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Capital Management, LLC

Let's Get Fiscal

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Exploring federal debt expansion's potential impact on your investments.

The equity market is not the only thing hitting an all-time high. US federal debt held by the public ended 2020 at $21 trillion, up from $9 trillion at the end of 2010. The Congressional Budget Office's baseline projection for federal debt released in February 2021 incorporated the major Coronavirus-related relief bills – the $2 trillion CARES Act in March 2020 and the $900 billion emergency coronavirus relief bill in December 2020. Their projection assumed the federal debt held by the public would rocket up by 57% through 2031, hitting $33 trillion. Federal debt held by the public as a share of GDP would go from 100% in 2020 to 107% in 2031, exceeding World War II levels.

These projections likely will inflect higher due to two new pieces of legislation from the Biden Administration. In March 2021, they passed the $1.9 trillion American Rescue Plan Act, and proposed the $2 trillion American Jobs Plan Act along with corporate tax increases. With fiscal policy now playing a more prominent economic role, we will explore the potential impact of federal debt expansion on the investment landscape.

Higher federal debt will influence asset classes primarily via its impact on interest rates and inflation. Importantly, these two interconnected forces are driven not only by federal debt.

In fact, during the 1970s when the United States last had material inflation that necessitated sharply higher interest rates, publicly held debt-to-GDP in the United States was close to 25%, down from over 100% in 1946. Meanwhile, Japan's public debt-to-GDP has exceeded 100% since the mid-1990s, yet its inflation and interest rates have displayed long-term downward trends.

So while some may throw around hyperbole that rising debt will lead to hyperinflation or make the US the next Japan, a developed economy burdened by debt, the less sensational view is that neither outcome is likely in the foreseeable future. Instead, while the risk of cyclical inflation is rising, structural factors likely could normalize inflation and interest rates to a modest level longer term.

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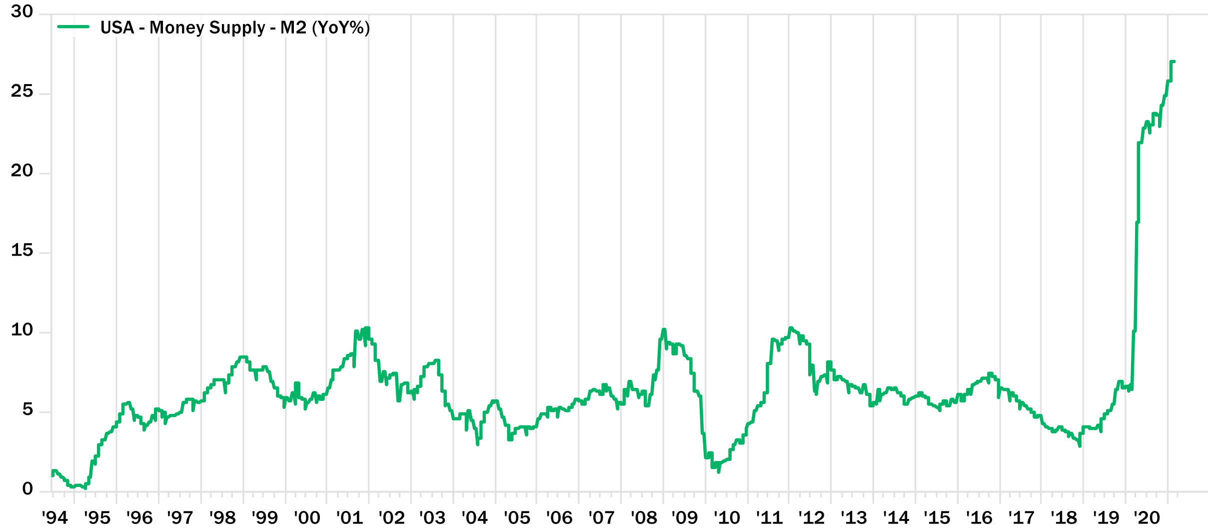
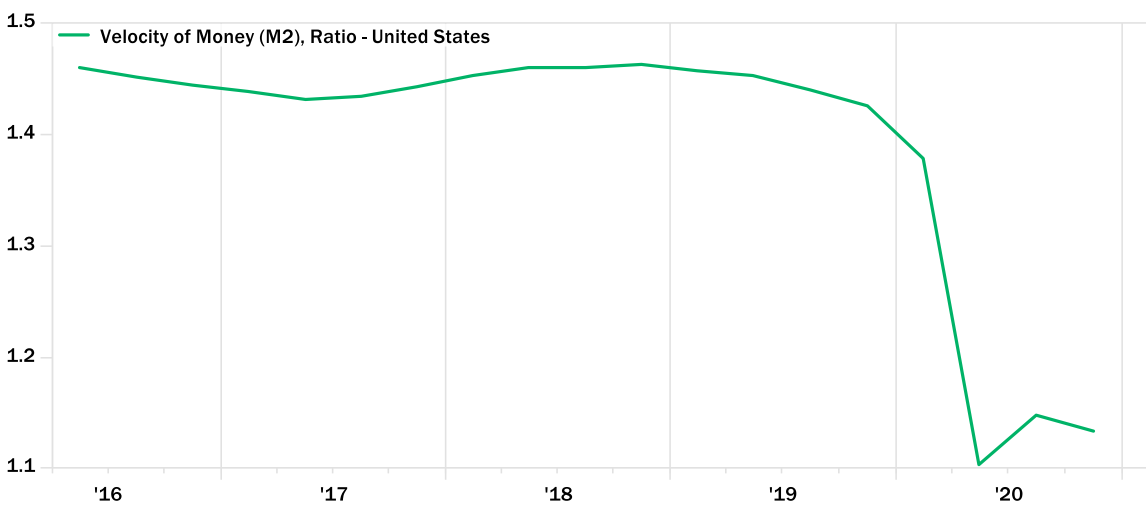


Monthly data as of 2/28/21 *©FactSet Research Systems*

The massive fiscal policies mentioned earlier have helped create the kindling for a flare-up of cyclical inflation. Money supply, as shown in the above chart, went parabolic in 2020 with most of the increase driven by an over $3 trillion increase in financial system deposits since January 2020 to almost $17 trillion. Two major drivers included 1) stimulus payments and 2) quantitative easing whereby the Federal Reserve supported the increase in the federal debt by buying more than $2 trillion of US Treasuries from financial institutions. Money supply alone does not dictate inflation; the velocity of money is the second half of the inflation equation.



Quarterly data as of 12/31/20 *©FactSet Research Systems*

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Velocity of money, in simple terms, is how fast money changes hands and circulates throughout the economy. When the Federal Reserve's preferred measure of inflation – core personal consumption expenditure price index, "core PCE" – was just over 2% for a sustained period from 2005 – 2007, the velocity of money was modestly above the longer term average. As shown in the above chart, it recently exited 2020 near an all-time low, reflecting the significant increase in deposits at banks. These deposits need to get loaned out to increase the velocity of money and feed demand for goods and services to support inflation. Until now, banks have yet to show a real sense of urgency to ramp up loan growth.

This dynamic could change soon. CEO confidence is at a 17-year high, consumer confidence has started to rise to a more normal level, and measures of bank willingness to lend were trending positively in the first quarter of 2021. As economic reopening accelerates, lending could quicken, helping monetary velocity and act as a cyclical tailwind for inflation to rise from 1.4% in February 2021 towards the Federal Reserve's 2.2% 2021 median estimate.

Cyclical inflation feeds higher interest rates as investors demand compensation for inflation, eating away at their income. An additional cyclical driver of interest rates is the federal government increasing supply of Treasuries, which could necessitate higher interest rates to incentivize purchase.

While the federal debt likely will influence interest rates and inflation cyclically higher, there are four structural forces that could moderate the cycle and prevent the runaway inflation experienced in the 1970s that required a sharp increase in short-term interest rates by the Federal Reserve to tame.

The first is demographics. In the 1970s, US population grew over 1% annualized. Population growth was 0.5% in 2018 and 2019. Slower population growth contributes to slower structural economic growth and a graying of the population that can involve more saving, both of which moderate inflation.

Second is globalization. Global trade volume as a share of GDP at around 60% is more than double the levels seen in the 1970s. More global competition helps reduce price pressures.

Third is technology. While difficult to measure, the digital economy is estimated to be over 15% of global GDP. Technology improves structural efficiency in the economy, naturally moderating structural inflation.

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Fourth is monetary policy. Unlike past periods of rampant inflation, the Federal Reserve has a clearer, more credible mandate backed by independent leadership where Jerome Powell is set to remain chairman until 2028. Independence is crucial to address cyclical bouts of inflation. Additionally, structural issues overseas that contribute to some foreign central banks keeping rates very low, creates an incentive for foreign entities to purchase US Treasuries that offer relatively attractive yields. These monetary policy dynamics can act as mitigating forces for rising inflation and interest rates.

Weighing structural and cyclical dynamics is an inherent part of the Osborne Partners investment process. Cyclical inflation and rising interest rates could pressure fixed income, while benefiting natural resources, and more value-oriented global equities. Market dynamics shift, so regardless of how the federal debt influences the investment landscape, Osborne Partners will apply its adaptable, resilient, multi-asset class approach to help you on the path to reaching your financial goals.