The debt overhang

The US equity market in local currency terms advanced again in January. Investors have continued to give the new US President's pro-business policies the benefit of the doubt. Many believe that his planned tax reforms, regulatory changes, and infrastructure investment will finally unleash the animal spirits needed to increase business investment, and promote more productive means of economic growth.

While tax cuts and reduced regulations may support corporate profits in the short term, their effect on the economy, along with infrastructure spending, often takes more time. Perhaps not considered in the bullish view of these economic policies is the government debt overhang that has the potential to limit the success of these policies.

The non-partisan US Congressional Budget Office (CBO) recently released their budget and economic outlook for the next decade. Their forecasts do not consider the new President's economic policies as they have yet to be confirmed. The CBO predicts the US fiscal deficit will continue to grow as a percentage of Gross Domestic Product (GDP), based on two key factors: the aging population, which reduces the tax base and increases spending on programs for seniors; and interest charges on the outstanding federal debt. Without a material increase to revenues or a large reduction in spending, the deficit is expected to grow to 5.0% of GDP, a significant rise from the current 2.9%.

Rising deficits will add to the gross federal debt, which as of July, 2016 stands at 104.8% of GDP, the largest percentage since the end of the Second World War. While the cost of this debt is a lot lower than in the 1980's and 1990's given the current era of low interest rates, the amount of US federal government debt that will need to be serviced, at approximately $19.8 trillion dollars, looms large for President Trump as a potential impediment to his growth plans.

Their plan to accelerate US economic growth is based on policies designed to increase private and public investment. Reducing barriers for investment (regulation), maximizing US corporate profits, and improving discretionary incomes to bolster consumer spending. These policies seem sound on paper. Implementing them without unleashing inflation, increasing debt, and strengthening the US dollar is the challenge.

Though the rise in bond yields since November is an indication that investors feel the new administration's economic policies will be inflationary, the debt overhang, combined with renewed threats of protectionism, cloud the economic outlook. We know a proposed border adjustment tax on US corporations' imported goods and services is being considered to help fund the corporate tax cut. The potential offsetting impact from a stronger US dollar needs to be considered. The success of these economic policies hinges on many factors. Given the size of the US debt, however, the most important of these may be the level of interest rates.

The fact that the US Congress is considering how to fund President Trump's economic policies without increasing indebtedness is a positive sign. Rising interest rates threaten to grow debt servicing costs to a larger portion of the fiscal budget, limiting the flexibility and investment power of the US government. One only has to look to Japan for evidence of how rising debt levels have failed to spur sustainable economic growth.

We continue to be cautious in our economic outlook. This QV Update only focused on US government debt; we could have easily written about the pace of debt growth in China, Canada or Europe. Our global economy remains highly sensitive to interest rate changes given the level of indebtedness. For this reason, we believe central bank policy rate changes will be gradual. We also believe the new US administration's economic policies have a chance of success if deficits are contained, and trade is not impeded.

Broad equity market valuations remain stretched and thus we remain vigilant in managing the downside risk in our equity strategies. The term to maturity in our bond strategies remain short, as longer term bonds yields, despite their recent rise, still do not offer enough of a reward to warrant extending our term. Our asset mix remains neutral, given the elevated valuations, and debt overhang.