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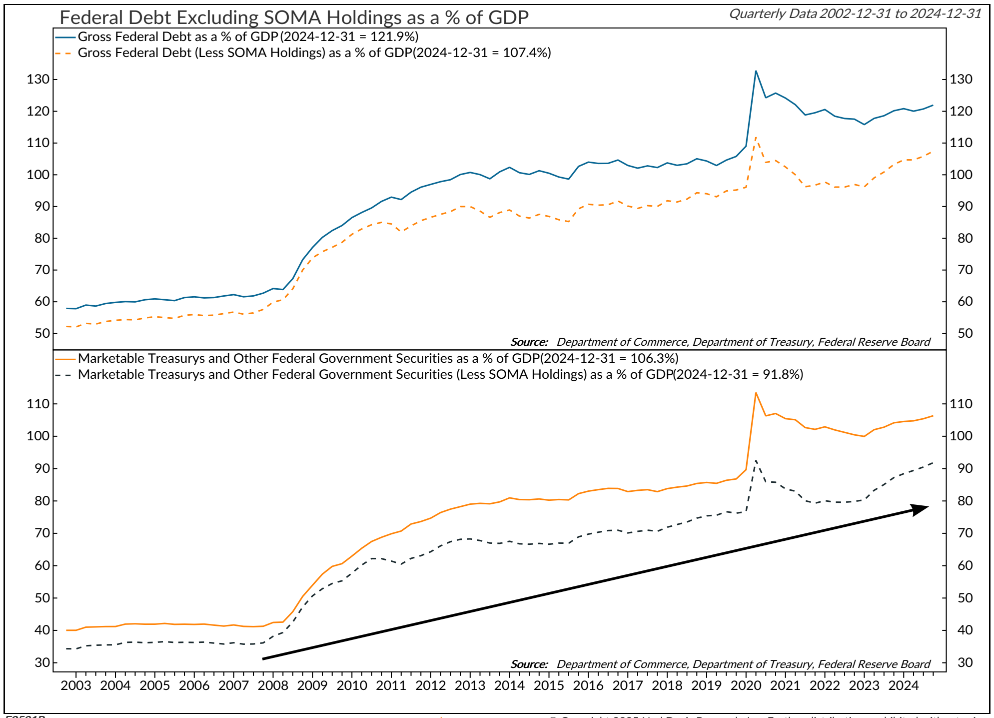
What you need to know about federal debt, deficits, and the impact on bonds

Key Takeaways

- Federal debt/GDP is expected to keep rising, led by net interest payments.
- Debt service is the key. When interest costs start to exceed growth, economic risks increase.
- Credit markets are not solely about federal debt. If you want to be bearish on bonds and see a wider term premium, then you need to see increased credit demand from the private sector.

Federal debt/GDP keeps climbing



Going back to at least Alan Greenspan, every Fed chair has warned that the U.S. is on an unsustainable fiscal path.

The debt/GDP problem

And every year, the federal debt/GDP ratio seemingly goes up. Reinhart and Rogoff warned us trouble usually arises when debt/GDP exceeds 90% to 100%. We've crossed that threshold and are currently at 106%. Excluding the Fed's SOMA holdings, the ratio is a more tolerable 92% as shown on the chart. The U.S., of course, enjoys an exorbitant privilege and reserve currency status that gives it more leeway than all other economies.

Even with that said, Japan's debt/GDP ratio exceeds 200% and no terrible economic collapse has ensued, although the Bank of Japan owns about half the debt.

So what's the problem? As long as debt grows slower than nominal GDP maybe there isn't one. But that hasn't been the case in recent years. Many projections, such as the one from the CBO, show large deficits well into the future.

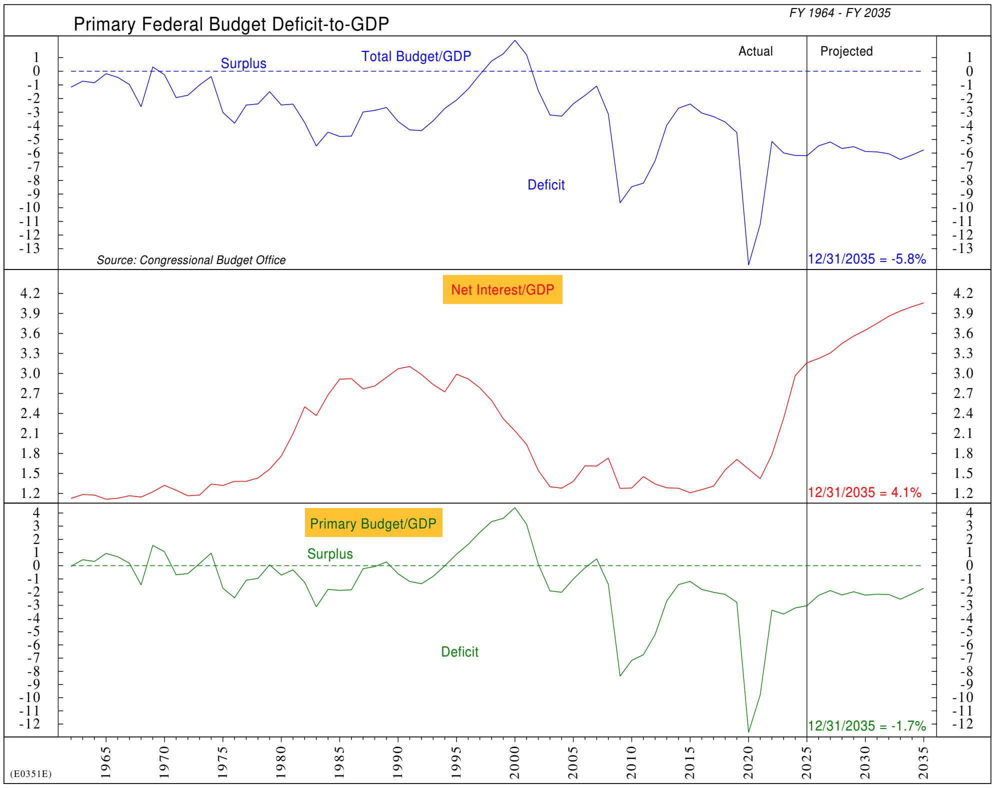
Interest - the big worry

What worries me most is the interest on the federal debt since that obligation must be paid. Default is not an option. Net interest is the fastest growing item in the federal budget, up around 25% in calendar year 2024. It totaled a record $900 billion and consumed 18.5% of all tax receipts. It comprised 44% of the budget deficit. In 2024, net interest exceeded the spending on national defense.

Moreover, **net interest is expected to climb from 3% of GDP to over 4% by 2035** (page 2, top chart). As a share of total outlays net interest is expected to jump from 13% to 17% ten years from now.

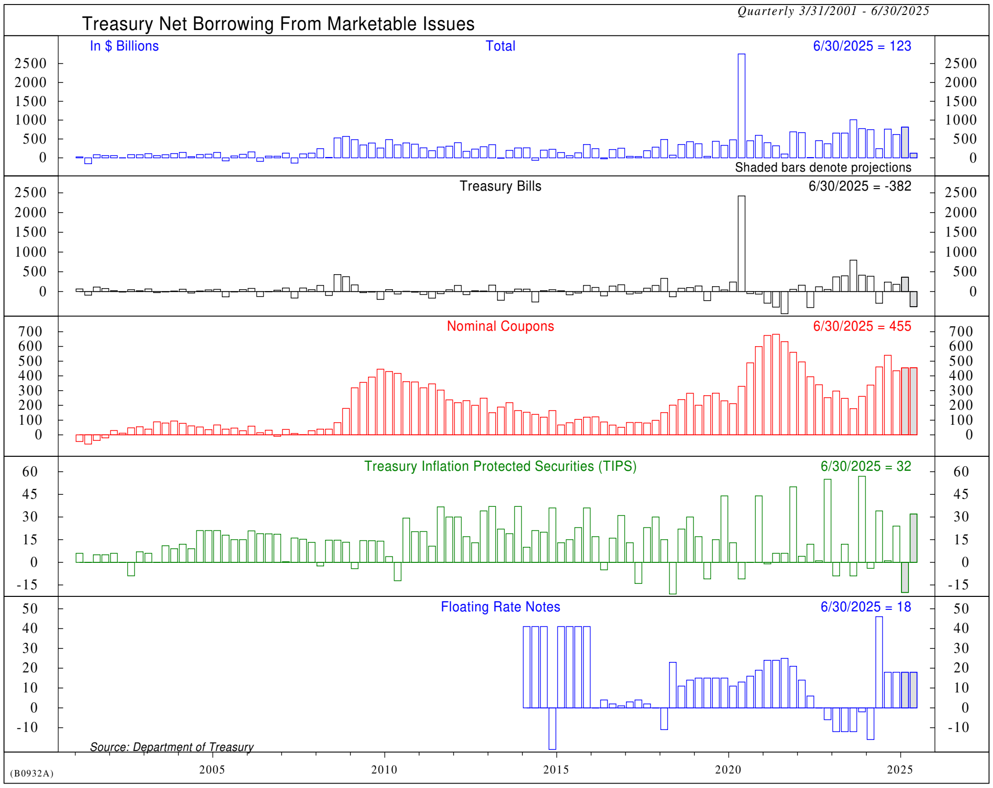
The primary budget, which is the budget deficit excluding net interest, is expected to average over 2% of GDP. It should be close to zero.

Net interest continues to climb



All other expenditures and taxes can theoretically be changed. As a result, I won't wade into the political fray about what the upcoming budget will look like or how successful DOGE will be. Treasury Secretary Bessent and some Republican leaders are well aware of the debt and deficits issue.

Issuance expected to be steady



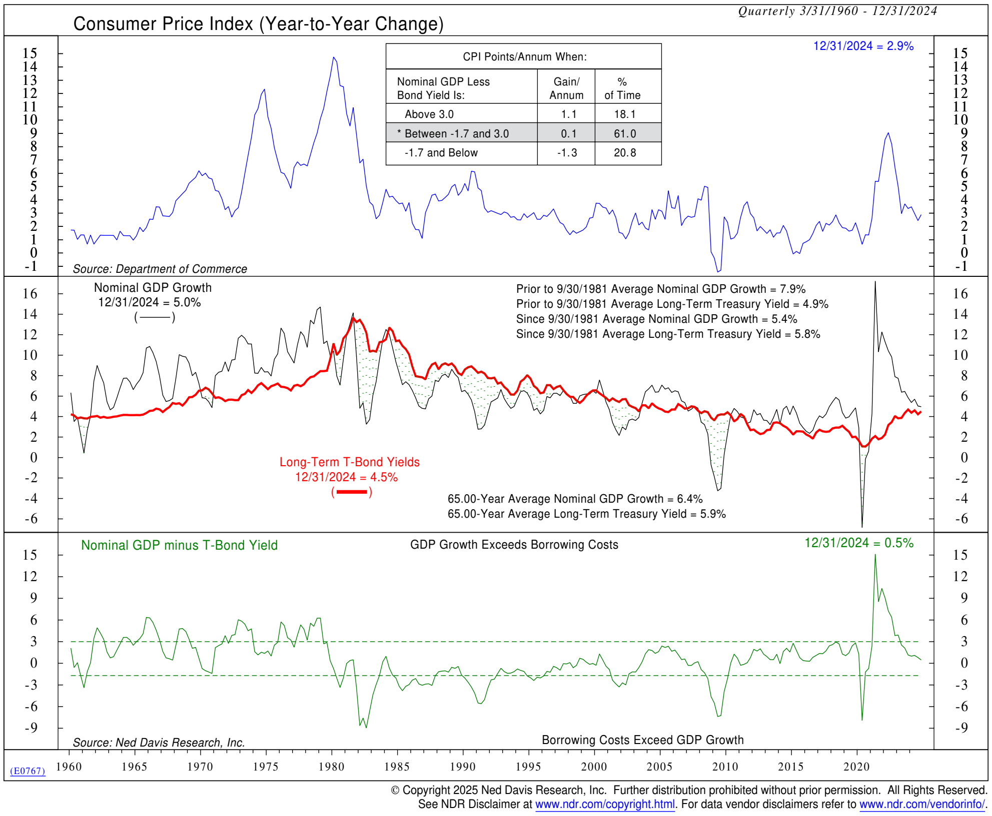
Bessent even surprised us in last week's Quarterly Refunding Announcement when Treasury kept language saying it would maintain auction sizes "for at least the next several quarters." Bessent also said he would focus on lowering the 10-year Treasury yield.

Debt service is key

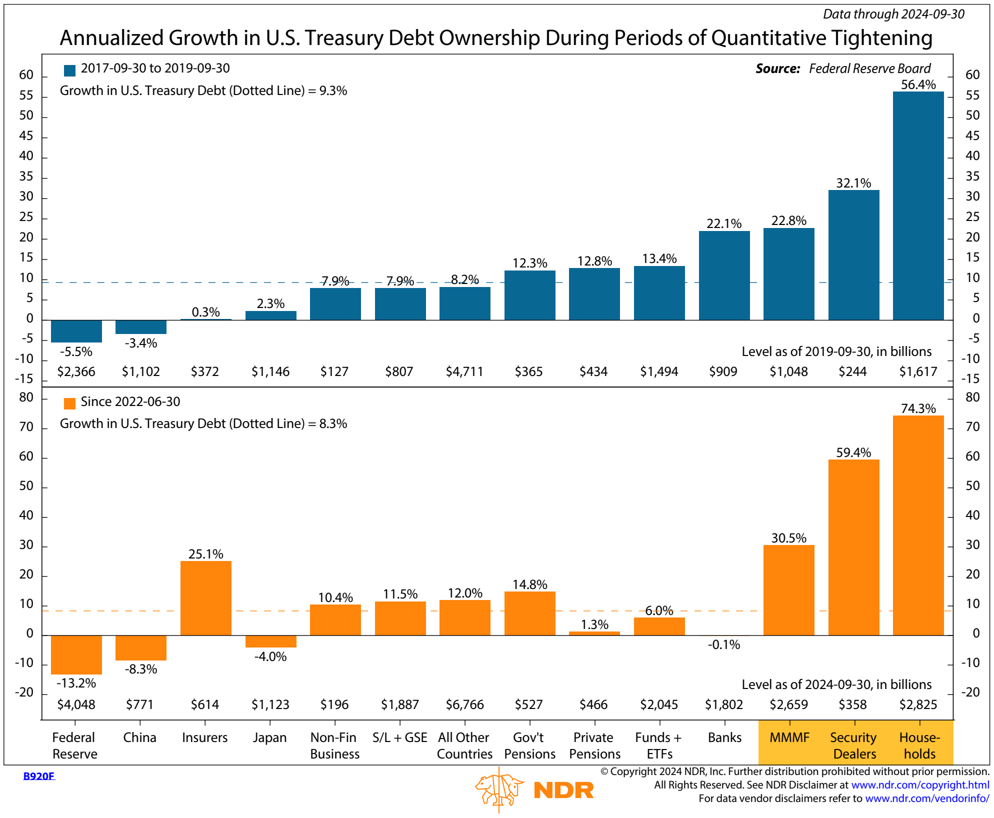
Although the amount of debt is important, what really matters is whether the debt can be serviced. As long as the interest on the debt is below the rate of growth of nominal GDP, then we should be okay. But **when interest costs start to exceed growth, economic risks increase, including a deflationary collapse**.

Last month, the U.K. went through such a scare when long-term borrowing costs approached 5%. With nominal GDP growth expected to be around 4% this year, it caused the government to pledge its support for fiscal rules in order to stabilize the gilt market.

Debt becomes problematic when r > g



Households and their proxies have been buying the debt

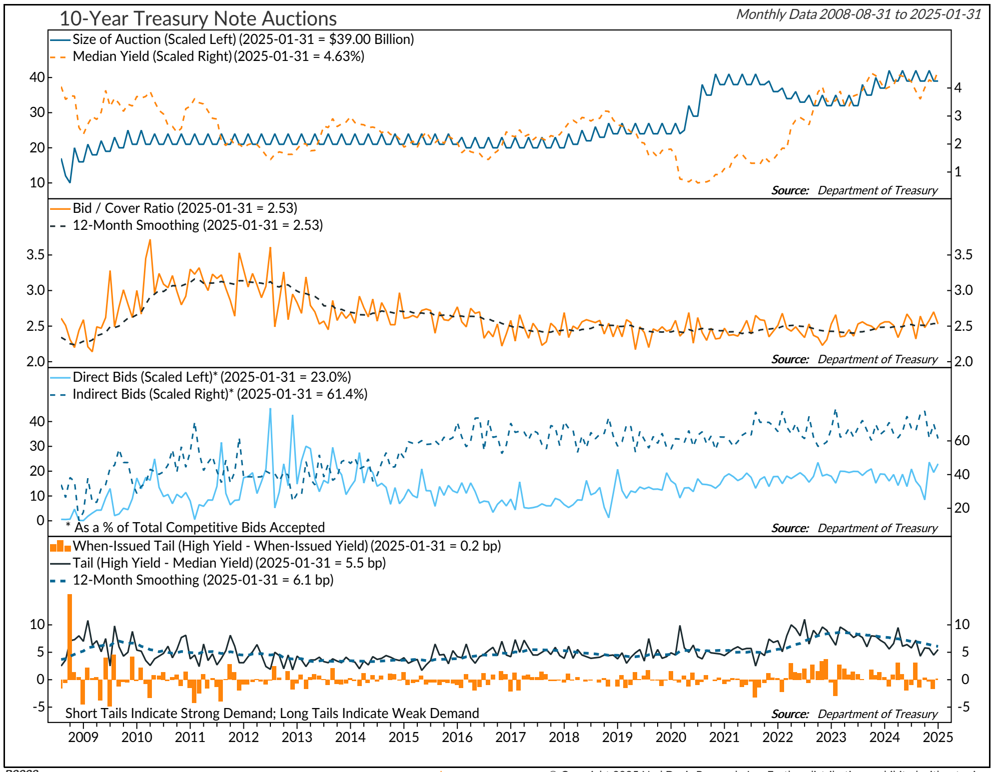


Markets' perspective

The rest of this report will look at the debt and deficit concerns from a markets' perspective. One issue among market participants is who is going to buy the debt? The Fed is no longer buying and continues to shrink its balance sheet. Banks are sitting on underwater securities. China and Japan are reducing their holdings.

Households, however, have stepped up, along with their proxies.

Auctions have been stable



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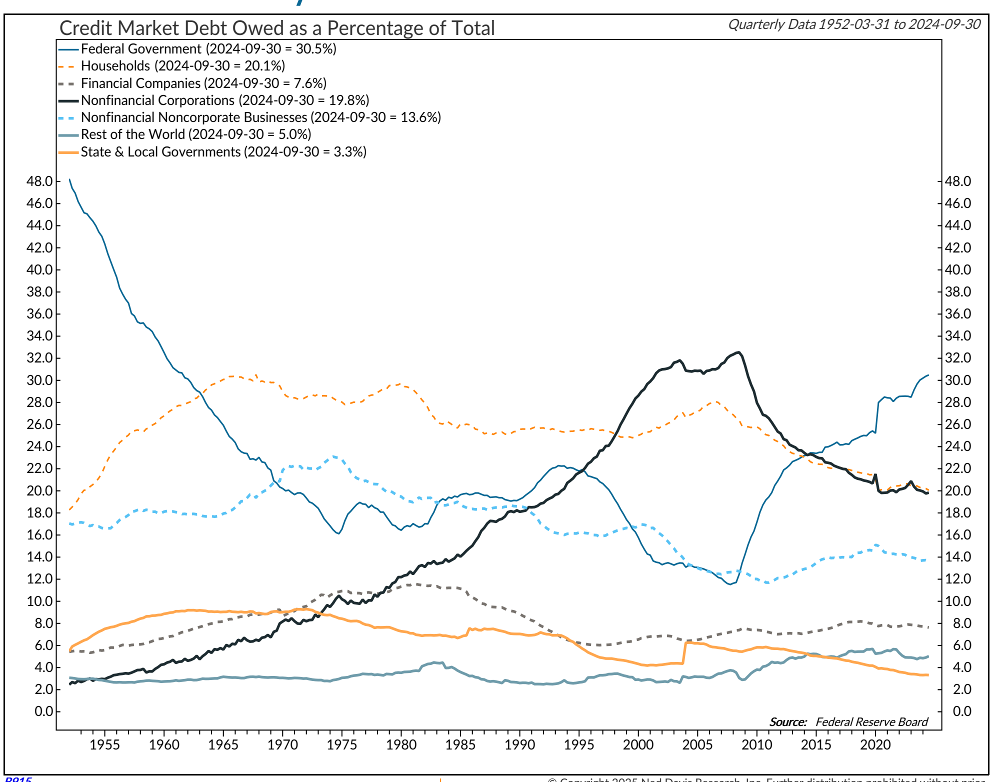
Some analysts watch the auction results for the health of demand looking at various metrics including the bid/cover ratio, the tails, and the dealer share. But **I've never found these metrics to be very useful for anything but the very short term**. If you disagree, let me know.

Federal debt is only 30% of total debt



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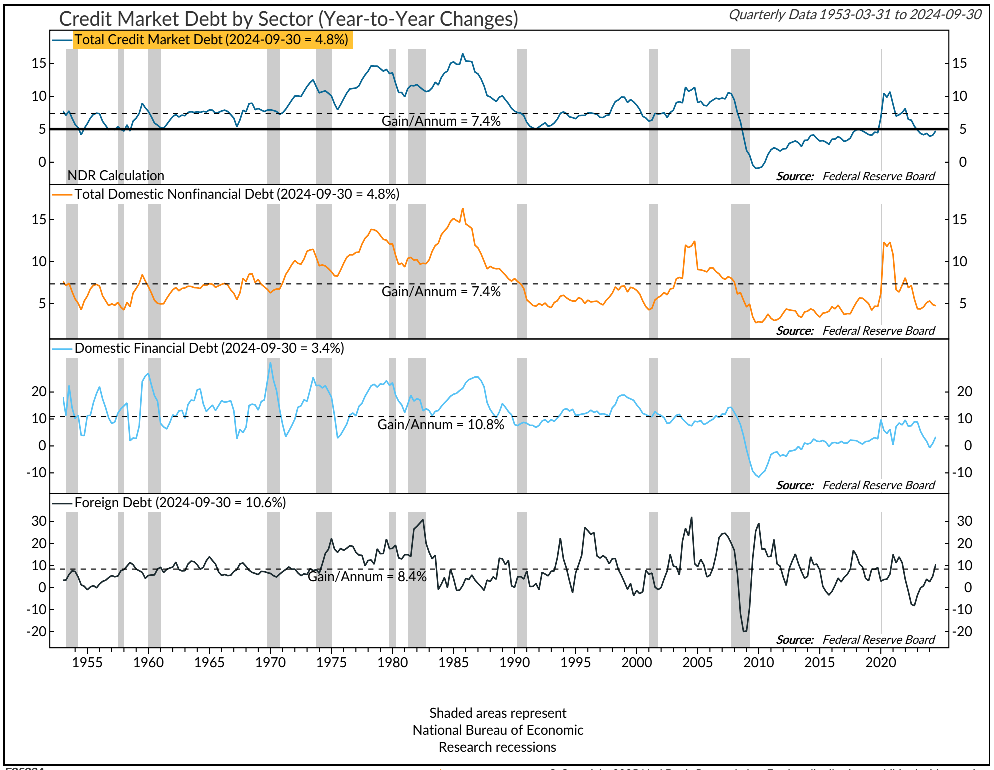
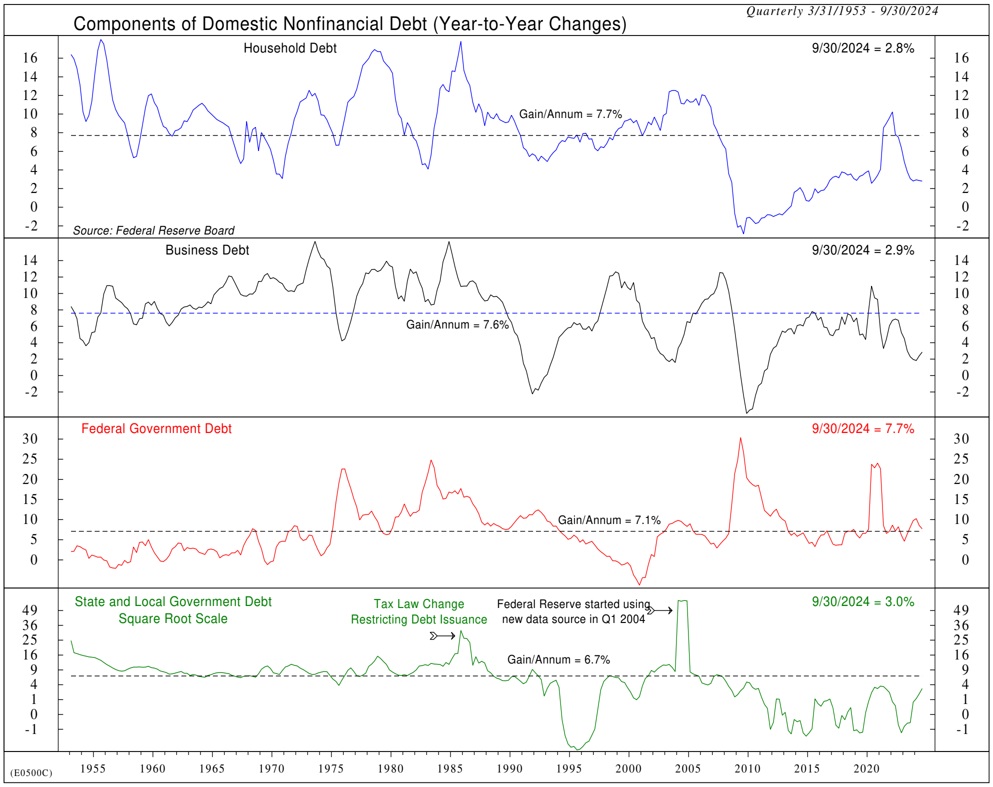
One common misperception from breathless deficit hawks is that the **credit markets are not solely about federal debt**. According to flow of funds data, federal debt is just 30% of credit, although its share has risen tremendously from 12% right before the GFC. But it also was much higher right after WWII.

Slower debt growth post-GFC



Instead of focusing on the smaller 30% piece, I pay more attention to the larger 70% piece, which is mostly the private sector. **Pre-GFC, total debt growth was never less than 5%. Post-GFC, it has never been more than 5%** except for the brief period around the pandemic.

Lack of private sector credit growth

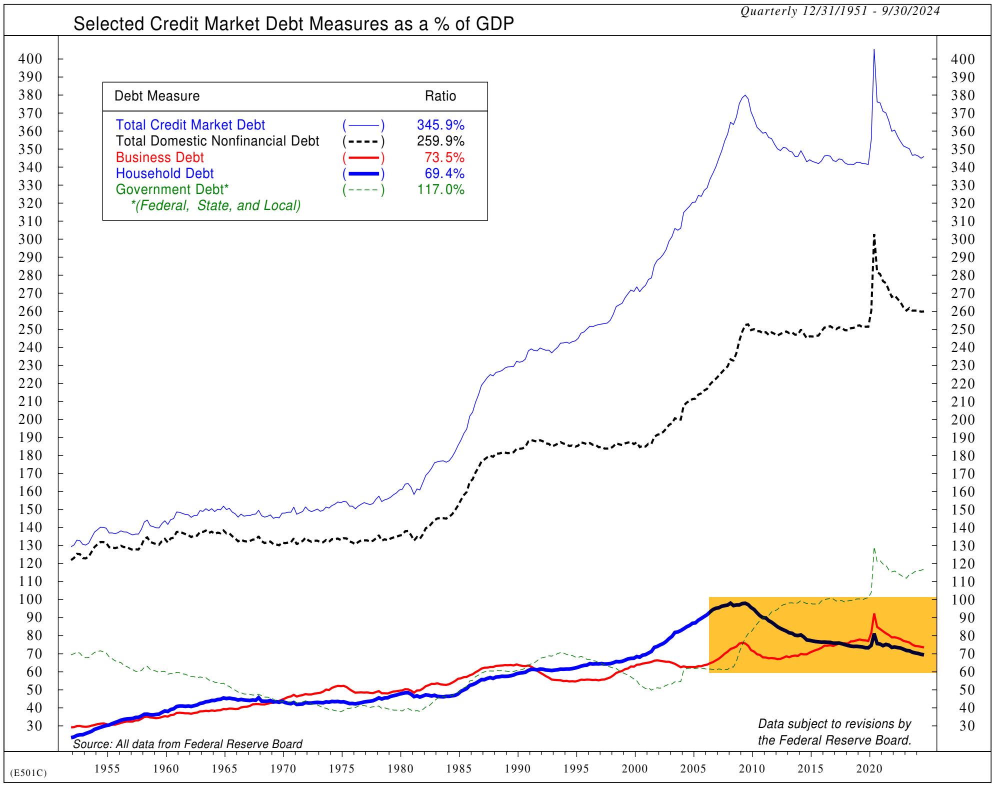


Although federal debt had been growing at double-digit rates, it has since slowed. Private sector debt growth, however, has been meager, growing in a range of 2% to 3%.

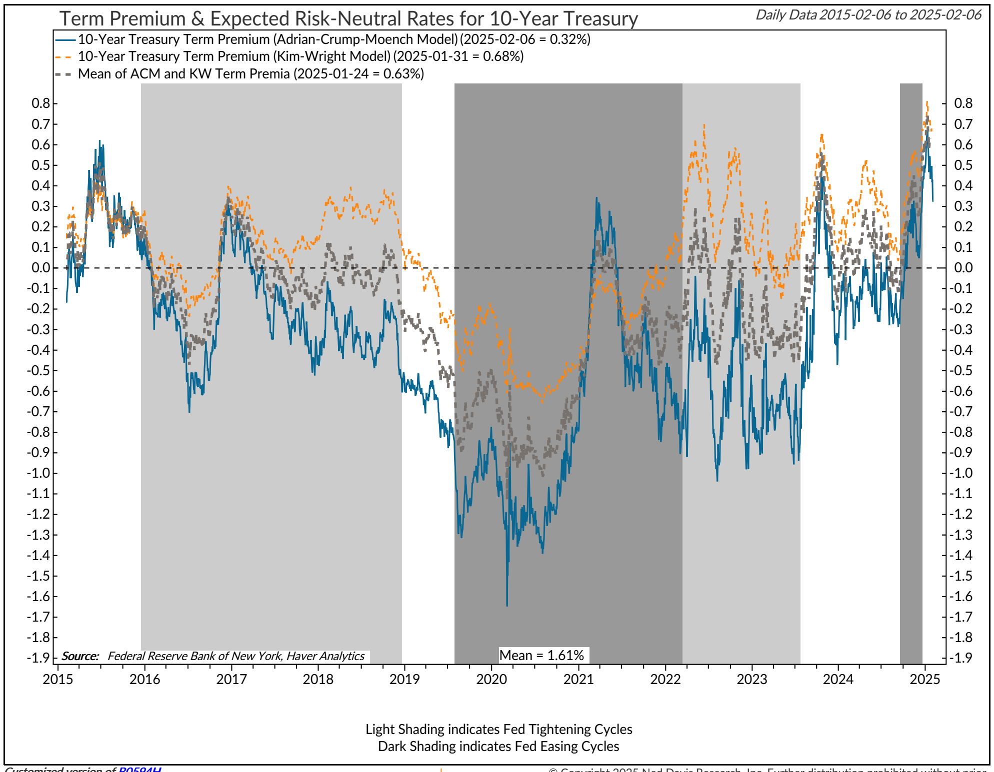
The Household sector, in particular, has been deleveraging since the housing bubble burst. Since the GFC, household debt/GDP has declined from roughly 100% to 70%. Business debt/GDP is about unchanged from the GFC.

Liability driven investors (LDI) had few alternatives to long term Treasurys, pushing the term premium into negative territory for most of the past nine years (below).

Private sector delevered after the GFC



Term premium has mostly been negative since 2016



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If you want to be bearish on bonds and see a wider term premium, then you need to see increased credit demand from the private sector. In deriving our fair value estimate for the 10-year Treasury this year, we assumed some acceleration in credit due to continued expansion of data centers, infrastructure and defense spending, and more M&A deals.

But **this is nothing like the late 1970s/ early 1980s when credit needs were orders of magnitude different than they are today** due to the coming of age of the Baby Boom generation. Back then, government borrowing did crowd out the private sector! Who are we crowding out today? Effectively nobody.

London Stockton has provided research support for this report.

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NDR HOUSE VIEWS (Updated February 4, 2025)

For global asset allocation, NDR recommends an overweight allocation to stocks, marketweight allocation to cash, and an underweight allocation to bonds. Our recommendations are in line with our Global Balanced Account Model.

Equity Allocation

U.S. | Our U.S. asset allocation recommendation is 70% stocks (15% overweight), 25% bonds (10% underweight), and 5% cash (5% underweight). On an absolute basis, we are overweight the S&P 500 (year-end 2025 target of 6600). We are neutral on small-caps versus large-caps (implicit overweight to mid-caps) and neutral on Growth versus Value.

INTERNATIONAL | We are overweight the United States, Canada, and Pacific ex-Japan; underweight Emerging Markets, the U.K., and Japan; and makeweight Europe ex. U.K.

Macro

ECONOMY | The global economy has shown notable resilience, with recession chances waning. Risks include monetary and fiscal policy uncertainty, a potential global trade war, sticky inflation, and easing Chinese growth.

FIXED INCOME | We remain 100% of benchmark duration, and are neutral on the yield curve. We are overweight MBS and underweight CMBS and ABS. We are marketweight everything else.

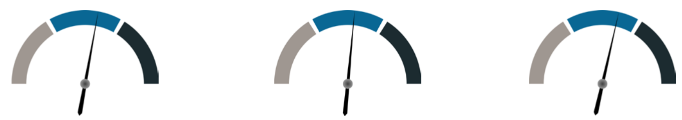
GOLD | We are currently bullish.

CURRENCIES | We are neutral on the U.S. dollar, euro, yen and the U.K. pound.

Economic Summary

February 10, 2025

Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy (3.1%) | U.S. Economy (2.0% - 2.5%) | U.S. Inflation (2.75% - 3.25%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2025 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- ● Stocks (70%)
- ● Cash (10%)
- ● Bonds (20%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- ● United States 69% | Canada (5%) | Pacific ex. Japan (4%)
- ● Europe ex. U.K. (13%)
- ● Emerging Markets (5%) | U.K. (2%) | Japan (2%)

Benchmark – U.S. (64.0%), Europe ex. U.K. (11.7%), Emerging Markets (10.2%), Japan (5.3%), U.K. (3.4%), Pacific ex. Japan (2.5%), Canada (2.8%)

Global Bond Allocation

- ● Europe (35%)
- ● U.S. (56%) | U.K. (4%)
- ● Japan (5%)

Benchmark: U.S. (57%), Europe (27%), Japan (12%), U.K. (5%)

U.S. Allocation

- ● Stocks (70%) | Mid-Cap
- ● Small-Cap | Large-Cap | Growth | Value
- ● Bonds (25%) | Cash (5%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- ● Financials (16%) | Consumer Discretionary (14%)
- ● Materials (1%) | Health Care (10%)

Benchmark: Technology (30.1%), Health Care (12.1%), Financials (12.6%), Communication Services (9.2%), Consumer Discretionary (10.6%), Consumer Staples (6.5%), Industrials (8.5%), Energy (3.9%), Utilities (2.3%), Real Estate (2.3%), Materials (2.3%)

U.S. Bonds — 100% of Benchmark Duration

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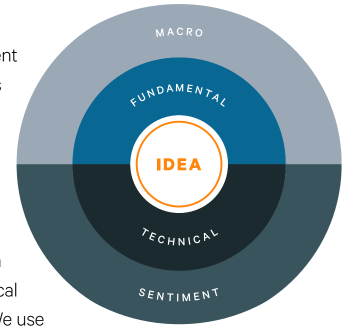

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