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Investment Institute

Special Report

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Global Fixed Income Strategy Team

Q&A — Addressing concerns about rising U.S. debt

"You can always count on the Americans to do the right thing after they have tried everything else." — Unknown[1]

Key takeaways

- Congressional Budget Office (CBO) projections for federal debt present a challenge to Congress and the president, today and in the coming decades, but, as the quote above suggests, we do not view the challenge as insurmountable.
- The U.S. Treasury market remains the largest and most liquid in the world, and we anticipate no imminent change to the importance of the U.S. Treasury market to global investors.

What it may mean for investors

- We continue to anticipate strong global demand for U.S. Treasuries and favor holding them as part of a long-term portfolio allocation.

In this Q&A report, we address some key questions we are hearing from investors around the fiscal health of the U.S. government and what implications fiscal challenges may have on investors. But first we highlight some key data points[2] from the Treasury Department and estimated projections from the CBO:

- Current average rate the U.S. government pays to finance the debt: 3.27%
- Over half of U.S. debt owned by the public (more than $14 trillion) will mature in the next 3 years
- Most likely this debt will need to be refinanced. If so, at current interest rate levels —somewhere between 3.75% – 5.25% — it would cost an additional $300 billion to service the debt.
- Annual deficits are estimated to run between $1.7 – $1.9 trillion over the next three years, so more debt will need to be issued to cover the deficit.
- Over three years, this will add another $5 – $6 trillion to the already $26 trillion debt owned by the public
- Over three years, this will also add $200 – $250 billion in annual interest expense
- In our view, U.S. finances require adjustments to spending and revenue.

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1. The quote at the top has been attributed to various speakers, including to Sir Winston Churchill. We do not doubt his wit or his appreciation for the United States, but the message is more important than the speaker.
2. "Debt Position and Activity Report," TreasuryDirect.gov, May 31, 2024. "An Update to the Budget and Economic Outlook: 2024 to 2034," Congressional Budget Office, June 2024. Wells Fargo Investment Institute, September 2024.

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1. Why is there so much concern about the U.S. fiscal health?

The federal government's debt as a ratio to the U.S. economy's annual output (gross domestic product, or GDP) is projected to reach 99% in 2024, its highest level since the end of World War II, and the latest projections from the CBO expect that this ratio will rise further, and, without action from Congress, could increase toward 166% over the next 30 years. The CBO projections present a challenge to Congress and the president, today and in the coming decades, but, as the quote on page 1 suggests, we do not view the challenge as insurmountable.

The U.S. government will have to choose some combination of higher taxes and lower spending to reduce the large and rising deficits implicit in the CBO's projections. As overall debt levels and interest expenses grow, the U.S. government will see net interest costs consume a larger percentage of GDP and likely would weigh on economic growth. Fortunately, there is history for just such adjustments. We believe this is the important point to remember, and the remaining questions below explore both the challenge and the opportunity before Congress.

2. What does history tell us about how federal debt is reduced, and how long will it take to come down from current debt levels?

The math is clear. The U.S. government spends more money than it collects. Hence, it must issue more and more debt to cover the deficit. The obvious way to help reduce the debt is to reduce the amount of spending, or to increase taxes to pay down the debt. Other schools of thought believe that the U.S. could increase productivity and economic growth (similar to what occurred after World War II) and keep a more stable debt/GDP ratio.

In our view, it is unrealistic to believe the government will aim to reduce the debt outright; its goal most likely will be to manage it in a way in which debt grows (the deficit) at a slower pace than the economy by implementing a target range of debt/GDP ratio. In this point, there is some similarity to a private household with a mortgage loan. Even if the amount of a mortgage may be large, the bank lender may approve a loan if it is no more than an allowable percentage of the household's assets and if the monthly income is a similarly acceptable ratio to the monthly loan payment. If Congress adopted such sound debt management practices, it would help maintain the U.S. Treasury's credibility with investors.

Fortunately, there are historical precedents for action by Congress and the president. Forty years ago, the U.S. federal debt servicing cost rose sharply, and rising interest costs squeezed the budget. Chart 1 illustrates the increase and the slew of laws passed to control the budget's expansion.

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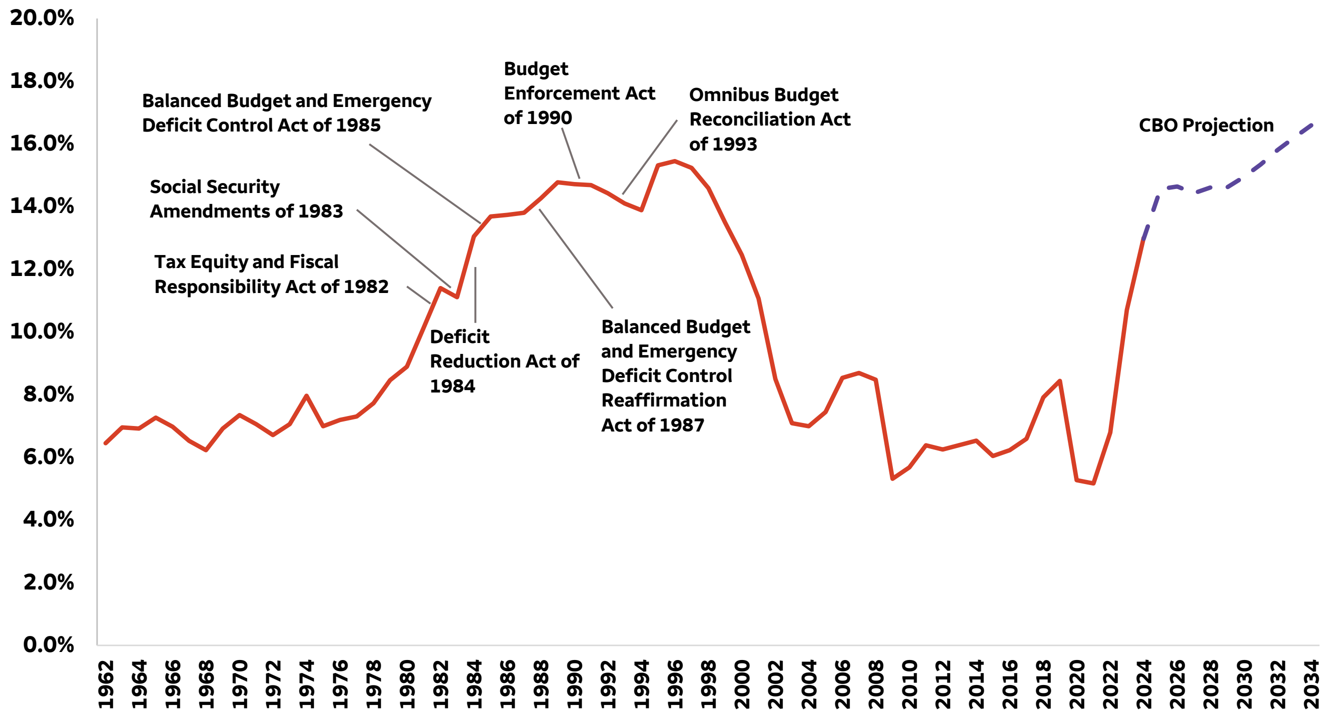
Chart 1. Federal interest payments as a percent of the budget



Sources: "An Update to the Budget and Economic Outlook: 2024 to 2034," Congressional Budget Office, June 2024 and Wells Fargo Investment Institute, September 2024. Projections are not guaranteed and are based on certain assumptions and views of market and economic conditions which are subject to change.

We are not seeing that inclination yet in Congress, but the budget's share of interest payments is already as high as in those earlier periods. In our view, the longer Congress waits to address the rising share of interest payments, the more investors demanding austerity are likely to push yields higher. In turn, higher yields should put downward pressure on economic growth and even more pressure on Congress to act.

What Chart 1 does not show is that the debt/GDP ratio declined in the aftermath of these measures, and with a strong tailwind from a growing economy. The period from 1994 – 2001 shaved nearly 20 percentage points from the debt/GDP ratio. A smaller reduction in the ratio occurred between 2005 – 2007. This could serve as a guide to our current lawmakers on how to start dealing with this issue.

3. Why then aren't financial markets pricing much concern over this unsustainable path currently?

If the U.S. remains on its current spending path, at some point financial markets could begin to press the Treasury for a higher premium (higher rates) to hold U.S. debt, especially those bonds with longer maturities. This would likely make long-term yields increase to higher levels than they otherwise would. But for now, in theory, as long as nominal economic growth outpaces the growth of the deficit, demand for U.S. Treasury debt should remain healthy. Recent Treasury auctions have been well received, another example of why there is no immediate pressure on politicians to act.

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4. I own U.S. Treasury securities inside my portfolio — How concerned should I be?

For perspective, we should remember that the U.S. Treasury market is the largest and most liquid in the world and is roughly the size of the other major tradable markets combined. Investors who look outside the U.S. Treasury market will find smaller markets, where the smaller number of buyers and sellers means that a large transaction could move prices for all in that market. By comparison, the sheer size and liquidity of the U.S. Treasury market gives U.S. and foreign investors greater reason to expect price stability. We believe these are the major reasons dollar-denominated securities remain the largest share of any global government security in the reserves of other countries. There simply are no good substitutes for U.S. Treasury securities, and we expect this to remain the case.

We believe an imminent crisis is very unlikely. Yields on Treasury securities have been higher than they were a decade ago but have been well within historical ranges. The U.S. has the world's largest and arguably most dynamic economy, the world's most frequently used currency for international investment, and a strong military. Taken together, we believe that the size and strength of the U.S. economy, and the liquidity and yield provided by the Treasury market, make U.S. Treasury securities the largest share of the reserves that foreign governments hold — and support the U.S. dollar as the world's principal currency for reserves and for global transactions.[3]

5. Does the debt become more bearable as interest rates go down?

Somewhat. The Treasury funds the debt and deficit through issuing Treasury securities. The Treasury issues short, intermediate, and long-term securities, but the highest percentage of issuance comes from short-term issuance (Treasury bills). In our view, the risk is that interest rates will stay at higher levels for longer than we saw from the financial crisis through the pandemic, when short-term interest rates were near zero percent for many years and 10-year U.S. Treasury maturities experienced rates under 3% for a significant period of time. Higher interest rates generally make servicing the outstanding debt more burdensome for taxpayers.

6. Could the Federal Reserve (Fed) manage monetary policy in a way that it influences interest rates lower to help ease the debt burden?

The Fed's goal is not to keep interest rates low just to ease the cost of financing the debt. By law, the Fed must try to support economic growth by managing inflation and unemployment levels in line with its stated goals. The Fed is not responsible for proper fiscal management; however, its interest-rate policies do affect debt issuance. Markets currently expect the Fed to lower interest rates significantly by the end of the year and through 2025. Overall, lower policy rates could once again create an environment that favors issuing more government debt, which could increase yields and further complicate the cost of financing that debt.

7. Moving forward, could the debt ceiling help limit debt issuance?

In June 2023, a joint resolution from Congress suspended the statuary debt limit through January 1, 2025. As a result, there is currently no debt ceiling in place. At the beginning of next year, the Treasury will be unable to increase the amount of debt outstanding — unless Congress passes another bill raising the debt ceiling. The Treasury will be able to use extraordinary measures to avoid default for many months after the January 1 deadline.

The debt ceiling does not directly impact federal spending and the Treasury cannot issue debt to cover spending that Congress has not previously authorized. The debt ceiling deadlines have mostly been used for political posturing in the past. While the political parties may use the deadline as a means to extract political spending

3. Please see our special report, "The U.S. dollar's future as the world's reserve currency", Wells Fargo Investment Institute, September 7, 2023.

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concessions, in practice neither party wants to be responsible for defaulting on the U.S. debt. Legislative uncertainty over raising the debt ceiling has at times brought about market uncertainty and rating agency downgrades.

8. We hear from both political parties that increased spending is expected and no entitlement reform is in sight. Isn't this going to further complicate the issue?

We believe political factors will most likely block major new tax and spending initiatives but also delay austerity reforms. The two candidates have offered policy plans that likely would increase federal deficits in the coming years. Vice President Kamala Harris has suggested rolling back the 2017 tax cuts when they expire at the end of 2025, and she favors expanded federal spending. Former President Donald Trump has promised to extend the 2017 tax cuts and also favors additional spending.

However, Congress has a role to play also, and we expect another Congress of small majorities and strong intra-party divisions. It may not be possible to pass extensive tax and spending legislation, even in the event of single-party control of the White House and the Congress. What's more, recent debt-ceiling debates have tended to dominate congressional attention to a degree that further complicates the chore of passing major tax and spending initiatives.

Investment implications

In sum, while we believe the CBO's debt growth projections point to unsustainable growth in the debt/GDP ratio over the coming decades, the trajectory can change. History has shown that Congress is capable of austerity measures to reduce the debt/GDP ratio as the interest burden rises. As well, the political necessity for some corrective measures can even encourage a faster-growing economy and, in turn, a more sustainable fiscal path. That political will seems lacking currently, so, on balance, 10-year U.S. Treasury yields seem likely to us to remain mostly around 4% (absent an economic crisis or recession).

Taking a broader perspective, our investment guidance includes an allocation to U.S. Treasuries in an effort to preserve and grow wealth, even as risks and opportunities continually change around us — just as they always have. In this case, we believe U.S. Treasury securities remain important for domestic and international investors, but uncertainty remains about how much and how quickly Congress can adjust its budgets. That risk can still be part of an investment plan that weighs risks and rewards across financial markets and types of instruments.

Portfolio diversification is a foundational principle that allows investors the flexibility to adjust to dynamic risks and potential rewards. For example, a diversified portfolio that seeks to reduce the risk of fiscal crisis may adjust the types and maturities of fixed-income securities and may include assets such as European equities and bonds, and real assets such as real estate, infrastructure, and gold. An investment professional can help investors identify their goals and risk tolerance and find an appropriate diversification strategy.

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Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets** are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates. Although **Treasuries** are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. Investing in **gold** or other precious metals involves special risk considerations such as severe price fluctuations and adverse economic and regulatory developments affecting the sector or industry. Investments in **infrastructure companies** expose an investment to potentially adverse economic, regulatory, political, and other changes affecting such companies. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

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