HAMILTON POINT
Investment Advisors, LLC

GETTING SMART ABOUT THE NATIONAL DEBT AND DEFICITS OF THE UNITED STATES

SEPTEMBER 2020

U.S. DEFICITS & THE NATIONAL DEBT

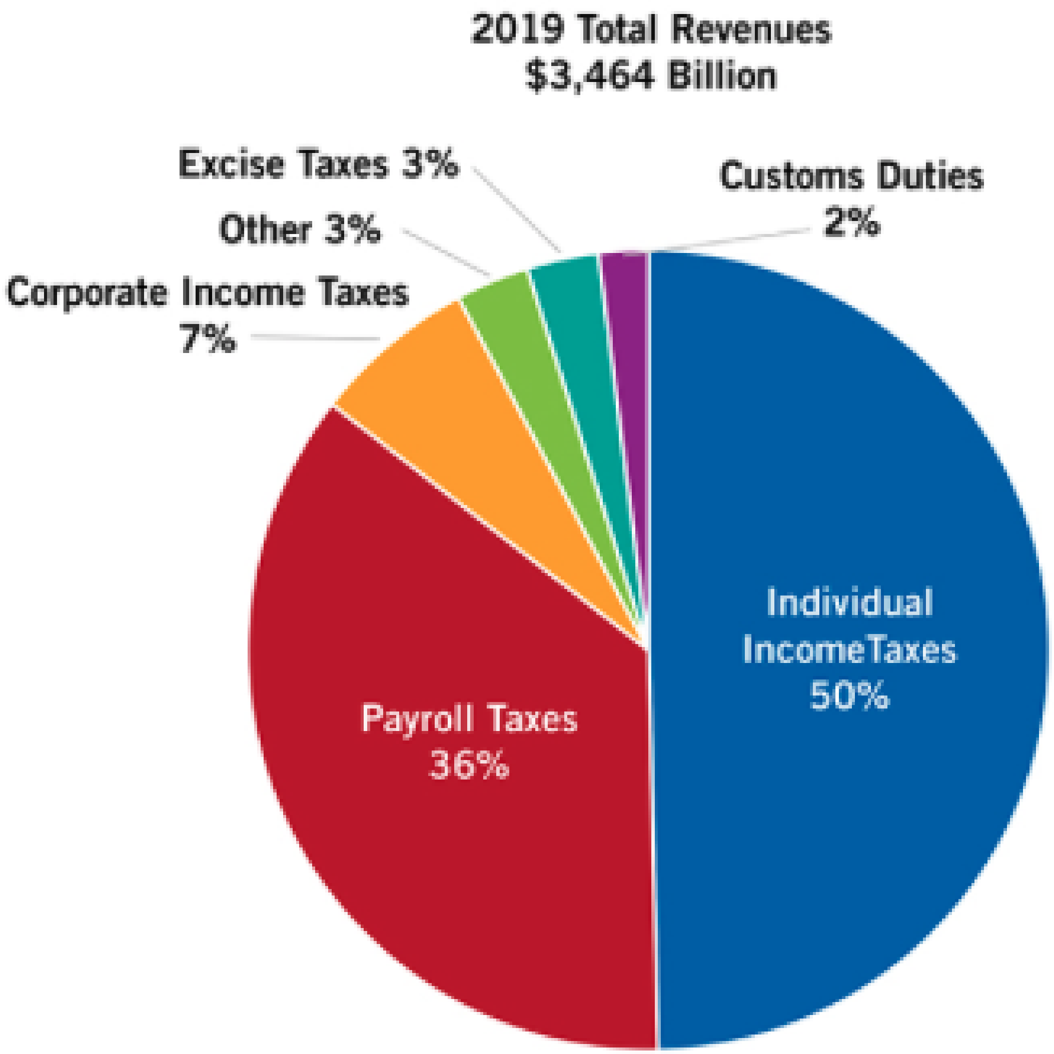
- There will be plenty written in the history books on the COVID Pandemic, but when it comes to the financial markets, the tale that stands the test of time may be one of DEBT. Debt burdens will be higher for nations, states, municipalities, corporations and individuals for years to come.
- Given the frequency that we've read both truths and falsehoods about U.S. deficits and the national debt over the past several months, we thought a discussion document on that specific topic may be warranted.
- As always, we've tried to leave our biases behind and just give you the simple facts. Any questions, comments and/or grievances are welcome.

WHAT'S THE DIFFERENCE BETWEEN THE DEFICIT & NATIONAL DEBT?

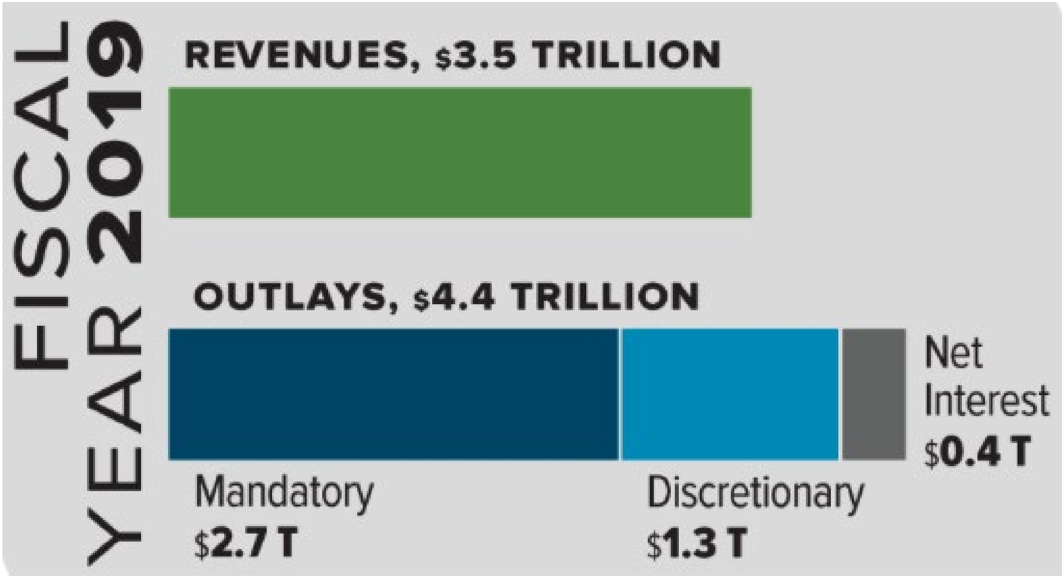
- For starters, let's begin with some terminology:
  - The Deficit – The budget deficit is the difference between the U.S. government's revenue (taxes) and expenditures (social security, military, etc.). A budget surplus is possible when revenue exceeds expenditures; we haven't seen one in many years.
  - The National Debt – The net accumulation of the federal government's annual budget deficits and surpluses.
- To quantify these figures
  - The U.S. deficit totaled **~$984 billion** in 2019 (i.e. the government spent $984b more than it generated in revenue last year).
  - The National Debt totaled **~$22.8 trillion** at the end of 2019 (i.e. the total of all the U.S. previous deficits/surpluses, plus the interest accrued on that debt, stood at $22.8T at the end of 2019).

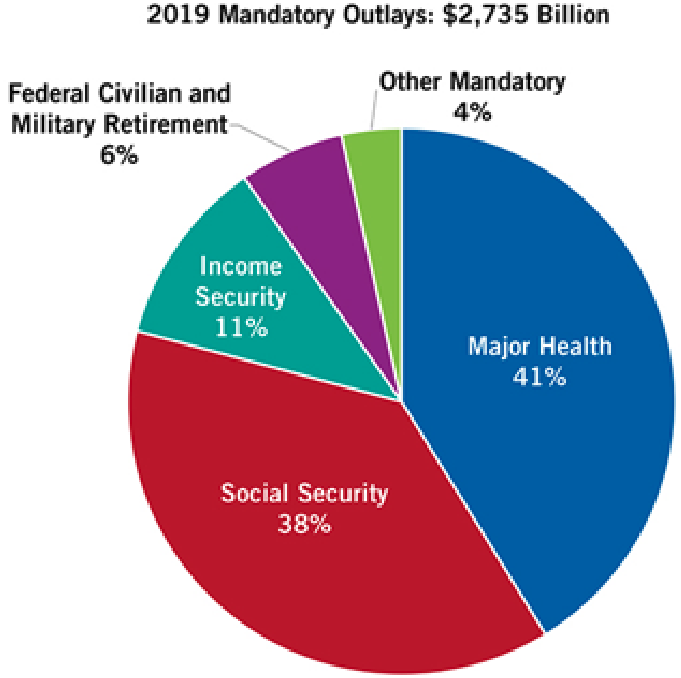
A CLOSER LOOK AT THE U.S. DEFICIT

- In 2019, the U.S. Government collected ~$3.46T in revenue.
- As shown, the largest share of government revenue is collected through personal income taxes and payroll taxes.



Source: Peter G. Peterson Foundation

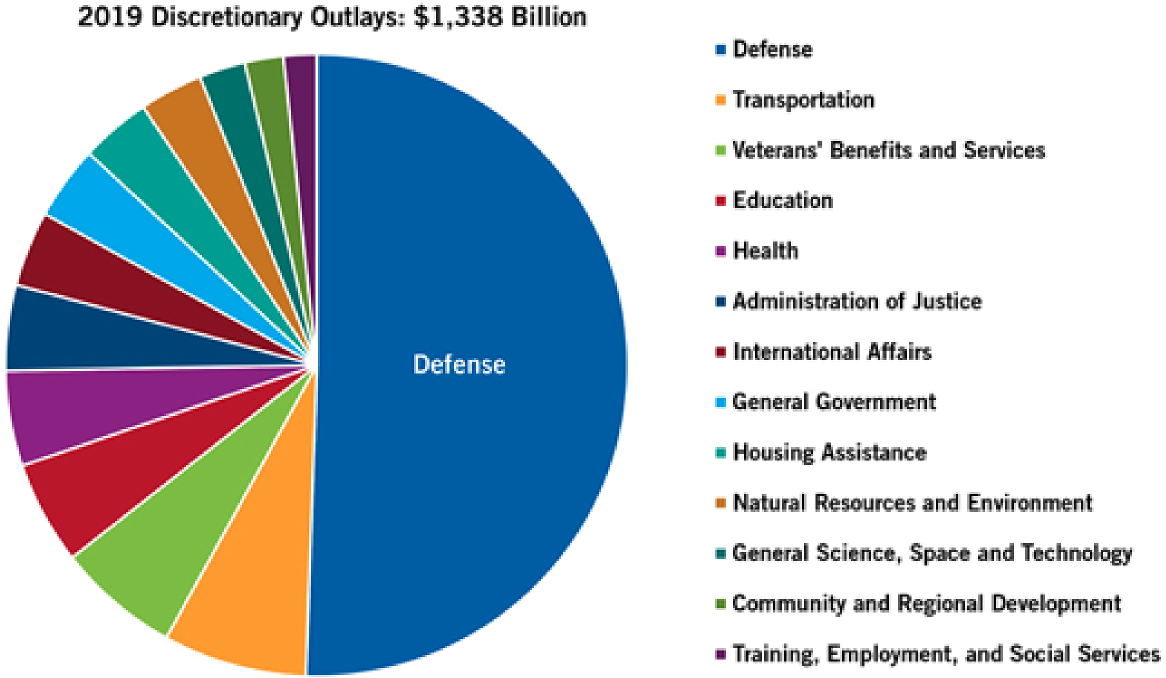




A CLOSER LOOK AT THE U.S. DEFICIT

- In 2019, the U.S. Government spent ~$4.4T. Spending is divided into 3 broad categories:
  - Mandatory –governed by existing laws (on ”autopilot” unless laws are changed)
  - Discretionary – determined annually by Congress
  - Net Interest – interest on the national debt

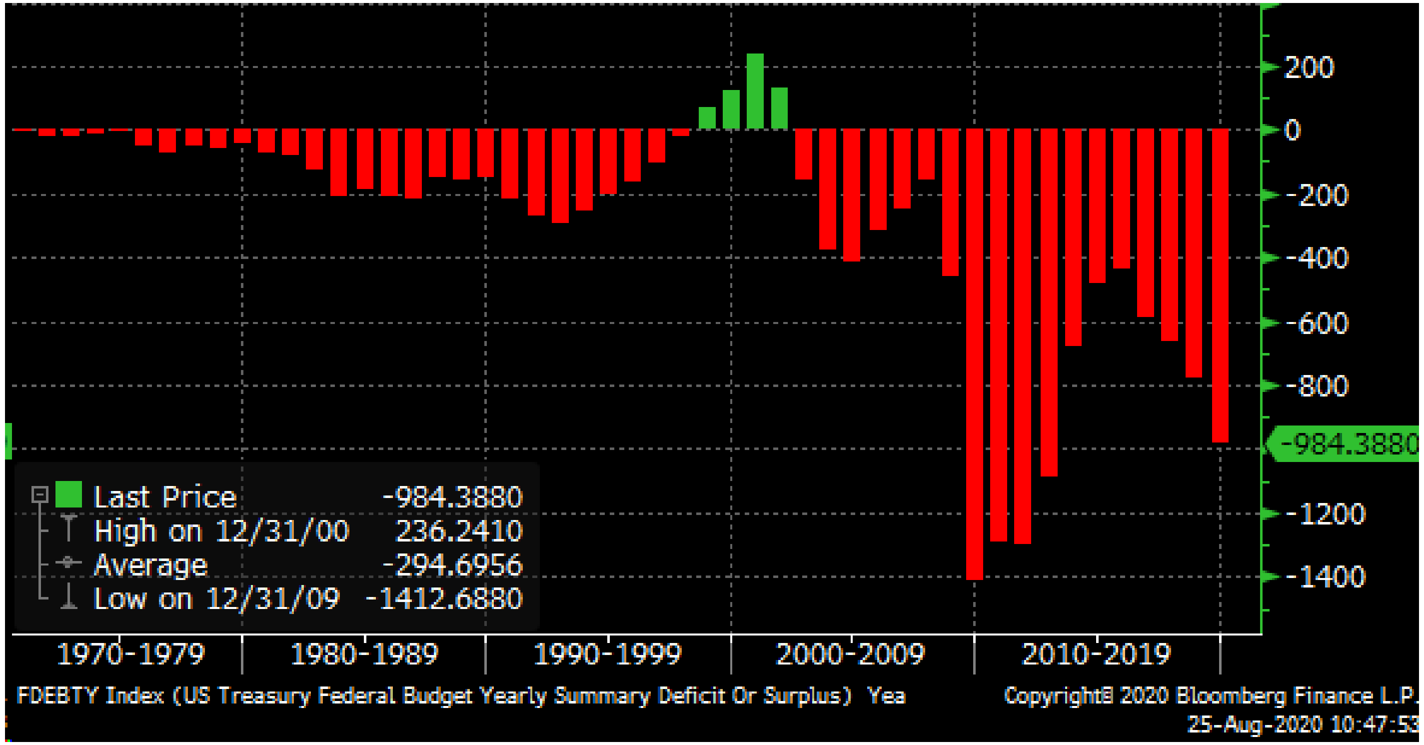
Source: Peter G. Peterson Foundation, Congressional Budget Office



U.S. DEFICITS IN DOLLARS

- As shown, our deficits steadily grew from the 70s to mid 90s.
- Following the Financial Crisis, our deficits exploded but returned to roughly pre-crisis levels, before rising again these past few years.
- Given the pandemic, the U.S. deficit is expected to rise to an all-time high of over $3T this year.

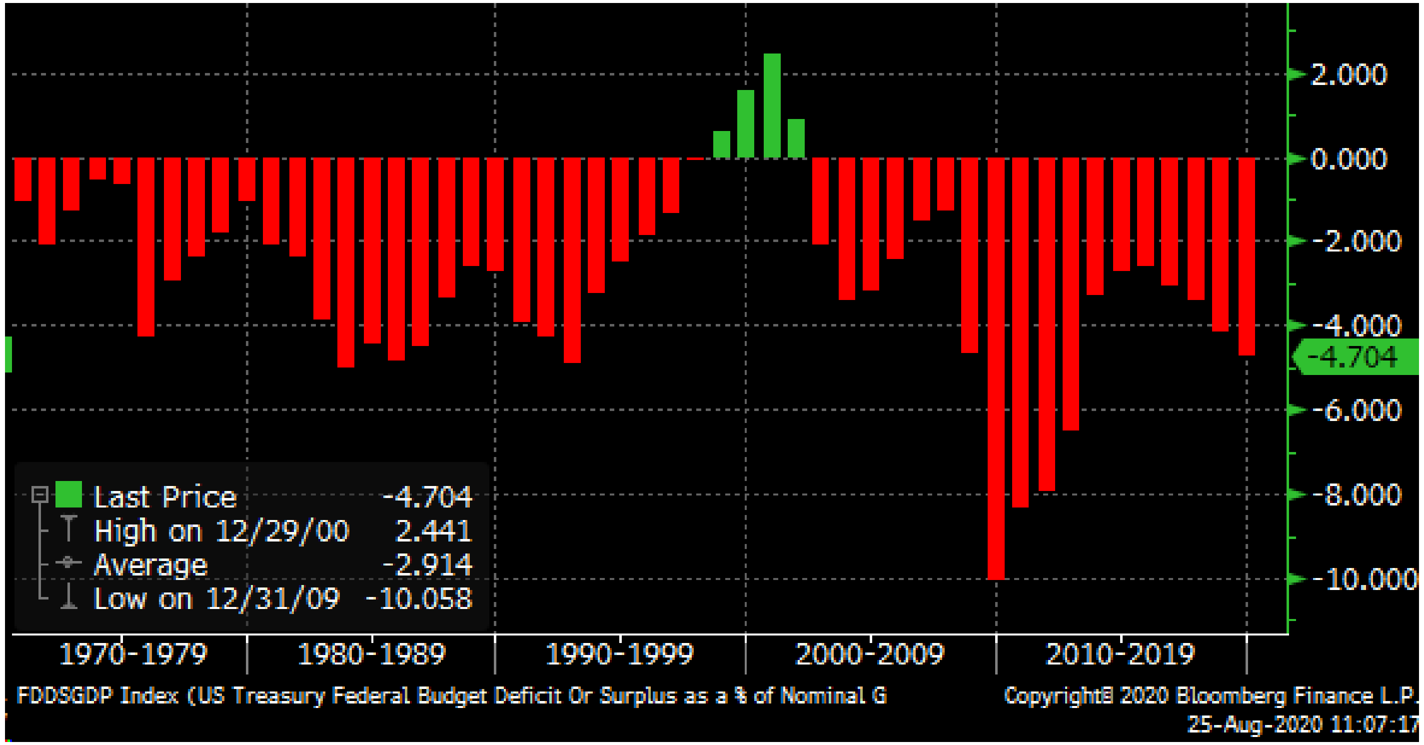
U.S. Annual Budget Deficit/Surplus ($ billions)



U.S. DEFICITS AS A % OF GDP

- Looking at the deficit in dollars can be informative, but we find examining it as a % of GDP to be more useful as both inflation and the size of the economy can change the context of "billions of dollars" over time.
- For example, $5k of debt for the average college grad in 1990 earning about $25k/yr has a different meaning than $5k of debt today for the average grad earning $55k/yr.
- From 1970 to 2019, the deficit has averaged -2.9% of GDP. Since 2000 it has averaged -3.6% of GDP. This year, it's expected to approach -17% of GDP.

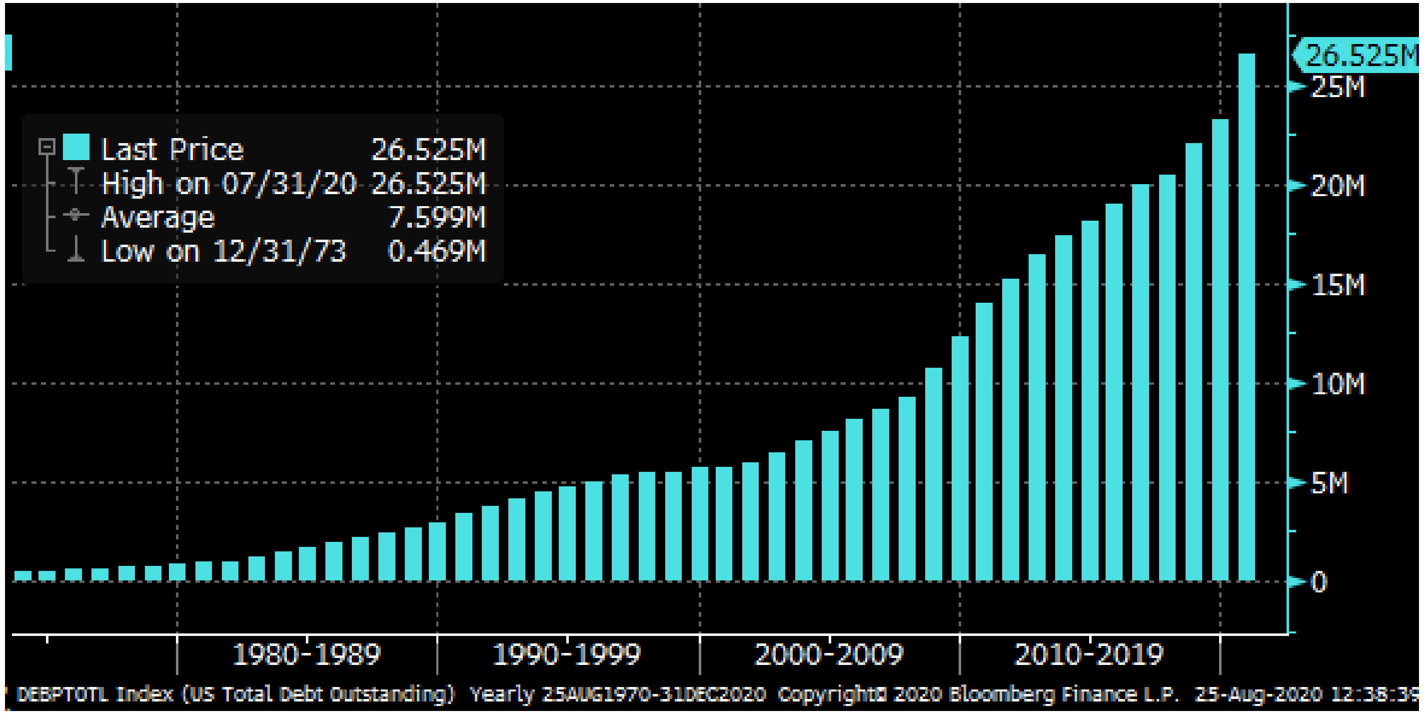
U.S. Annual Budget Deficit/Surplus (as a % of GDP)



OVER TIME, THOSE DEFICITS ADD UP

- The U.S National Debt has roughly doubled in every decade since the 1970s. This persistent compounding has resulted in a large debt balance for the country.
- Here again, the pandemic has taken its toll. The national debt was $23.2T at the start of 2020 and will eclipse $28T by the end of the year.

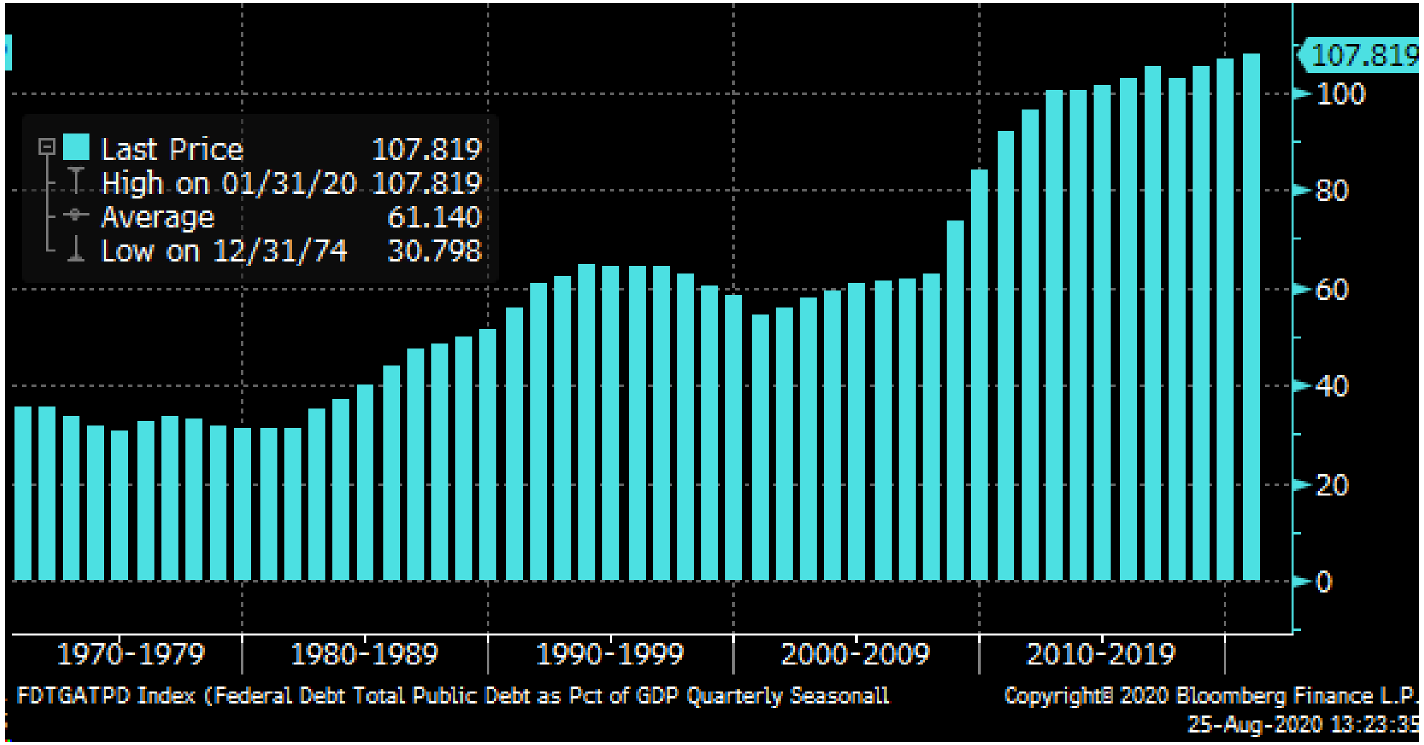
U.S. Total Debt Outstanding ($ Trillions)



DEBT IS NOT ONLY GROWING IN ABSOLUTE TERMS

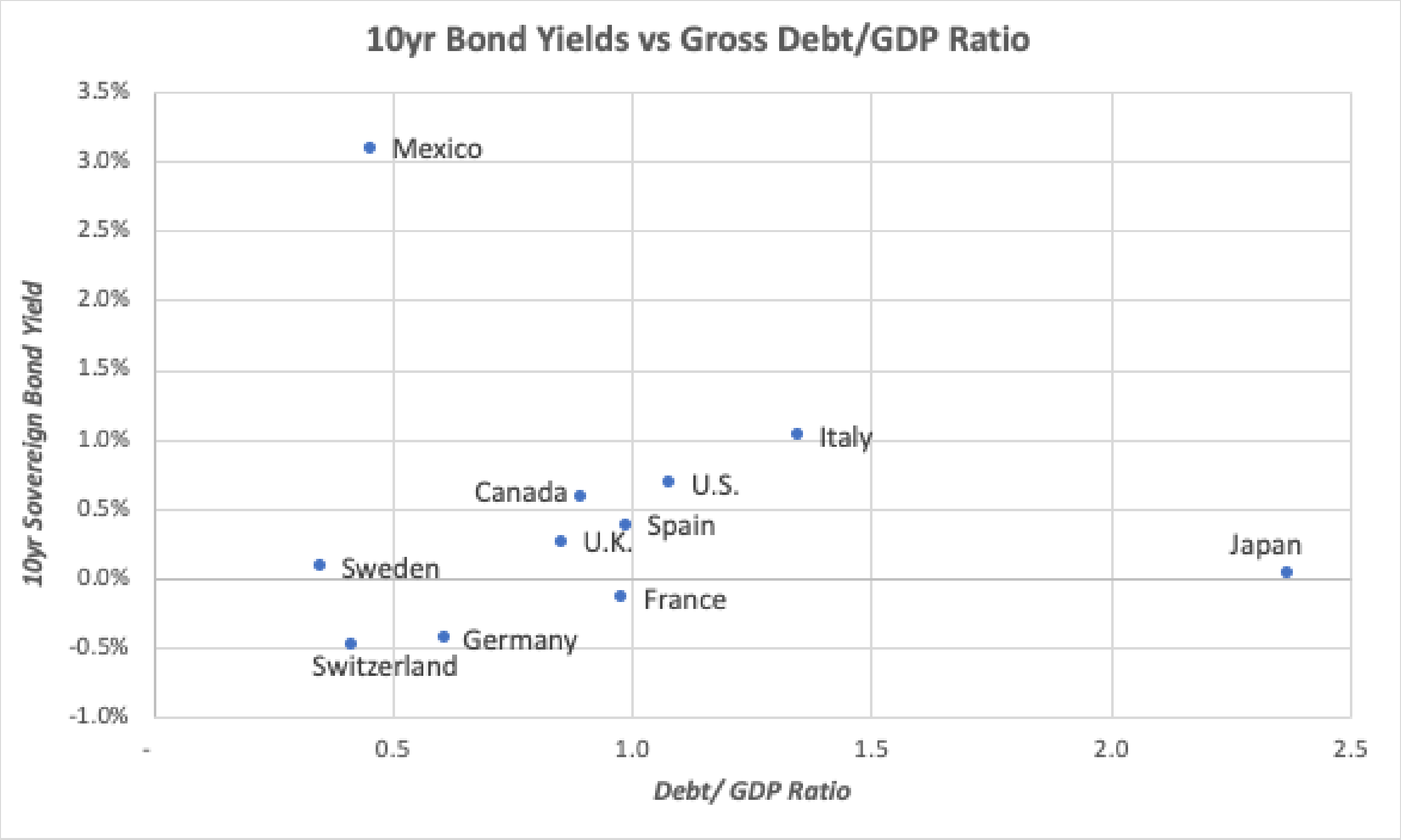
- Our debt is not only growing in absolute terms, it's growing relative to the size of our economy, as measured by GDP (our total national output).
- There were sizable step-ups in our debt burden in the late 80s/early 90s, as well as after the Financial Crisis. The pandemic will likely be another step-up as U.S. debt approaches ~110% of GDP by year end.

U.S. Total Debt as a % of GDP



ON A RELATIVE BASIS…

- Traditionally, a debt to GDP ratio of 1.0x was thought to be the line of demarcation for a higher level of sovereign risk.
- Now, several economic powers (including the U.S.) carry a debt/GDP ratio of ~1.0x or higher, yet the bond market has not deemed many highly risky…for now at least.
- And your eyesight does not deceive you! Yes there are 3 countries (Switzerland, Germany, France) on this graph with negative 10yr bond yields.



Source: Bloomberg, Hamilton Point

SEVERAL ARGUMENTS YOU MAY HEAR (AND MAY CHOOSE TO IGNORE)

- **"I can't spend more than I make, and neither can the government"**
  - Actually it's likely that you can spend more than you make. You can get a mortgage to buy a house, get a loan to buy a car or use a credit card to buy just about anything. The U.S. government definitely has the ability to spend more than it makes, and it has been doing so for the better part of the past century.
- **"Our country will have to pay all this money back one day or we will go bankrupt!"**
  - Many use logic that they'd apply to their personal finances and incorrectly apply it to our nation's finances. Yes, an individual must eventually settle their debts – be it at the time of death or sooner. But imagine if you never died. You could continue earning money and borrowing it over the years – that's closer to how a nation's finances work. Now in both cases, you'd have to pay off debts as they mature. So the individual needs to pay off the car, and the nation needs to pay off its bonds due in 20 years. But assuming both the individual and the nation satisfy their obligations along the way, there's no reason to believe that either wouldn't be able to borrow money in the future and continue to carry debt…UNLESS, the market suddenly decides that neither the individual nor the nation is creditworthy…that's when the calculus changes.

SEVERAL ARGUMENTS YOU MAY HEAR (AND MAY CHOOSE TO IGNORE)

- **"I've heard the real debt of the U.S. is close to $70 trillion."**
  - The federal government is obligated under current law to make mandatory payments for programs such as Medicare, Medicaid and Social Security. The present value of these unfunded obligations is approximately $45T. Adding our current debt (~$26T) to these unfunded obligations (~$45T) gets you to roughly $70T.
  - If one is to look at these obligations as debt, one should also recognize that most of these unfunded liabilities will become assets to people in the future (i.e. the government will send you a social security payment, and it will become cash in your bank account).
  - Including future liabilities – without taking stock of future assets – presents a misleading picture to the American public.
  - Further, laws (and hence liabilities and assets) can change in the future to reduce/increase the unfunded segment of these liabilities. The U.S. has a great deal of assets to draw upon. For context, American households currently own ~$120T of assets (not including the future value of government transfer payments).

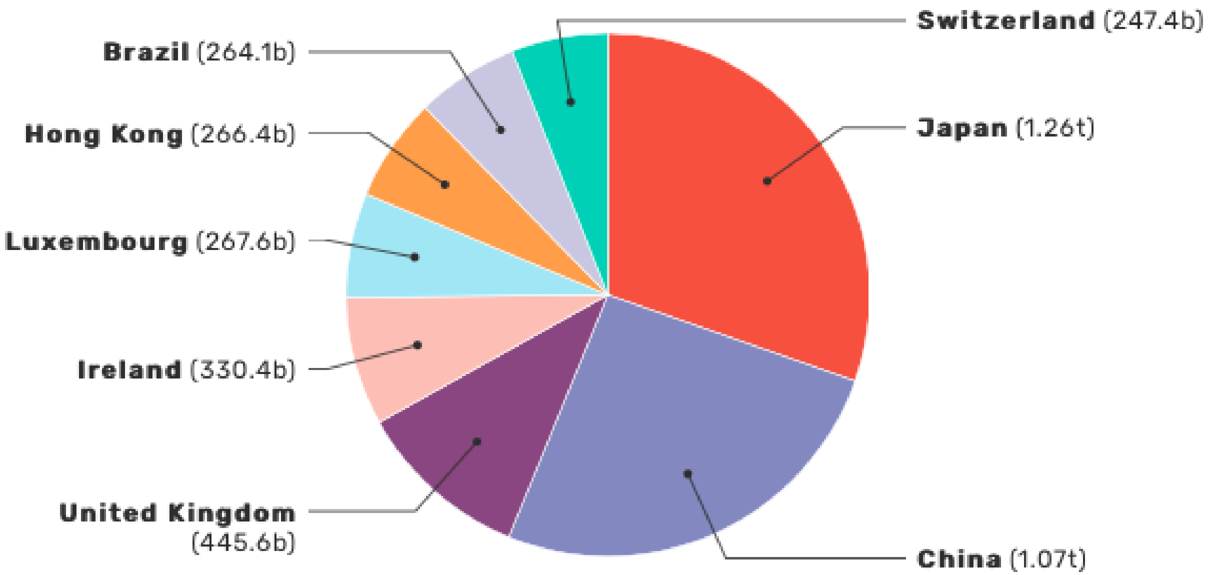
SEVERAL ARGUMENTS YOU MAY HEAR (AND MAY CHOOSE TO IGNORE)

- "Foreigners hold all of our debt, and they're going to own this country"
  - As we stated earlier, the U.S. currently has ~$26.5T in outstanding debt. As of July 2020, approximately **23% (~$6T)** of that debt was held by other U.S. government agencies. Some agencies take in more revenue than they spend, so instead of just keeping it in cash, they invest in U.S. Treasuries. The largest holders in this category are the:
    - Social Security Trust Fund: $2.9T
    - Office of Personnel Management Retirement: $929b
    - Military Retirement Fund: $913b
  - With these U.S. agencies owning ~23% of our debt, the "public" (aka – anyone outside of our government) owns the other **77% (~$20.5T).**
    - Foreign entities own ~$6.8T of that ~$20.5T
    - U.S. investors (through banks, mutual funds, pension funds, and insurance companies), state & local governments, and the Federal Reserve own the other $13.7T

SEVERAL ARGUMENTS YOU MAY HEAR (AND MAY CHOOSE TO IGNORE)

- ”China could bankrupt this country!”
  - As shown, China is the 2nd largest holder of U.S. Treasuries with ~$1.07T (~4% of total U.S. debt).
  - It seems a stretch to say that any single country can bankrupt us. Keep in mind that these countries own bonds maturing this month all the way out to 30 years from now. As long as we pay these bonds as they mature, there is no event of default.
  - A more likely scenario is that a country stops buying our new debt, or a country sells their holdings in the public markets. That has happened at times in the past with minor repercussions. A large holder could quickly liquidate its holdings and cause havoc in the Treasury market, but the market would eventually stabilize at new price levels/yields.

Top Foreign Holders of U.S. Public Debt



Source: U.S. Department of the Treasury

THESE ARGUMENTS GIVE US MORE PAUSE

- “We’re robbing our children with all of this debt”
  - This argument carries a bit more truth than some of the previous ones. The more debt a nation takes on, particularly relative to its GDP, the more difficult it becomes to borrow in the future, theoretically speaking. That “difficulty” surfaces in the form of higher interest payments and less availability to borrow.
  - For instance, the U.S. has had no problem borrowing for the pandemic, but one could imagine a future disaster where the market for Treasuries was much more expensive….or much less available.
  - Oddly enough, interest rates have dropped around the globe as most developed countries have taken on more debt over the past 30 years. There have been isolated sovereign debt crises along the way (Greece, Iceland, Argentina), but in aggregate, interest rates are lower. There are a number of reasons for this phenomena, but it’s worth mentioning, as it implies that the global markets have generally not yet started “charging” more or limiting borrowing to more heavily indebted countries like the U.S.

THESE ARGUMENTS GIVE US MORE PAUSE

- “Now is the time for more debt”
  - Here again, we’d tend to agree. To the extent that you’re going to run deficits and borrow money, now would be a good time to do it. The U.S. economy suffered a historic shock to economic activity and employment. Consequently, tax receipts are falling while businesses, state and local governments, and individuals need assistance. Certainly, there are a number of valid arguments for exactly how much fiscal and monetary stimulus should be deployed, so we’ll happily leave that issue for others to decide.
  - Given that we’d agree that now would be a logical time for more debt, it’s implicit that there are periods when we’d argue it’s time for less debt. Since we’re apolitical on this topic – we’ll refer back to slides 6 and 7. We count **4 years since 1970** when the U.S. had a budget surplus. Most of the time our nation’s debt burden has continued to grow. Evidently, the decision to spend more than the government generates has been alluring to both parties for decades (and of course both parties would take credit for the 4 years of surplus)! At a bare minimum, we’d suggest striving for a deficit growing more slowly than GDP when the economy is performing well.

CONCLUDING REMARKS

- Due to persistent budget deficits, the U.S. national debt is large (approaching $28T/~1.1x GDP) and has been growing for decades, even adjusting for inflation.
- There are a variety of sensational headlines warning against sudden, impending doom from our country's debt burden, but we'd advise a more nuanced view in evaluating those claims.
- We acknowledge and worry about the long-term ramifications of these high levels of debt; given the experience of other developed economies that have carried high debt burdens, we're most concerned about slow economic growth and higher future borrowing costs.
- Given the pandemic will only worsen our country's fiscal situation, we'd urge steps to make lowering budget deficits a priority in the future. Our soaring debt has not significantly impeded our country's growth thus far, but we fear that may not be the case indefinitely.
- In terms of our investment philosophy, the growing debt burden that our country faces reinforces our **commitment to quality and growth**. **High quality** companies carry little to no debt, and as a result, don't depend on well-functioning capital markets to survive. **Growing** companies with a high value-added product/service can thrive even if growth at the national level stalls. We plan to lean on these principles as debt continues to weigh on the global economy in the future.

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As Director of Research and member of the Investment Committee, Mr. Nelson focuses on monitoring current market conditions and optimizing the firm's investments to achieve long-term results for the firm's clients. Over the course of his career, Mr. Nelson has built and managed multi-billion dollar funds that focus on fixed income and event driven strategies. His views on the markets have been regularly reflected on CNBC, Bloomberg, the Wall Street Journal and the Financial Times.

Outside of the office, Mr. Nelson volunteers as a youth sports coach with Chapel Hill Parks & Recreation and teaches yoga at Franklin Street Yoga Center.

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