CLIENT QUESTION OF THE MONTH: How does the US Federal deficit affect my investments?

- As of the end of 2020, the US debt held by the public amounted to $22 trillion, an increase of approximately $5 trillion from the year before and well over double the level from a decade ago.[1] This trend may be worrisome for investors expecting an adverse impact on stock returns once the bill for all this spending comes due.

- The US has hardly been alone in its recent escalation of debt. Exhibit 1 shows that roughly half the Organization of Economic Co-operation and Development (OECD) member countries had general government debt-to-gross domestic product[2] (debt/GDP) ratios above 70%, with 10 countries—including the US, Japan, and the United Kingdom (UK)—exceeding 100% as of 2020.

EXHIBIT 1

Due Process

General government debt as a percent of GDP in OECD countries as of 2020

  - Debt/GDP data from OECD (2021). General government debt as a percent of GDP, 2020 or latest available. General government includes central, state, and local governments and the social security funds they control. Debt is the sum of currency and deposits; debt securities; loans; insurance, pensions, and standardized guarantee schemes; and other accounts payable.

- The history of sovereign defaults suggests ballooning country debt is an ingredient, but one of many variables contributing to the cause. Japan, for example, has experienced over a decade of debt/GDP levels above 200% without a default.[3] Conversely, we have seen instances of countries defaulting on their debt at debt/GDP ratios lower than where many countries stand today. Argentina provided a relatively recent example: Debt/GDP of only 90%[4] in 2019 was followed by a default in the first half of 2020. Ivory Coast defaulted in January 2011,[5] when its 2010 debt/GDP was just 46%.[6]

- Pursuing this further, the evidence suggests there has not been a strong relation between country debt and equity market returns. In fact, from 1975-2018, in aggregate high-debt developed countries outperformed low-debt developed countries by 0.88% annualized.[7]

    - **Past performance, including hypothetical performance, is no guarantee of future results. Actual returns may be lower.**

- The lack of relation between country debt and stock market returns could signify that debt affects drivers of stock returns in ways that ultimately offset one another. It should also be interpreted as further evidence of the forward-looking nature of markets. Whether it be debt, economic growth, inflation, or interest rates, we believe market prices quickly incorporate information and expectations.
- This underscores the importance of having an investment strategy that you can stick with. Ballooning debt is one of many challenges that face investors. Those who stick to their strategy and ignore market headlines may increase their probabilities of success.

Footnotes

[1] US Department of the Treasury (2021).

[2] General government debt tends to be a larger number than central government debt held by the public, as the former includes intragovernmental holdings and state and local government debt. For example, using the $22 trillion figure for federal debt held by the public and OECD's 2020 figures for debt/GDP and GDP yields an estimate of 66% for the proportion of US general government debt that consists of federal debt held by the public. Likewise, an estimate of 54% for the UK can be attained by subtracting out Bank of England and local government holdings from central government liabilities (data provided by the UK Debt Management Office), similarly calculating general government debt using OECD's 2020 figures for debt/GDP and GDP, and applying a GBP/USD currency conversion from Bloomberg as of the end of 2020.

[3] General government debt from OECD (2021).

[4] Central government debt from International Monetary Fund (2021).

[5] Reuters (2011).

[6] Central government debt from International Monetary Fund (2021).

[7] Central government debt from International Monetary Fund (2021).

RISKS

Investments involve risks. The investment return and principal value of an investment may fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original value. Past performance, including hypothetical performance, is not a guarantee of future results. There is no guarantee strategies will be successful.