US Macroeconomics

June 20, 2024

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Troubling and Unsustainable Deficits

The Congressional Budget Office is projecting record large budget deficits as a share of GDP over the next 10 years. These long-term forecasts are overly optimistic in the sense that the CBO is not predicting a recession, which is almost always the case. The high likelihood the economy will experience a downturn between now and 2034 means the current deficit projections are probably much too low, at least based on current fiscal policy.

The CBO raised its estimate of the fiscal year budget deficit to GDP ratio from 5.6% to 6.7%, and the lowest the Agency expects it to fall is to 5.5% in 2027 before again rising back to around 7% at the end of the forecast horizon. These massive deficits imply that gross federal debt as percent of GDP will continue to rise. The CBO is projecting a record large ratio of 137% in 2034.

Imbedded in these projections are estimates of federal revenues hovering around an historically high 18% of GDP. These are reasonable assumptions if the unemployment rate averages just 4.4% over the next decade as the CBO expects. But, if there is a downturn, unemployment will rise much more, and revenue growth will collapse. At the same time, outlays are likely to increase as the government spends more on counter cyclical measures such as unemployment insurance. This is why the budget deficit relative to GDP ratio often jumps several percentage points from its pre-recession starting point. Note, too, that the CBO is already forecasting an extraordinary amount of federal spending which is expected to average 24% of GDP over the next 10 years.

With budget deficits historically high relative to an economy operating at full employment, the government could be facing double-digit budget deficits when the next downturn hits. Record large Treasury financing needs may limit the government's ability to pursue fiscal stimulus as the bond market could revolt by demanding much higher yields. In turn, this could potentially extend the period of economic weakness. The economy and financial markets may be closer to this tipping point than some investors realize.

Over the past 12 months, the Treasury has financed almost 70% of its borrowing needs with T-bills, meaning securities with one-year or less maturity. While this exposed the Treasury to significant rollover risk, the decision may have been made to reduce the size of the Fed's reverse repo facility which effectively negates the Fed's quantitative tightening. More bank reserves mean more liquidity and easier financial conditions all else being equal.

Given the government's need to raise large sums of money over the next 10 years, the Treasury is going to be forced to diversify its borrowing mix away from bills. **Most of the additional supply would come in the five- to 10-year sectors**, potentially leading to a bear steepening in the yield curve as intermediate and long-term rates rise sharply (relative to short-term rates) to entice buyers. Perhaps, this is how the record long yield curve inversion eventually ends.

Fixed income investors are currently giving these concerns short shrift, but that could change if the economy slows more noticeably in the months ahead, which we expect. **Slower economic activity necessarily means lower tax revenues and hence bigger deficits**. Going forward, could an unruly supply-led sell-off in the Treasury market change the government's spending behavior? Will the Fed backstop the Treasury market by restarting quantitative easing, effectively acting as the buyer of last resort? What would a tightening in financial conditions mean for an already slowing economy and record high stock prices?

Whatever happens, the latest CBO projections speak to a longer-term fiscal outlook that we view as highly troubling and unsustainable. Bond investors should begin to take note.

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