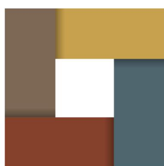


Personal Wealth Management

GHP Global Markets

INVESTMENT INSIGHT

The Bond Market's Role in Shaping U.S. Fiscal Responsibility

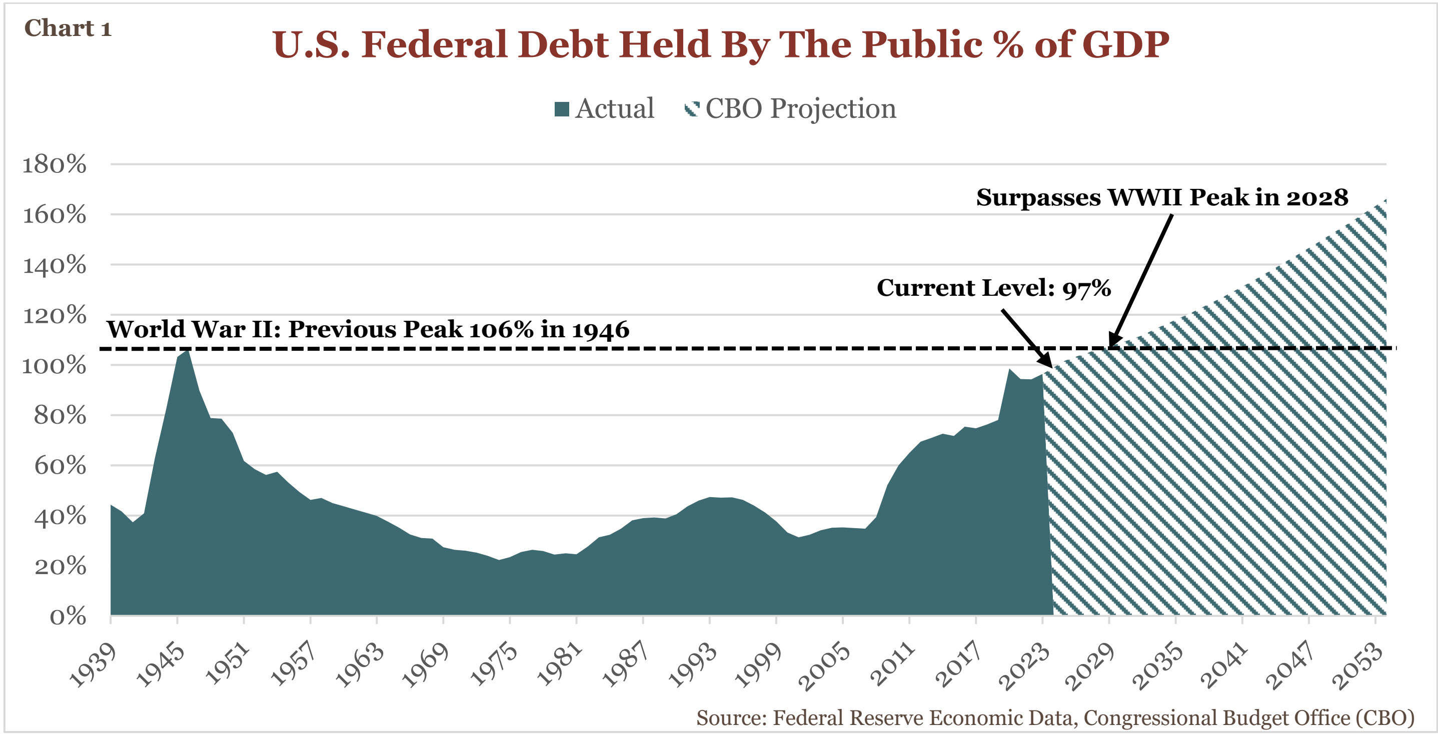
By Carin Wagner CFP®, Senior Vice President of Wealth Management

As the U.S. public debt approaches 100% of Gross Domestic Product (GDP), a threshold not breached since World War II, conservative forecasts indicate we will soon surpass this historic high. Alarmingly, our primary deficit, which excludes interest expense on debt, is the highest level ever experienced by the United States. **Chart 1** paints a grim picture: U.S. debt is on track to exceed WWII highs by 2028, a mere four years from now. These projections account for the scheduled sunsetting of the Tax Cuts and Jobs Act of 2017 at the end of 2025.

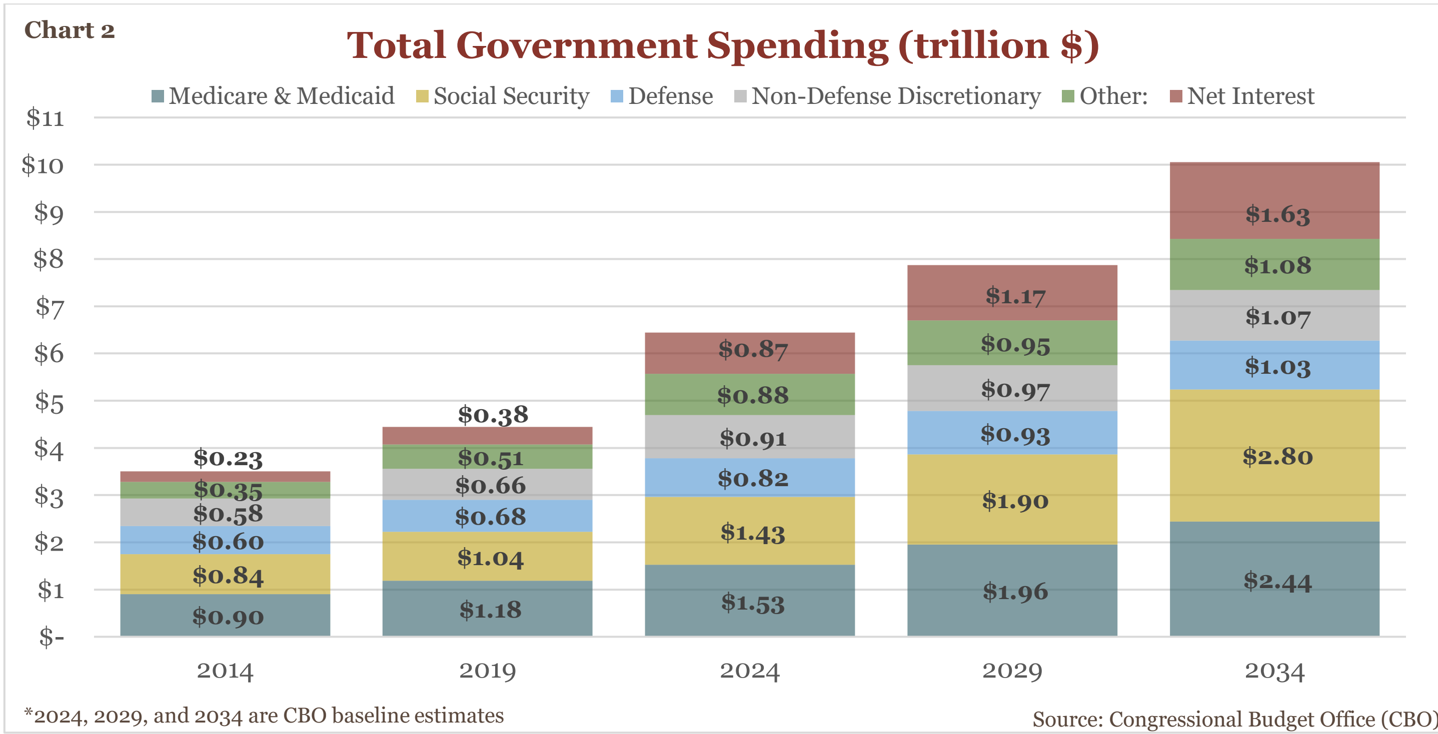
The key to managing the U.S. debt challenge lies not in eliminating the deficit altogether, but ensuring the deficit as a percentage of the economy remains below the growth rate of the economy.

Government Debt Explained

Since World War II, U.S. government debt experienced substantial fluctuations. Debt levels declined in the mid-1970s but began to rise due to a stagnant economy, rising inflation, and higher interest rates until the mid-1990s. By the late 1990s, the combination of economic growth and prudent fiscal policies resulted in budget surpluses. The 2000s marked a dramatic shift away from the budget surpluses of the late 1990s due to the economic impact of the early 2000s recession, the financial crisis of 2007-2008, tax cuts, and increased spending.



In recent years, low interest rates allowed the U.S. government to maintain higher spending levels throughout both the financial crisis and the COVID-19 pandemic. Despite this temporary respite, the ratio of U.S. federal debt held by the public to gross domestic product (GDP) remains at a concerning level, as depicted in **Chart 1**. Additionally, **Chart 2** underscores the challenges posed by the combination of higher borrowing costs (red bars) and an aging population reliant on Medicare and social security benefits (blue and gold bars). **By 2034, combined spending on just Medicare, Medicaid, social security benefits, and net interest is projected to surpass $6.8 trillion, matching total government spending in 2024.**



The Bond Market as an Enforcer

Historically, the bond market acted as the ultimate enforcer of fiscal discipline. When borrowing costs rise and investor confidence wanes, politicians are compelled to implement necessary reforms. The following historical examples illustrate how the bond market, not politicians, dictate the course of action to address burgeoning debt.

Market Discipline

When investors lose confidence in a government's fiscal policy, they either sell off bonds, causing bond prices to drop and yields to rise, or become reluctant to purchase new issues. For example, the period of the late 1970's was marked by a combination of high inflation and sluggish economic growth (i.e. stagflation). By 1979, the situation escalated to the point where the U.S. Treasury faced difficulties in auctioning its bonds, known as the "failed Treasury auction". In response to these challenges, President Carter appointed Paul Volcker as Chairman of the Federal Reserve. He implemented a series of aggressive monetary policies to control inflation, including raising interest rates sharply. These actions, though painful in the short-term, stabilized the bond market and set the stage for economic recovery in the late 1980s.

Borrowing Costs

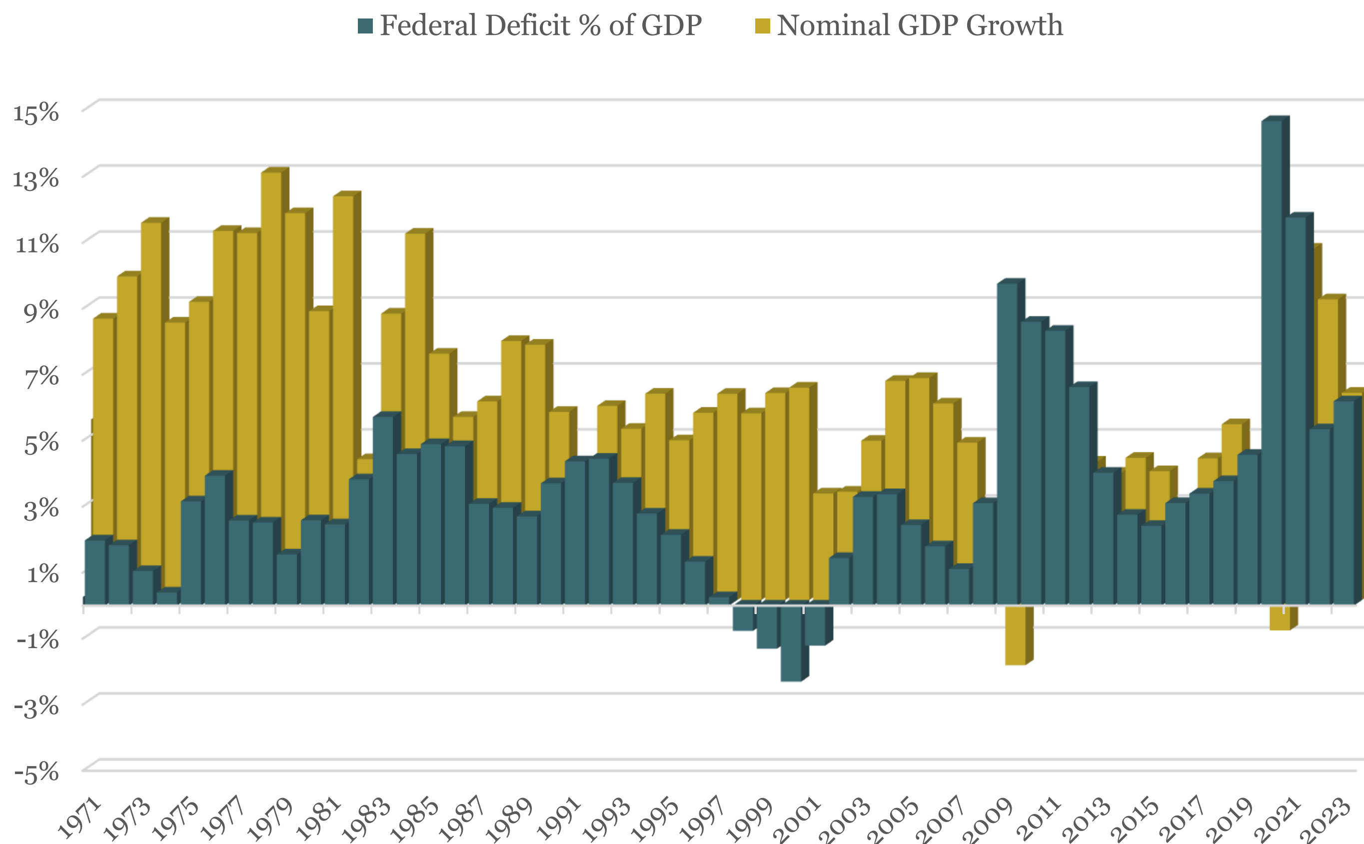
Governments finance deficits by issuing bonds. The bond market, assessing the risk of lending to the government, influences interest rates. As an example, in the early 1980's the U.S. bond market experienced significant turmoil due to the Federal Reserve's aggressive actions to combat high inflation. The high interest rates resulted in a dramatic increase in the yields on government bonds, which in turn raised the cost of servicing the national debt.

As a result, the Reagan administration and Congress prioritized maintaining investor confidence and responded by enacting the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, which was the largest tax increase in U.S. history at that time. Additionally, there were efforts to cut federal spending, though these were more limited in scope compared to the tax increases.

Proposals for Change

The bond market will continue to act as the catalyst for change. The key to managing the U.S. debt challenge lies not in eliminating the deficit altogether, but ensuring the deficit as a percentage of the economy remains below the growth rate of the economy. It is a straightforward concept: for sustainable fiscal health, economic growth must outpace the growth of the deficit.

Chart 3 illustrates a shift over time: historically, U.S. economic growth (the gold bars) outpaced the federal deficit as a percentage of GDP (the blue bars). However, over the past decade this dynamic has reversed, signaling an unsustainable trajectory.



To navigate these challenges successfully, incremental changes to spending and taxation must be implemented over time. Through this methodical approach, we can move closer to achieving greater fiscal responsibility and sustainability.

While the burden of high debt levels may not immediately endanger American society, it undoubtedly signals the immediate need for adjustments. These changes will not stem from political foresight, but rather from the demands of the bond market.

If you're interested in a video on this topic, please visit www.ghpia.com and watch the 2024 Economic Outlook Forum – Securing Tomorrow: Addressing the Government Fiscal Crisis.

Market Summary

The GHPIA Equity Valuation Dashboard

Asset Class	Price/ Earnings 2024:Q2	P/E Benchmark	Over / Under Valuation	Price/ Book Value 2024:Q2	P/BV Benchmark	Over / Under Valuation	Price/ Cash Flow 2024:Q2	P/CF Benchmark	Over / Under Valuation
Large-cap growth stocks	30.1	27.0	11.5%	11.5	5.7	101.8%	25.7	17.5	46.7%
Large-cap value stocks	16.5	20.2	-18.5%	2.8	2.5	12.8%	14.2	13.1	8.2%
Mid-cap growth stocks	19.4	24.8	-21.7%	4.1	4.5	-8.9%	13.3	16.1	-17.1%
Mid-cap value stocks	13.7	19.1	-28.1%	1.7	2.2	-22.8%	8.3	12.4	-33.4%
Small-cap growth stocks	16.5	23.2	-29.0%	2.6	3.5	-25.8%	11.0	15.0	-26.6%
Small-cap value stocks	14.1	18.2	-22.5%	1.3	2.1	-38.5%	6.5	11.8	-45.1%

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Returns by Index

Index	2024:Q2	YTD
DJIA Total Return*	-1.27%	4.79%
S&P 500 Total Return*	4.28%	15.29%
S&P 500/Growth*	9.40%	23.14%
S&P 500/Value*	-2.65%	4.57%
S&P Midcap 400/Growth	-3.61%	11.14%
S&P Midcap 400/Value	-4.04%	-0.64%
S&P Smallcap 600/Growth	-1.70%	2.67%
S&P Smallcap 600/Value	-5.43%	-5.85%
MSCI EAFE	-1.37%	3.51%

Source: FactSet as of 06/30/2024.
**Dividends reinvested.*

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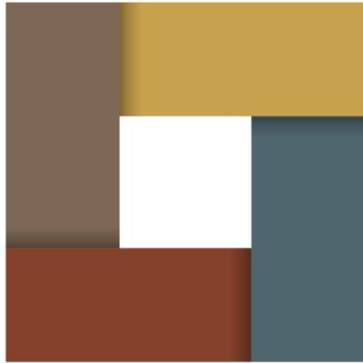

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