treasury; † 2020 figure as of September 9, 2020, all others as of fiscal year end. Foreign central bank holdings including within "All Other Holders." Right Chart: Congressional Budget Office (CBO). CBO estimates for 2020 through 2030 based on current laws.

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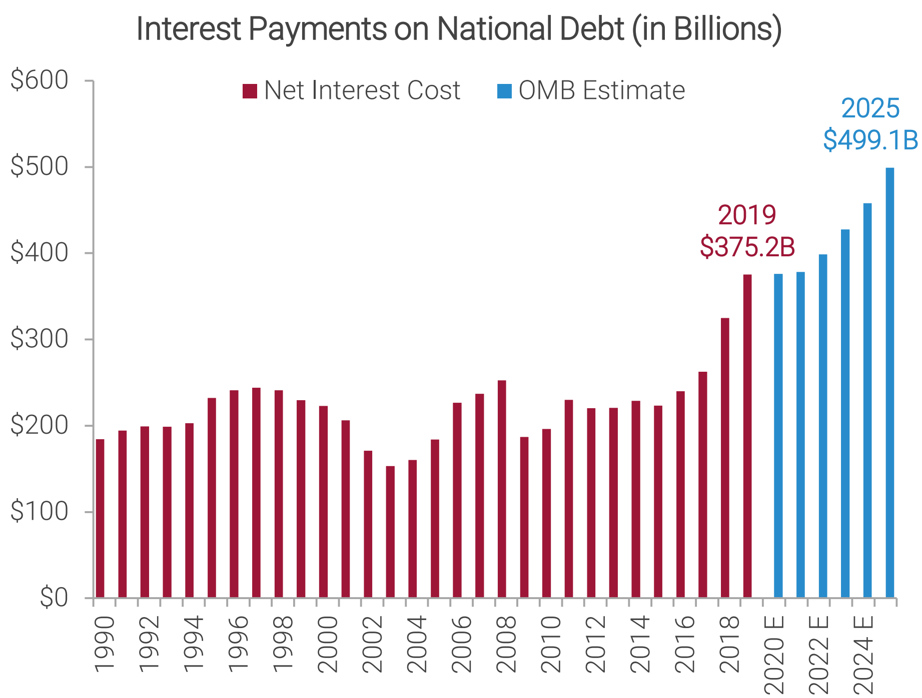
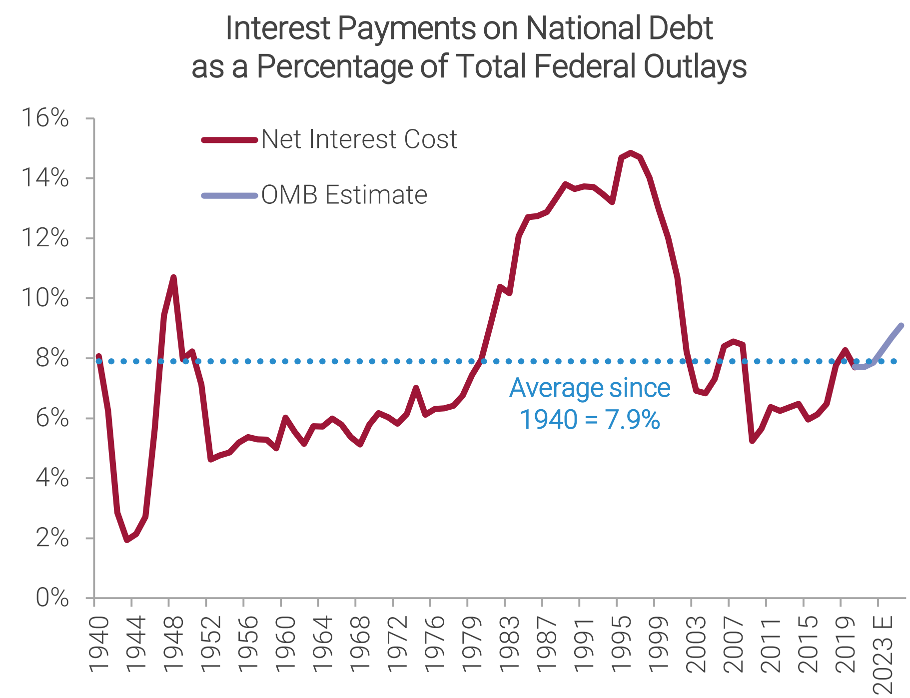
Interest Payments on National Debt are Currently Manageable

Interest payments on the national debt are expected to escalate by 2025. However, given that interest payments on the national debt are an estimated 8.2% of total federal outlays for fiscal year 2019, we think these levels are manageable. In fact, interest payments as a percentage of federal outlays are roughly in-line with the long-term average of 7.9% since 1940. As it stands today, interest payments are expected to rise to 9.1% by 2025, which would be below the mid-teens proportion during the period from the mid-1980s through 2000.





Data Source: Office of Management & Budget (OMB), SunTrust IAG. Left chart illustrates current dollars for net interest payments, and OMB estimates for 2020 through 2025. Right chart uses constant dollars, as of fiscal year 2012, for both outlays and net interest payments and OMB estimates for 2020 through 2025.

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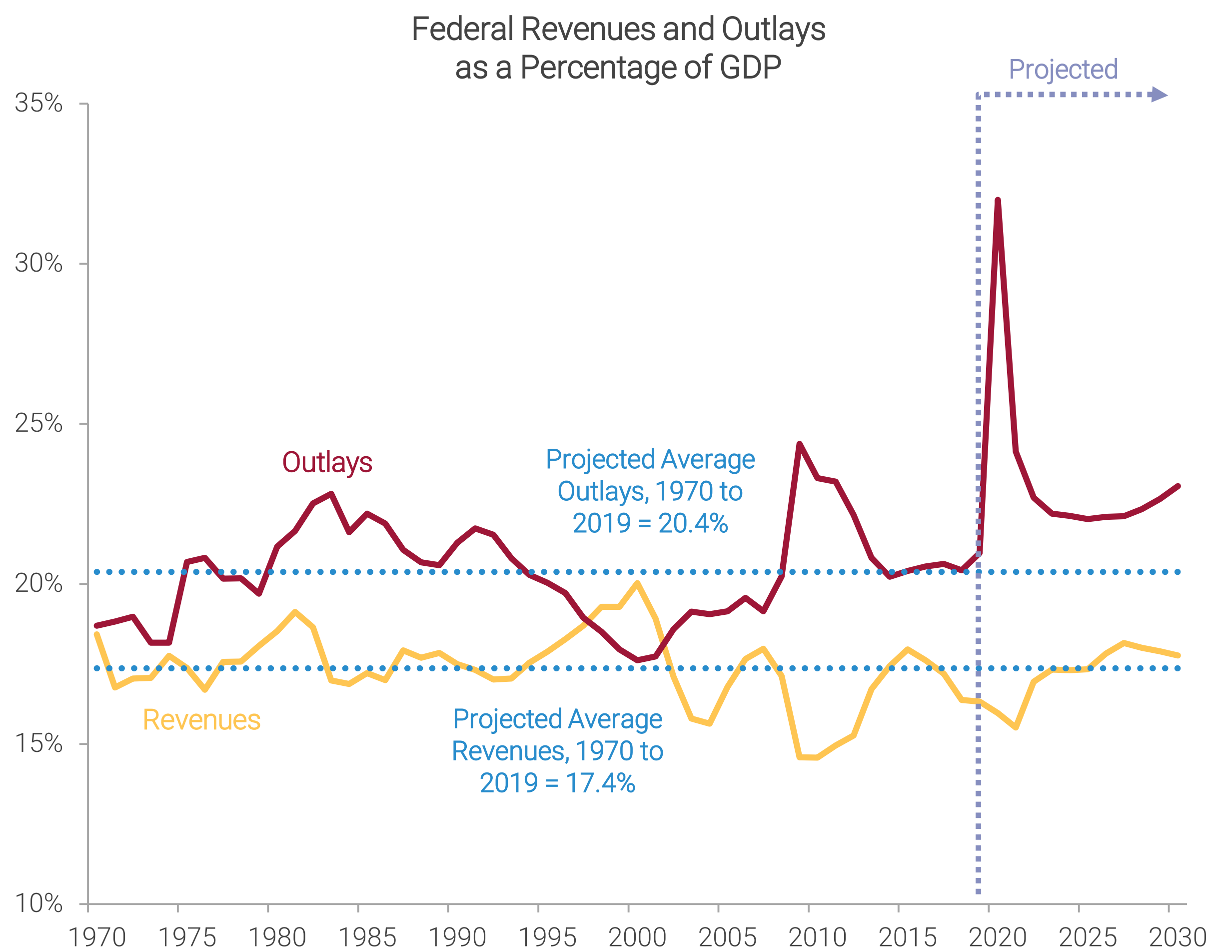
US Federal Budget is Temporarily Out of Whack

Like all of the key economies, the US government provided much needed support to address the pandemic. That has spiked fiscal deficits as federal spending—aka outlays—increased to 32% of gross domestic product (GDP). Note that part of the spike is because GDP has declined due to the pandemic.

Nonetheless, the federal budget is temporarily out of whack, which will continue for the next few years. Looking ahead, the next president and Congress will need to prioritize narrowing the gap between long-term spending and revenues (taxes).

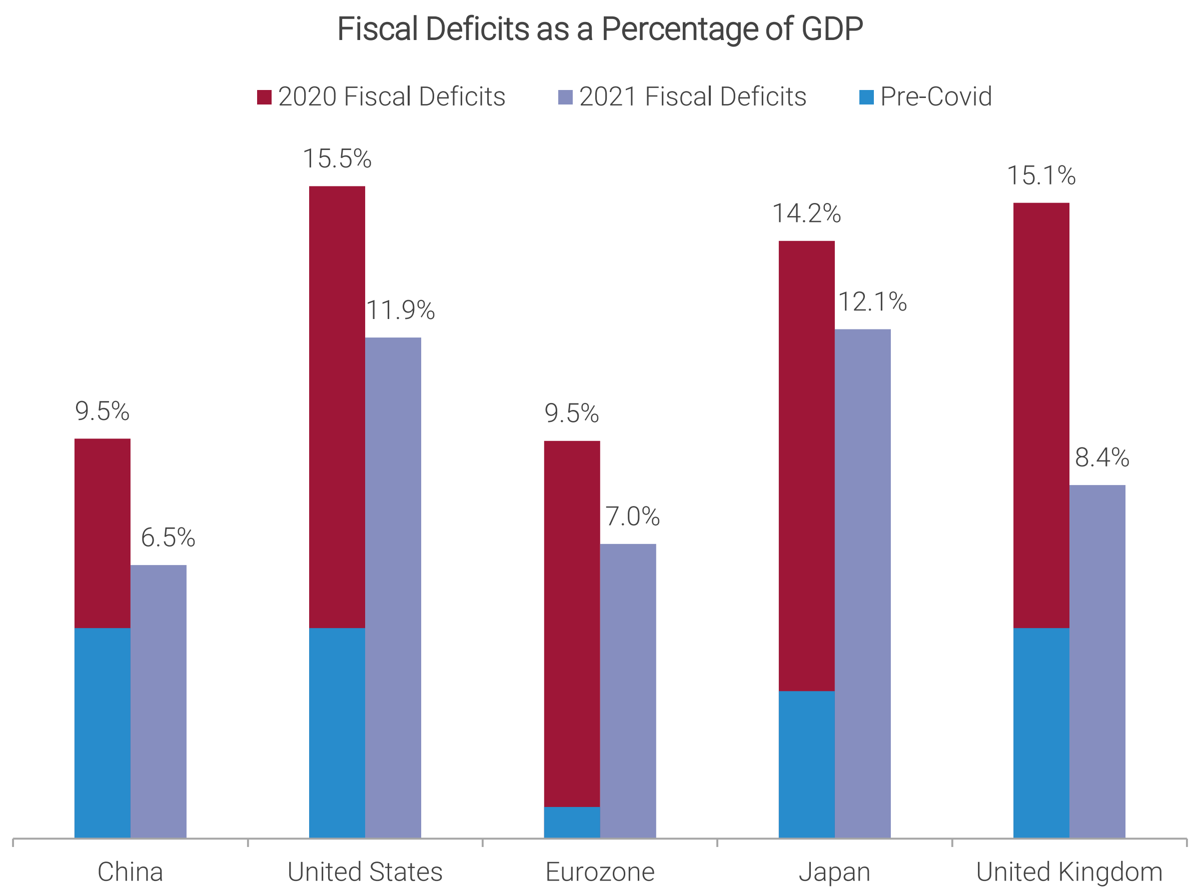


Data Source: SunTrust IAG, Congressional Budget Office. Figures show are as a percentage of gross domestic product (GDP).

Pandemic Responses Dramatically Expanded Fiscal Deficits Globally

Governments around the world scrambled to support their economies during the pandemic. One of the consequences, though, has been a dramatic increase in fiscal deficits.

In 2020, fiscal deficits are at or above 10% of GDP in all of the key economies. These fiscal deficits will remain bloated in 2021 and will likely remain elevated for years to come.



Data Source: SunTrust IAG, Barclays. Figures show are as a percentage of gross domestic product (GDP).

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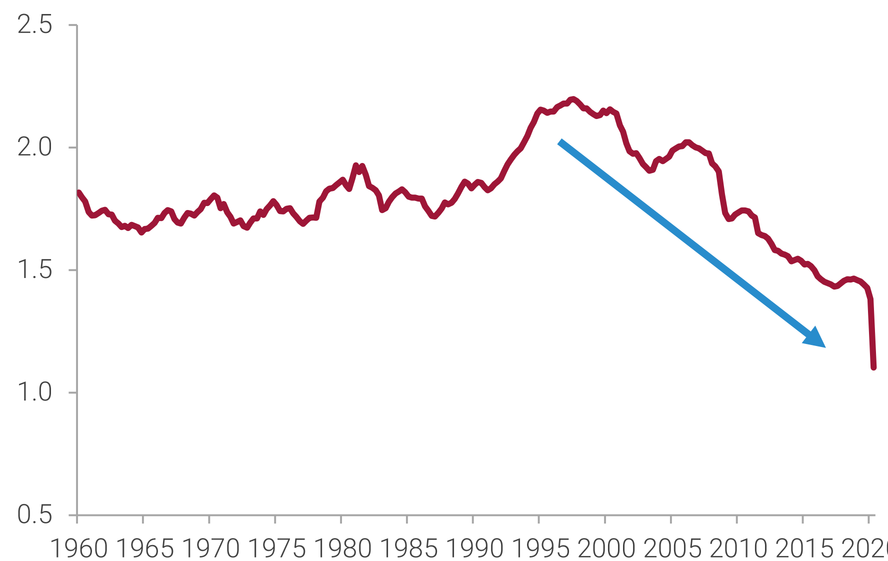
Want Inflation? Follow the (Velocity of) Money

With the dramatic increase in the size of the Federal Reserve's (Fed) balance sheet, many people are concerned about inflation. However, inflation has remained historically low for the past 20 years. The Fed's preferred inflation metric—the annual change in PCE prices—has averaged just 1.5% in the past decade and 1.8% since 1999.

The lack of inflation over this span coincides with a sharp decline in the velocity of money, which is the number of times a US dollar is spent to buy goods or services. Thus, with individuals and businesses holding more cash, there is less chasing of goods and lower inflation generally.

Personal Consumption Expenditures (PCE)
Price Index Year-Over-Year Change

Velocity of US Money Stock (M2)



Source: SunTrust IAG, Data Source: SunTrust IAG, Bloomberg; data through September 2020.

Federal Reserve Velocity of Money measured by the ratio of quarterly nominal gross domestic product (GDP) to the quarterly average of M2 money stock. M2 is the money supply of currency in circulation (notes and coins, traveler's checks [non-bank issuers], demand and checkable deposits, saving deposits, certificates of deposit (less than $100,000), and money market deposits for individuals

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