WELLS FARGO
Investment Institute

November 2022

Paying America's bills

What investors should know about how the U.S. government manages its finances

Key takeaways

- At over $30 trillion, the federal debt is staggering but currently manageable. What's troubling is the prospect for its continued growth over the long term.
- We believe the Treasury has done a good job of managing the debt expense, and investors have shown no reservations about buying Treasury securities. Lower rates over the past decade helped keep funding costs low, but if rates rise further and current spending trends continue, that could change.
- Although it's unlikely that investors will feel the most damaging effects of America's fiscal challenges anytime soon, Wells Fargo Investment Institute (WFII) is already factoring the potential impact into our strategic models and recommending portfolio changes for investors to consider.

A factual look at U.S. debt, deficits, and entitlements

The Congressional Budget Office (CBO) expects that the budget deficit will decline to $1.0 trillion in 2022. It was $2.8 trillion last year, as the government issued debt to deal with issues associated with the pandemic. Still, rising interest costs and greater spending for programs that provide benefits to elderly people are expected to increase the deficit to 6.1% of GDP in 2032 according to the CBO.

The bottom line is many of the current trends are unsustainable over the long run. Fortunately, we think there is still time to make corrections before a crisis emerges. The necessary changes are likely to be more drastic the longer the U.S. waits to act. In the past the U.S. has been adept at dealing with crisis. Will the U.S. be just as adept at pre-empting one? We believe there is danger that the steps required may be too great to instigate action before a crisis occurs.

Our country is not alone in facing these challenges; the U.S. is unique, however, in that we remain in a position of strength globally. Our economy is the world's largest and most diversified, and the U.S. dollar is the globe's primary reserve currency. While that's still the case, can our political parties work together to enact sweeping changes to correct our long-term trajectory?

Any discussion of America's debt and budget is often politically charged. In the following pages, we provide a nonpartisan presentation of our nation's fiscal trends. At the conclusion, we look at how we have adapted our investment guidance as a result of these trends and make some portfolio suggestions for you to consider.

$30.6[1] trillion
Total U.S. debt

$7.2[1] trillion
Portion of U.S. debt borrowed from government sources

$40.4[2] trillion
Projected total U.S. debt in 2032

$2.6[2] trillion
Projected 2022 spending on Social Security and major health care programs

1.88%[1]
Current average rate government pays to finance the debt

1. TreasuryDirect.gov, Debt Position and Activity Report, July 31, 2022

2. CBO, The 2022 Long-Term Budget Outlook, July 27, 2022

Cutting through the federal budget fog

Why doesn't the federal budget balance?

Like any budget, the federal budget is merely a plan for revenues and expenditures for the fiscal year. While that may sound simple enough, there's often a cloud of confusion around the federal budget.

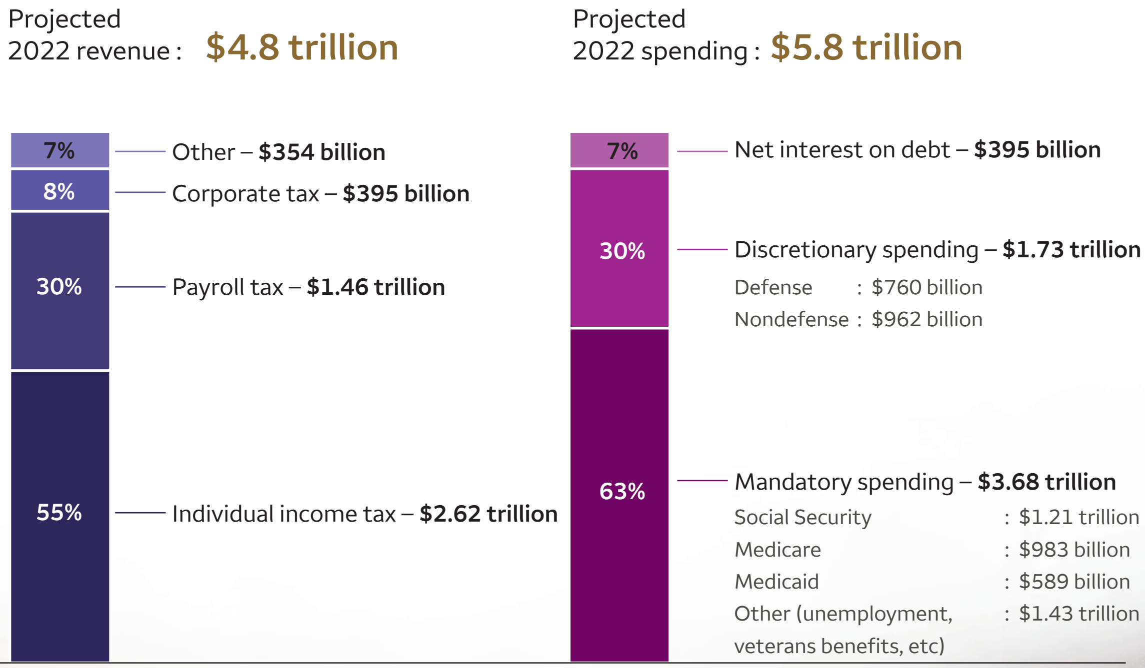
Lawmakers have little wiggle room to reduce expenditures. Although cutting federal spending to help balance the budget is frequently a matter of intense debate, the fact is only about one-quarter of government expenditures is discretionary — meaning they can be easily reduced. These comprise spending that lawmakers control through annual appropriation acts and can be broken down somewhat evenly between defense and nondefense expenditures.

The bulk of government spending is actually considered "mandatory," which is somewhat of a misnomer. These "entitlement" expenditures can, in fact, be reduced, but doing so would be extremely difficult (and probably unpopular).

Government spending exceeds revenue

When a business or family does budgeting and subtracts expenditures from revenues, the goal is usually to end up in positive territory. When the federal government does it, the result often is a negative number, or a deficit.

While politically unpopular, “entitlement” expenditures can, in fact, be controlled by lawmaker action. For example, significant unemployment and small business spending related to the coronavirus response significantly increased outlays in 2020.



Revenue		Spending		Deficit
$4.8 trillion	—	**$5.8 trillion**	=	**$1 trillion**

Sources: Congressional Budget Office, “The 2022 Long-Term Budget Outlook”, May 2022.

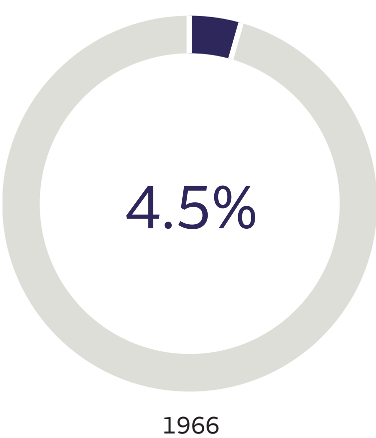
Taking a closer look at spending

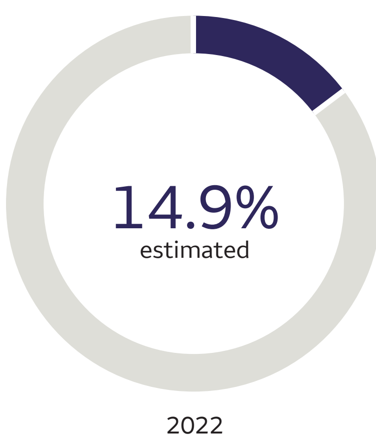
Why is the shift in spending a concern?

With a greater proportion of spending going toward mandatory expenses, policymakers could face challenges down the road.

For some historical perspective, the government spent 4.5% of gross domestic product (GDP) on mandatory expenses in 1966; in 2020, that figure skyrocketed to 22% due to pandemic spending. In 2022, the Congressional Budget Office (CBO) projects that mandatory spending will decrease to 14.90% of GDP, equal to the 14.20% of GDP projected in 2032 if entitlement program payout formulas remain unchanged.

The significant increase in mandatory expense outlays over time presents the possibility that the government may lack fiscal flexibility when it comes to dealing with future economic challenges. Recently, legislators seem willing to increase deficit spending in both good and bad economic environments. Lawmakers chose to decrease tax revenue in 2017 during a relatively healthy economy. More recently, spending was substantially increased in response to a steep decline in economic output due to the coronavirus pandemic. Some level of deficit spending is likely sustainable, but as the population ages, a greater burden will likely be placed on the government budget and resources — resources which may have otherwise supported economic growth to support increased costs for social programs. Interestingly, high debt levels and difficult demographic issues have not yet led creditors to demand higher yields. In fact, interest rates across the globe still remain at relatively low levels when compared to history, despite the recent increase in interest rates due to elevated inflation.



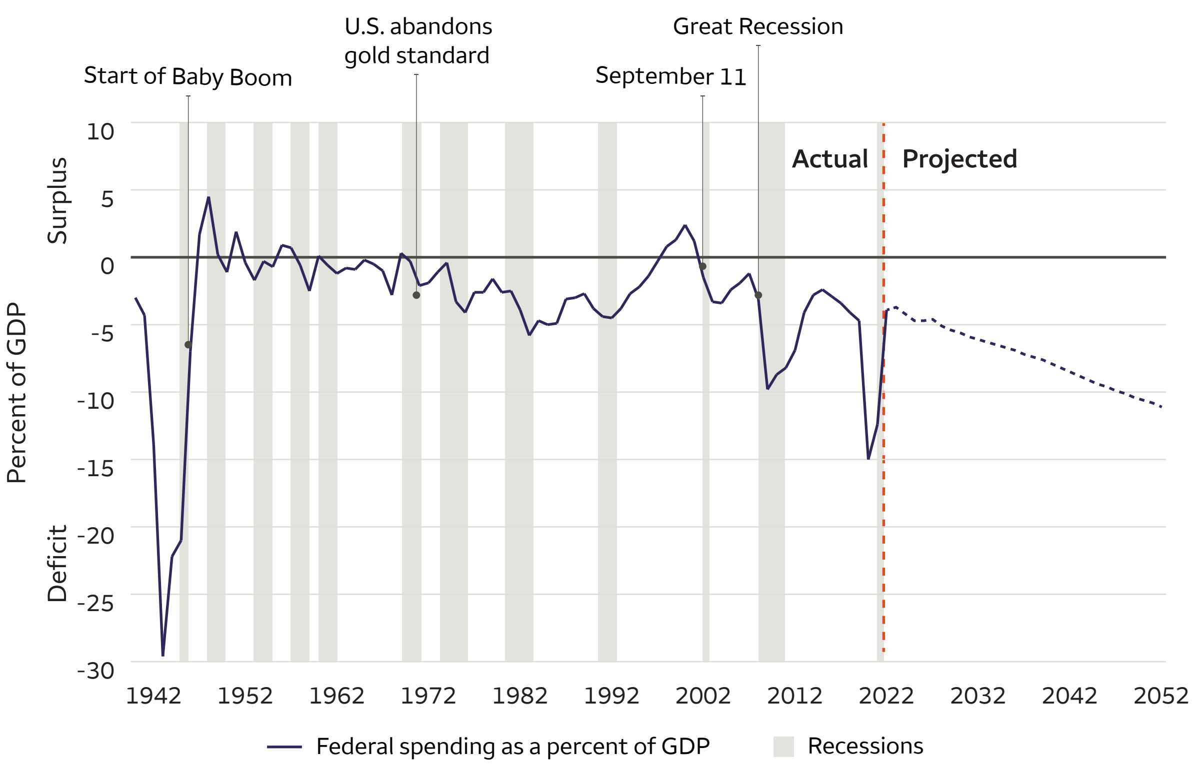


Government spending of GDP on mandatory expenses, per the Congressional Budget Office

Deficits — not necessarily a bad thing

While federal deficits are definitely a concern, keep in mind that they are an important part of managing through economic cycles. In theory, deficits grow during recessions as the government increases spending to help stimulate economic activity while tax receipts decline. During better times, the opposite should occur, potentially resulting in surpluses. However, as the chart shows, the government has run deficits on a fairly consistent basis — in both good times and bad — going back to 1929.

Deficits and surpluses as a percentage of GDP



Source: Congressional Budget Office, May 2022. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Going behind the debt numbers

Why is there so much talk about the debt?

At more than $30 trillion, the federal debt's size is indeed staggering. But keep in mind that the raw numbers do not tell the full story.

When consuming debt statistics, investors should understand how debt numbers are being calculated. Total debt numbers often include debt the government owes itself. Government-owned debt is similar to you taking a loan from yourself — a default on a loan to yourself would not result in a default to your creditors and does not need to be financed in the public debt markets.

The U.S. government holds its own debt in various trust funds, such as the Social Security and highway trust funds. We have also included Treasury debt held by the Federal Reserve in government-owned numbers.

Who owns the debt?

The U.S. government is the biggest holder of the debt (latest available data as of March 2022)

Owned by the U.S. government		Owned by the public			
		U.S. investors		Foreign countries	
40%		35%		25%	
Social Security trust fund	$2.7T	Depository institutions	$1.75T	Japan	$1.2T
Medicare trust fund	$191B	State and local governments	$1.45T	China	$1.03T
Federal Reserve	$5.5T	Private pensions	$889B	Others	$5.3T
Other trust funds	$3.8T	Mutual funds	$3.3T		
		Others	$3.2T		
Total: $12.3 trillion		**Total: $10.5 trillion**		**Total: $7.6 trillion**	
		Total: $18.1 trillion			
Total: $30.4 trillion					

The government currently owes more than $18 trillion to public investors. Out of the total held by public investors, foreign investors hold over $7.6 trillion in Treasury securities — a level that increased dramatically throughout the last two decades.

Source: U.S. Department of Treasury, Bureau of the Fiscal Service, "Treasury Bulletin", September 2022. Data as of March 2022.

How does U.S. debt measure up?

A country's public debt-to-GDP ratio is one measure of its government's ability to pay its debt. Treasury debt owned by the Federal Reserve is considered public debt. If a country's debt was equal to its annual GDP, the ratio would be 100%. In 2020, the U.S. ratio reached 100%, the highest level since World War II — a dramatic increase from the 50-year average of 44%.

According to CBO projections, the U.S debt-to-GDP ratio is poised to reach 110% in 2032 and 185% in 2052. We believe a high debt-to-GDP ratio increases the risk that investors might, at some point, begin to doubt the government's ability or willingness to pay off the public debt. That could result in benchmark interest rates rising and drastic spending (austerity) measures being necessary to maintain creditor support of the government's debt.

But debt-to-GDP does not tell the full story regarding creditworthiness — after all, Japan's debt-to-GDP is estimated to be over 250%, yet it still enjoys the lowest borrowing costs in the world. Other factors to consider include:

- **Who are the bond buyers?** When a country's own citizens purchase the majority of the government's debt, the likelihood that selling pressures or a buyers' strike could materialize is small. As a result, a higher debt-to-GDP level may be sustainable.
- **How healthy is the economy?** Countries with higher economic growth and more diverse economies historically have had a greater ability to pay back debt, and the market may bear higher debt-to-GDP ratios.
- **How is the debt being managed?** Countries with high debt-to-GDP levels that have implemented reforms such as those listed below may gain investors' support:
  - Cutting spending
  - Raising revenues through higher taxes
  - Implementing policies to increase economic growth

While the U.S. currently has a debt level that's very high from a historical perspective, we feel the danger zone is not in the near term but over the long term, should the debt burden continue to grow.

What does it cost to finance the debt?

Although the debt has ballooned, the cost of financing it is actually less than it once was, and it appears manageable. For now.

While the federal debt has grown considerably over the past decade, the percent of the federal budget needed to finance it has actually fallen from a high of 15.4% in 1996 to a 2022 projection of just 6.8%.[1] This is a modest decline over the 8.4% dedicated to interest expense in 2019. Lower pandemic-related spending will allow the deficit to shrink to $1.0 trillion in 2022 according to the CBO. However, higher interest rates will cause greater net interest outlays when compared to 2020 and 2021.

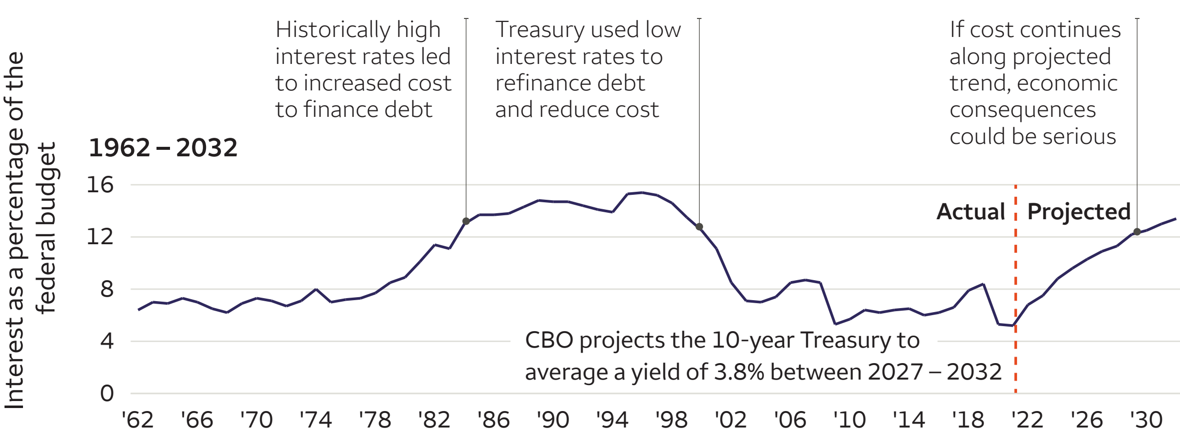
Current CBO baseline projections show the debt service increasing to over 13% of the federal budget by 2032. Under this scenario, interest expense costs would remain manageable. However, additional economic shocks or a faster-than-expected increase in interest rates could be concerning.

Steadily falling interest rates over the past decade afforded the United States a significant amount of fiscal flexibility despite the significant increase in total debt. However, the expectation of a longer-term trend of increasing interest expense could have serious economic implications.

$795 billion

Added interest expense in 10 years the CBO estimates in its projections as a result of increased debt and modestly higher interest rates[2]

U.S. net interest as a percentage of the federal budget



Source: Congressional Budget Office, May 2022

1. Congressional Budget Office, May 2022

2. Assuming all other economic variables remain unchanged. Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Dealing with the debt ceiling

Even as debt costs remain manageable, markets with some regularity concern themselves with the debt ceiling. The Treasury can issue debt only if Congress and the president have given it authority to do so; this authority has become synonymous with the debt ceiling. Failure to raise the debt ceiling when necessary could result in the U.S. government defaulting on its obligations, which it has never done. Currently, the debt ceiling is slightly below $31.4 trillion. This limit is expected to cover federal borrowing needs until the second half of 2023.

Raising the debt ceiling does not directly alter federal spending going forward — debt is issued only when the Treasury needs funds to cover spending that Congress has already authorized. Legislative uncertainty over raising the debt ceiling has, at times, forced the Treasury to take extraordinary measures and brought about market uncertainty, rating agency downgrades, and intense political wrangling.

Political brinkmanship is likely to continue to dominate future debt ceiling deadlines, yet we expect the U.S. government will continue to take the steps needed to pay its bills in a timely manner. Investors should not be overly concerned as this inevitable deadline once again approaches. Maintaining investment exposure and taking advantage of any market dislocations should be investors focus.

Debt ceiling through the years

1917	Congress establishes the debt ceiling
2011	Debt ceiling issues, in part, lead to the very first credit-rating downgrade
2021	In December, a joint resolution from Congress (Public Law 117–73) increased the debt limit by $2.5 trillion, setting the current level at $31.4 trillion
78x	Since 1960, the debt ceiling has been raised 78 times* — 49 times under Republican presidents and 29 times under Democratic presidents

*** Source:** Treasury Department, September 2022.

Looking ahead

Potential warning signs of a debt problem

It is likely that the U.S. can support a meaningfully higher debt level than today given the country's dominant global economic position and the dollar's stance as the world's primary reserve currency.

Even if the country can sustain a meaningfully higher debt level, projected increases remain concerning. Keep in mind it is impossible to predict exactly how much federal debt the country could bear before investors lose faith in the government's ability or willingness to pay, potentially pushing borrowing costs higher and the nation into a fiscal crisis.

Even if a crisis is not imminent, the consequences of a significant national debt are likely to be real and far-reaching for citizens and investors. Before any true financial crisis occurs, investors should watch for potential effects of a growing debt, such as:

Crowding-out effect

A large amount of federal debt issuance could lead to a greater portion of private investment spending and consumption being diverted to Treasury debt, shrinking the pool of capital available for private investment. This would likely result in lower economic output, lower incomes, lower investment of capital, and lower investment returns.

Higher borrowing costs

In the longer term, the laws of supply and demand imply that an increase in debt supply will lead to lower bond prices and higher interest rates — assuming all else remains equal. If rates rise materially, the added cost would require increasing government revenues, reducing spending, or implementing some combination of the two.

Decreased fiscal flexibility

An increasing debt level would restrict policymakers' ability to respond to unexpected events. Future shocks may have a more significant negative economic impact as lawmakers might lack flexibility to deal with them fiscally.

Addressing the challenges

To put the federal budget on a sustainable long-term path, lawmakers would have to make major changes to tax policies, spending policies, or both. However, when it comes to these issues, Congress typically finds itself stuck between a rock and a hard place.

On the one hand, these are politically challenging positions to advocate for in legislation given a politician's incentive to be popular and electable during election cycles. On the other hand, the sooner these issues are addressed, the less drastic the size of such changes would be required. The ultimate size and scope of the changes that would be required would depend on the amount of federal debt that lawmakers consider appropriate. Given the choice between taking potentially unpopular action and "kicking the can down the road," Congress has generally opted for the latter.

When, if ever, our lawmakers do act, there are several schools of thought, overviewed below, for them to debate regarding debt management and appropriate fiscal policies.

What can be done?

Spending cuts

Given the budget's makeup, a significant portion of any cuts would likely need to come from popular social programs, which would be politically challenging.

Tax increases

Much like spending cuts, tax increases would likely be unpopular — at least with some segments of the population. In addition, they would go counter to recent policy, which is to simplify the tax code and reduce rates.

Higher economic growth

Arguably the best way to reduce debt-to-GDP is to grow GDP. But based on CBO estimates, it appears unlikely the U.S. will be able to reach and maintain a growth rate in excess of mandatory spending increases over the next five years.

Negative real rates

An inflation rate greater than the interest rate paid on the debt could help manage an increasing debt load and aid in any deficit reduction efforts. While the Federal Reserve can help manage interest rates, there is no guarantee that the Fed would allow inflation levels to be above its long-term target.

Inflation or debt renegotiation

Printing dollars to pay off maturing debt or renegotiating outstanding bonds would likely erode investors' and citizens' savings and make it difficult to borrow again and should be used only as a last resort.

Waiting to act will likely compound the problem and necessitate more significant measures in the future. We believe acting sooner rather than later by implementing slow, planned spending-reduction and revenue-growth policies would help the U.S. reduce its reliance on unsustainable debt trends.

Implications for investors

Economic trends factor into our long-term strategy

Although it's unlikely that the most damaging effects of America's fiscal challenges will affect investors anytime soon, there are impacts to our long-term investment stategy, and Wells Fargo Investment Institute recommends keeping them in perspective.

Modest inflation assumptions

High government debt levels historically have had a deflationary effect as funds that may have otherwise been used toward investment and consumption must be diverted to service a growing debt burden. However, we believe that long-term inflation levels will trend closer to the Fed's 2% target level, but with periods when the rate fluctuates around that level by more than in past decades.

- When building your investment plan, keep in mind that bouts of rising inflation can increase your expenses but also can increase investment returns and vice-versa.

Lower yields and longer maturities

Firmer inflation will outweigh restraint on yields from increased demand for fixed-income securities by an aging population, insurers and pension plans in nudging longer-term rates higher.

We continue to create and offer innovative income-oriented strategies to help replace traditional income sources.

- Talk to your investment professional to determine whether our diversified income approaches are right for you.

Lower return assumptions

Fiscal trends and an aging demographic make it more likely that asset-class return expectations will be lower in the future than we have experienced historically.

- Lower long-term return assumptions may require that you revisit your investment plan to help ensure that you are on track to meet your goals.

Investment actions to consider

Fixed income

Rising interest rates and mounting debt to pay for benefits such as social security could cause the Treasury to increase issuance over the next decade. The issuance increase from the pandemic response has already impacted many fixed income indices, which now include a larger percentage of government debt.

- Corporate bonds and preferred securities should continue to pay a premium over U.S. Treasuries. Moving down the credit spectrum is a viable strategy to increase yield but must be done so with caution. We recommend investors use active management when purchasing lower-quality investments.
- Investors may consider holding emerging market fixed income securities. The higher yield available in this asset class would be attractive, especially those issues denominated in local currency should markets be concerned with U.S. fiscal trends and the resulting impacts of a weaker U.S. dollar down the road.

Equity markets

Equities are likely to remain volatile as investors question the outlook of future economic and earnings growth in a challenging fiscal environment. However, we believe equities may remain a better source of return than bonds.

- Fiscal and monetary support are likely to be implemented congruently should a future crisis arise. These actions tend to lift financial asset prices, with equities markets being a significant beneficiary.

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