The Debt Dilemma

With each passing year our country swims farther into uncharted and increasingly hazardous financial waters. Over the last 20 years, federal debt has grown 4 times faster than the economy. The U.S. runs an annual budget deficit, consumes more than it produces, and exports less than it imports. A good parent would advise their child to underspend their income, stay out of debt, and do their best to make rational intelligent decisions. The U.S. government has set a very poor example in recent decades, embodying the hypocrisy of "do as I say, not as I do."

The growing debt problem was pulled forward with the pandemic response, resulting in the largest debt surge since World War II. Staggering debt levels make the economic situation more volatile and fragile. But the long-term risk lies in the growth impact of continuous deficits, trade imbalance, and poor capital allocation decisions.

In the mid-19th century, the U.S. had budget and trade deficits that resulted in completion of the transcontinental railroad. For 20 years the U.S. has traded assets and "I Owe Yous" for consumption goods and government programs. Two investments that don't contribute to sustained future growth.

The recent capital allocation decisions have produced more debt and a clear negative return on investment. Slowing growth and debt service issues are major headwinds picking up speed. The Federal Reserve's "soft landing" narrative is difficult to justify given the state of foundational economic pillars covered in this letter.

Overview

The U.S. budget deficit is projected to average $1.6 trillion per year for the next 10 years, while federal debt to GDP presently stands at 124%. The current account deficit or dollars leaving the country, rose 30% to $291 billion for the first quarter of 2022. Available lifeboats look to be as abundant as they were on the Titanic, and the growing weight of this debt burden will be realized in one form or another.

"The easiest way to solve a problem is to deny it exists." (Isaac Asimov)

Additional debt carrying capacity requires additional growth in earnings or assets. The debt to economic growth imbalance has entered unexplored territory for the United States. It's unknown when government credibility may be called into question. What's certain is, future earnings of U.S. businesses and households will bear most of the debt cost.

Debt and Government Spending

My June 2022 letter details the growth of government spending, and real GDP growth that occurred in the accommodative environment of the last 10 years. There are no magical accounting tricks or loopholes for the U.S. Government to evade servicing its debt. Warren Buffett eloquently outlined the available options and risks in his 2009 New York Times Op-Ed - The Greenback Effect. The debt can be financed by borrowing from foreigners, borrowing from U.S. citizens, or a roundabout process of printing money. When Buffet wrote the piece, U.S. current account deficit was in the **$300-400 billion range annually**. The current account deficit was **$291.4 billion for just the first quarter of 2022.**

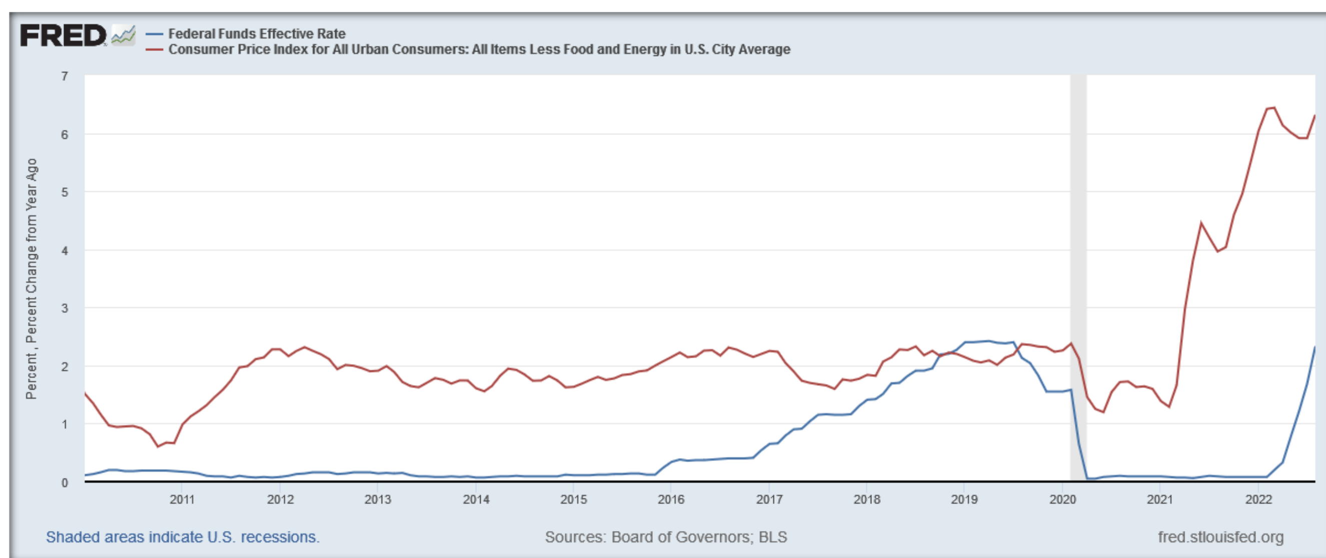
The projected U.S. budget deficit of $1.6 trillion per year for the next 10 years is impossible to rationalize. That's a cumulative total of $16 trillion by 2032, on top of $31 trillion in existing national debt. Some form of "printing money" to pay for this debt appears to be the most probable outcome.

> *"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens… The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose." (John Maynard Keynes, 1920)*

The "inflation tax" cited in Buffets Op-Ed, becomes more visible with each spending package and annual budget deficit. The basic effect of this "stealth tax" is a redistribution of wealth from savers (bondholders) to issuers (government) through currency debasement.

Artificially holding interest rates below inflation, while the Fed "prints" new base money to buy government bonds, is precisely the "inflation tax" scenario we've observed in recent years.

See the comparison on the chart below of the Federal Funds Rate and the Core Inflation Rate. Interest rates have been kept well below inflation in the quantitative easing (QE) era.



Last year's transitory inflation narrative was accepted for a remarkably long time. As inflation climbed higher, zero percent interest rates and the asset purchase program continued far beyond any rational timeline. Only after inflation rose to 7% in November of 2021, was the Fed forced to announce changes that would begin sometime in 2022. Inflation rose to over 9% in the months following the announcement, as the asset purchase program continued through March 2022.

This concealed "inflation tax" is a likely candidate for how the government might delay addressing the inevitable debt burden. It allows them to avoid openly raising taxes and continue spending until something breaks. True default on government debt is not an option for the world reserve currency. It bears repeating that additional debt carrying capacity requires additional growth in earnings or assets.

Debt above a certain threshold can result in a feedback effect that slows economic growth, which leads to more debt, to boost growth temporarily. This was mentioned during the first quantitative easing programs from 2009-2014 but has scarcely been cited since. The side effects of the initial QE and debt explosion have yet to be realized or felt. U.S. and global debt positions today, are substantially more dangerous than they were 13 years ago.

Government cuts and historic levels of growth are required to pull the existing obligations back from the edge. This seems unlikely as it is difficult to be elected in the U.S. democratic system by promising less. The alternative option is to continue the Fed's inflation experiment and see where we end up. This reveals the more probable outcome as "printing money" to service debt into a slower growth environment. The described scenario is the definition of stagflation.

The Federal Reserve's interest expense will exceed interest income by year end 2022.

The Fed continues to "battle inflation" with interest rate hikes, driving up the interest expense on their balance sheet liabilities. Negative earnings by the Fed will result in the creation of a "deferred asset" written against future income. The deferred asset must first be repaid before future interest earned can be remitted to the U.S. Treasury. This negative carry will be booked as an asset created by the Fed, but it's a liability (to us) as a reduction in future cash flows for benefit of the U.S. taxpayer. The Fed estimates a 3 to 8 year pause in payments to the Treasury, implying a deferred asset peaking in the $60-$180 billion range.

> *"Because there has never been a deferred asset of any significant size, there is little guidance as to whether or not there is a limit to the potential size of the asset." (Federal Reserve Board, 2015)*

By year end 2022, the U.S. lender of last resort will have negative earnings. This creates a new growing liability for taxpayers that pauses Fed payments to the Treasury, thereby reducing Treasury earnings by $50-$100 billion per year.

In a broad sense, this may produce a new drag on future growth and further complicate the existing nightmarish budget situation.

"To the man with only a hammer, every problem looks like a nail."

Demand destruction is the only tool possessed by the Fed to address inflation and maintain credibility. By mandate they must hammer away. The Federal Reserve can create bank reserves and lower interest rates. They cannot increase the supply of foundational components like labor, materials, and energy.

The Debt Situation Matters

The present debt burden and impact of poor allocation decisions must not be understated or ignored. How the borrowed money is spent holds just as much significance as how much money is spent. For the last 20 years, the United States has transformed a tremendous amount of debt into consumption and government programs. Two components that do not contribute to future periods of sustained economic growth. We must not look past the fact that **the debt does matter**. Its impact will be felt in one form or another.

Financial conditions are beginning to tighten after 13 years of accommodation. The debt burden and tightening process create stress and volatility across the economy and markets. Tremendous investment opportunity can present itself in uncertain times like these. As we enter the early stages of tightening economic conditions, the best opportunities are yet to come.

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