Economic Views Brief

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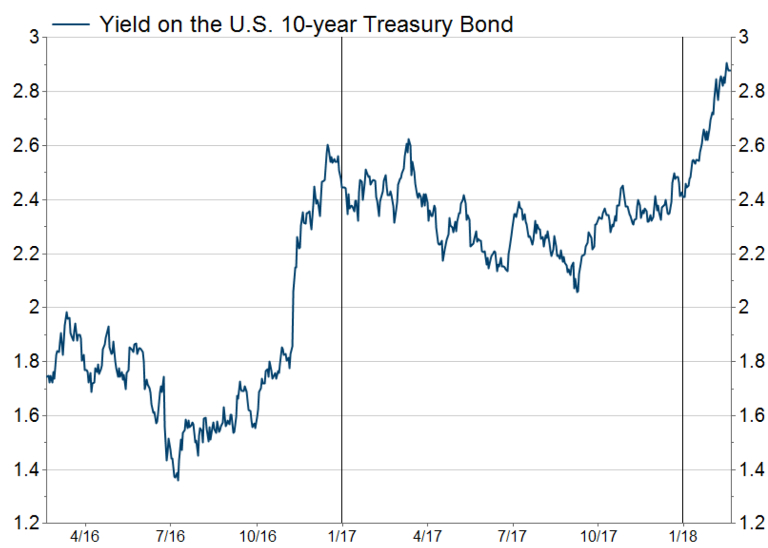
February 20, 2018

HIGHER INTEREST RATES AND THEIR IMPACT ON FEDERAL DEBT

Will higher interest rates make government deficits worse by costing more money to finance the debt? Yes and no. But, mostly yes.

Interest rates have been rising at an accelerated pace since the start of the year. As seen in the chart at right, the yield on the benchmark 10-year Treasury bond ended 2017 close to 2.4% but it now resides at approximately 2.9%.



Source: FactSet

Ultimately, higher interest rates increase the amount of interest expense incurred on U.S. debt obligations. It should be noted, however, that the Congressional Budget Office (CBO) has long assumed higher interest rates in their long-term debt and deficit projections. In fact, over the last few years CBO estimates have widely over-estimated interest costs in comparison to actuals. As of its most recent long-term projection report (June 2017), CBO assumed an average 10-year Treasury rate for 2018 of 3.0% and 3.4% for 2019. After rising to 3.5% in 2020, CBO forecasts a 3.7% rate thereafter.

Although rising interest rates will indeed lead to higher debt financing costs, in isolation they may not cost more than already expected - over the near-term at least.

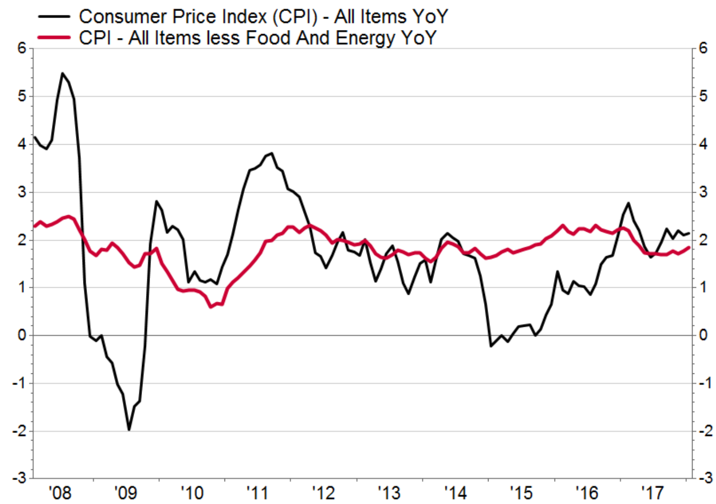
Total U.S. debt and deficit projections, however, will see an upward adjustment when the CBO releases its next update in-light of recent actions to cut taxes and increase spending. (Note: the term deficit refers to annual budget shortfalls for an individual fiscal year, while debt is the total accumulated amount owed.)

Higher rates reflect larger government deficits than previously expected, and signs of rising inflation. Tax cuts passed at the end of December (under legislation commonly referred to as the *Tax Cuts and Jobs Act*) will add approximately $1.5 trillion to federal debt over the next ten years, according to the CBO. More recently, a bipartisan budget deal agreed to hike defense and non-defense spending over the next two years by a combined $300 billion.

Until recently, the federal government had not been issuing new debt securities due to its having reached its legally mandated debt ceiling. From a strict supply /demand perspective, while this constraint was in place it may have resulted in some downward pressure on rates as buyers competed for reduced availability. However, the recent budget agreement suspended the debt ceiling until March 2019. Consequently, Treasury issuances are likely to be quite large over the near-term as borrowing needs are caught-up. These supply-side considerations, coupled with ongoing Federal Reserve efforts to reduce its balance sheet, have been key considerations for the bond market and may yet lead to further upside in rates.

Inflation: Bond investors usually require a return on their money that at least covers inflation. As such, when inflation expectations rise, interest rates usually do as well. The economic stimulus resulting from the tax cuts and spending increases noted on page one come at a time when the economy was already nearing full employment, leaving investors on watch for signs of inflation.

The Core Consumer Price Index (C-CPI) has been creeping higher over the last several months (as indicated by the red line in the chart at right), but inflation in general remains well contained, in our opinion. Analysts focus on prices excluding food and energy (i.e. core rates) as these components can often move for non-economic reasons such as drought in the case of food prices, or geopolitical problems in the case of energy.



Source: FactSet

We do expect inflation pressures to rise this year, but we believe trend rates are likely to remain relatively well contained overall. Core inflation was 1.8% in 2017 and we forecast it to rise to 2.0% on average in 2018, and likely a bit higher in 2019.

Pressure from wage inflation? Wage inflation is finally gaining some traction and thus contributing to inflation concerns. Historically, higher wages have filtered through into broader consumer price pressures, but at a relatively slow pace. At a recent unemployment rate of 4.1%, the labor market is tight and some industries such as trucking, construction, agriculture and skilled trades are experiencing notable labor shortages. Labor costs are likely to see further gains in our view, but the translation into consumer prices may be partially offset by recent tax cuts. Normally, businesses would have to pass along higher labor costs to maintain what are often slim profit margins. But in the present situation, lower tax rates could enable higher wages AND higher profit margins, without necessitating higher prices, at least over the near-term.

What if other countries decide not to buy our debt securities as our debt levels rise? Recent tax cuts and spending hikes will boost federal deficits over the near-term, lifting total debt levels over the long-term, leaving an already difficult U.S. government debt outlook even more challenged. The question has been raised: will foreign buyers keep purchasing U.S. Treasuries as U.S. debt levels continue to grow? It's impossible to know the intentions of foreign buyers, but given the primary reason that many foreign countries own U.S. Treasuries in the first place, it suggests to us that they likely will – at least over the intermediate-term.

Most foreign country holdings of U.S. Treasury debt are related to trade flows. For example: the U.S. has a very large trade deficit with China ($347 billion in 2016) and as of November 2017 China owned approximately $1.2 trillion in U.S. Treasuries, according to the Treasury Department. How this works… we send all those U.S. dollars to China to pay for the items we import. If China were to convert all those dollars into its currency, the Yuan, it would put considerable upward pressure on the Yuan, making China's exports more expensive for US customers over time (an outcome they want to avoid). As such, it's more economically efficient to park the excess dollars in U.S. Treasuries.

Even with this problematic debt outlook, the U.S. is still considered a "good credit." Currently, U.S. debt-to-GDP is approximately 77%. However, CBO projections PRIOR to the tax cuts and spending hikes had debt-to-GDP crossing the 100% threshold by 2032, and climbing rapidly thereafter. The CBO's next update will include these recently enacted provisions and the timeline for crossing the 100% threshold will certainly be pulled forward. This is just a round number, however, and it is impossible to tell at just what level markets will become more concerned about the U.S. debt situation. The fact that the U.S. controls its own currency sidesteps most default scenarios as in a worse-case situation the Treasury could print more dollars to pay the debt. However, such circumstances would be highly inflationary under most scenarios. Overall, we do not see U.S. debt projections as being at crisis levels. We believe elected officials likely have another 10 to 15 years to "bend the curve" so that debt projections are eventually placed on a better path.

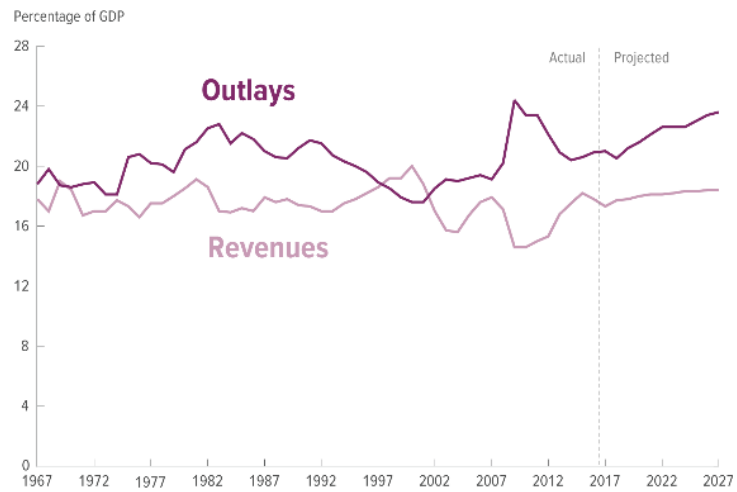
Foreign ownership of U.S. Treasuries:

	U.S. treasuries held (in billions)	as % of of foreign owned debt	as a % of total U.S. debt held by the public
China	$1,176.6	18.5%	**7.9%**
Japan	$1,084.1	17.1%	**7.3%**
Ireland	$328.7	5.2%	**2.2%**
Cayman Isl.	$269.4	4.2%	**1.8%**
Brazil	$265.3	4.2%	**1.8%**
Switzerland	$250.9	4.0%	**1.7%**
U.K.	$237.9	3.8%	**1.6%**
Luxembourg	$218.3	3.4%	**1.5%**
Hong Kong	$194.9	3.1%	**1.3%**
Taiwan	$179.9	2.8%	**1.2%**
Saudi Arabia	$149.0	2.3%	**1.0%**
India	$140.8	2.2%	**0.9%**
Singapore	$124.2	2.0%	**0.8%**
Belgium	$115.3	1.8%	**0.8%**
Russia	$105.7	1.7%	**0.7%**
S. Korea	$98.5	1.6%	**0.7%**
Canada	$82.6	1.3%	**0.6%**
France	$74.9	1.2%	**0.5%**
Germany	$71.6	1.1%	**0.5%**
Sub-total	$5,168.6		
All other countries	$1,174.5	18.5%	**7.9%**
Total foreign held debt	$6,343.1		**42.5%**
Total U.S. federal debt held by the public	**$14,918.7**		
Intergovernmental debt (largely Soc. Sec. IOUs)	$5,671.7		
Total federal debt owed	**$20,590.4**		

Source: Treasury Department. All data as of November 2017

U.S. federal outlays and revenues:

Note: The chart below is sourced from the CBO's most recent *Budget and Economic Outlook* as published June 2017. Given recent changes in fiscal policy (tax cuts + spending hikes), the projections are very likely to get worse when the next update is issued.



Summary: Recent inflation concerns may be a bit overdone, in our view, but the rise in interest rates has likely been justified given new fiscal stimulus plans. Previously, we had projected a 2018 year-end 10-year Treasury rate of 2.70%, but this estimate was made prior to recent fiscal policy changes. From an economic perspective, we now believe the 10-year Treasury yield is likely to end 2018 near 3.0%, or slightly higher.

Consequently, consumer and corporate borrowing rates are also likely to move modestly higher, but solid balance sheet fundamentals should enable these sectors to manage modestly higher rates without much difficulty. Overall, higher rates should act as a headwind to economic expansion, yet we still foresee a solid pace of economic growth combined with modestly higher inflation metrics, as the most likely path over the next several quarters.

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