Market Commentary: Are US Debts Too High?
May 2023

The United States has thankfully diverted a default by raising our debt limit. Our national debt stood at $31.4 trillion, representing over 125% of GDP[1] - it will now continue its march higher. One can assume that nobody is a fan of the political wrangling that takes place in order to approve payment of the debt we actually owe. The more pertinent questions in our mind are:

- Is the national debt level too high?
- What are the potential future consequences of carried debt levels?

In our recent *Investment Wars* podcast (episode 4) we had an interesting conversation on this topic with our guest, Matt Orton.[2] In that discussion we dive deeper into some of the questions posed in this commentary as well as tackle potential effects of demographics on debt and relative positioning of international countries. It is worth a listen.

Is the national debt level too high?

To attempt to answer this question, it's helpful to understand why debt is used in the first place from an individual and corporate level, and then try to apply our learning to the government level.

Individuals take out debt for a plethora of reasons. Some examples include:

- **Student loans**: It is fair to look at this form of debt as an investment in one's future.
- **Credit card loans**: This may be a result of us living beyond our means. Perhaps we have no choice due to a liability that may have occurred such as an unfortunate health care scare. Or we just want to enjoy life and take that trip to Europe and simply use future earnings to pay it back.
- **Real estate loans**: A primary residence typically costs materially more than a family's annual income. A mortgage is essentially an asset backed loan where the first level of risk is held by the homeowner in the form of home equity. The family continually uses the house for their benefit with regular payments over that time.

Corporations may borrow money in order to make investments that are supposed to provide a return on capital. Those investments have a range of timeframes and expected payback. For example, a company may borrow to fund a current marketing campaign that the company expects to see higher sales from in the near to mid-term. Or a company may borrow to purchase expensive equipment that has a longer expected life of use, similar to a mortgage, in that there is continued use of and (presumably) business benefits from the equipment while the company is paying for it.

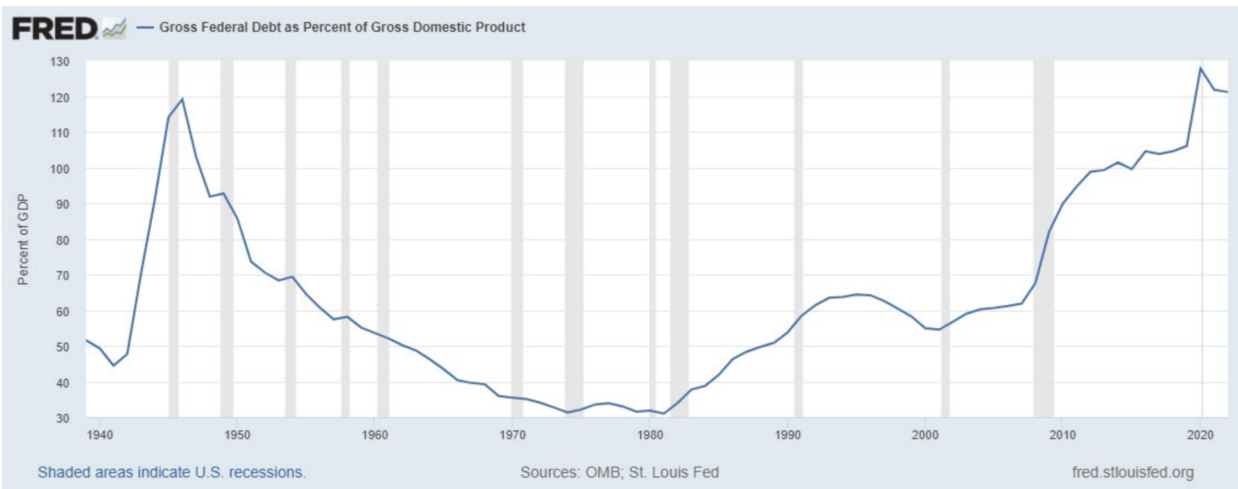
The balance sheet, revenue, and costs of individuals and corporations are not too complex to analyze. A mortgage may be many times the value of the annual income of an individual but as long as (1) there is a belief that the value of the real estate collateralizing the mortgage is above the loan value and that (2) the individual has the ability to pay monthly payments, that mortgage will be

[1] GDP measure the monetary value of all goods and services produced in a country - Gross Domestic Product: An Economy's All (imf.org)
[2] Matt Orton| Raymond James Investment Management (rjinvestmentmanagement.com)

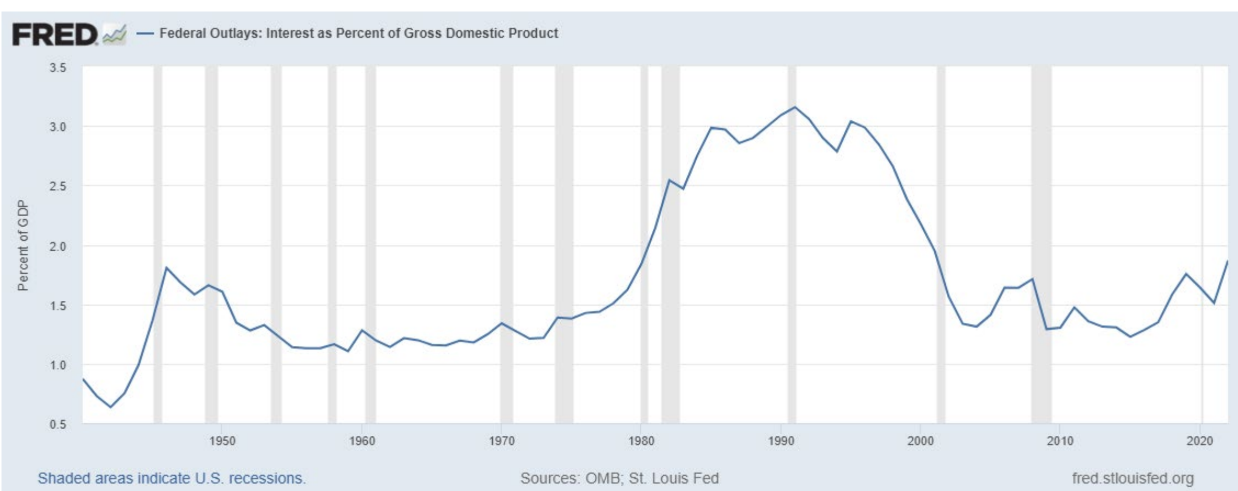
approved. In assessing debt of individuals and corporations it comes down to whether the lender believes they will be able to pay expected interest payments and eventually pay back the loan provided based on personal or corporate balance sheets and annual earnings.

Government debt is much more complex.

The most used metric in measuring our relative debt level is by comparing our national debt to annual gross domestic product (GDP). Current levels have surpassed that of America at the end of World War II. Even without the material spend during COVID, our government was approaching these historic levels as can be seen in the following chart:

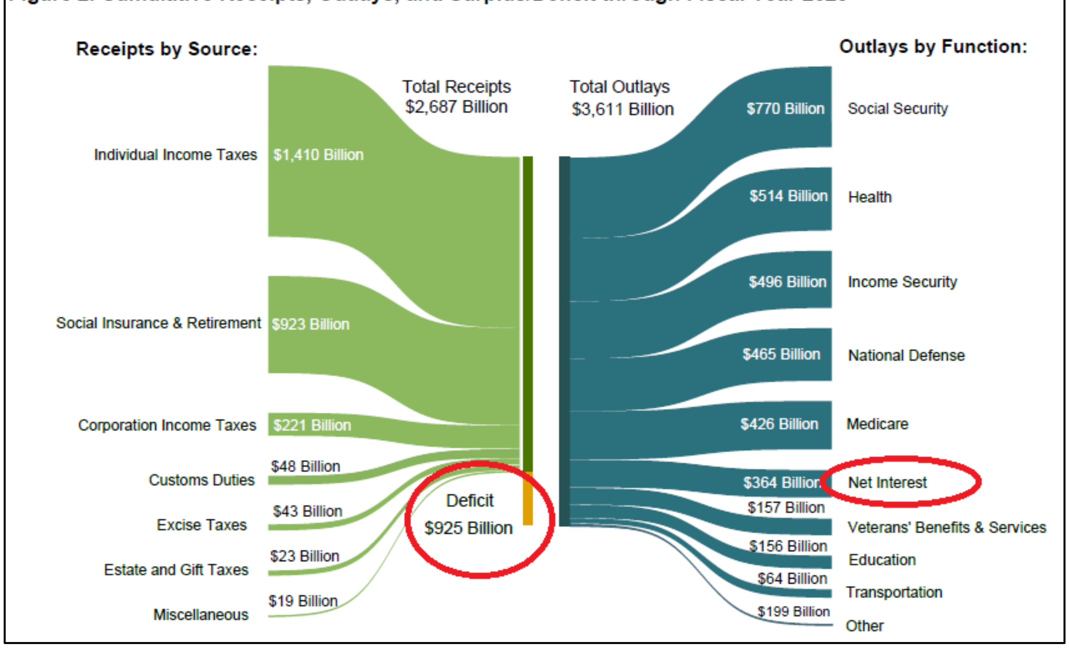


Due to interest rates being historically low over the last decade, the cost to service this historically high debt is in the middle range of costs over the last 75 years – again relative to GDP.



Now, GDP is not equal to government revenue. It is one of a few measurements that tries to express the production of a country. Actual government revenue is primarily collected via taxes. The following chart shows the income and expenses of the government through April of the current fiscal year (US Government year-end is September 30).

Figure 2. Cumulative Receipts, Outlays, and Surplus/Deficit through Fiscal Year 2023



[3]

One can see the deficit of close to $1 trillion in the last seven months alone, in addition to the fact that interest payments represent 13.5% of total receipts.

That feels high. And with the current federal funds target rate of 5% - 5.25%, while the average yield of outstanding government debt is at 2.07%, interest payments are only going to increase. Based on the deficit level over the first seven months of the fiscal year, it is very easy to see how debt will continue its inevitable rise unless something changes.

America itself, though, is composed of its citizens, companies, land, natural resources and so on. It is easily worth many times the amount of debt outstanding. According to the Financial Accounts of the United States, the

Consequences of High Debt Levels

If the government spends xx% of its budget on paying interest on debt owed, it cannot use that money for other initiatives that may be beneficial for its constituents, such as education and infrastructure upgrades. This in turn may lower future productivity.

If debt is perceived to be too high, it lowers the capability of government to act at times of crisis such as in 2008 or at the outset of Covid when it demanded its citizens to shelter in place.

Simply stated, high debt levels limit government flexibility and future initiatives.

[3] From the Monthly Treasury Statement for Fiscal Year 2023 through April 30, 2023, and Other Periods

net worth of households and not-profit organizations alone as of the end of 2022 is $148 trillion.[4]

On our podcast, Matt Orton commented that Japan has close to 2x the debt of us relative to their GDP yet has lower interest rates and a currency that is considered a conservative, safe haven despite materially worse demographics among other characteristics as compared to the US. One reason there is still significant demand for government debt is that banks and pension funds and other institutional managers invest significant funds into these "risk free" government bonds partially from a risk budget standpoint and partially due to government regulations. Government debt in turn assists in providing the necessary returns on future retirement, insurance policies and other assets consumers and businesses own.

A function of American, and by extension world debt, is the "full faith" of the government. It is why it was so important for the government not to default. Ultimately, the US has an abundance of assets worth placing its full faith in – materially more so than the debt owed - and it could always raise revenue if needed.

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[4] The Fed - Chart: Balance Sheet of Households and Nonprofit Organizations, 1952 - 2022 (federalreserve.gov)