04 July 2024

Research US

The looming fiscal risk

- US government finances are increasingly a risk factor for local and global financial systems, but it is difficult to say if and when they will trigger a crisis.
- In this note, we go through some of the basics.

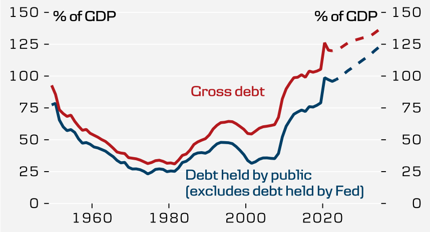
Given current policies, the already large US federal debt will continue to grow and hence, public finances are not sustainable. Although still not a major market theme, concerns seem to be increasing and there was more interest than usual around the budget projections presented on June 18. The primary risk is that markets question whether monetary policy will be allowed to maintain inflation at 2% and hence investors start to demand significantly higher risk premia for markets to clear. That could lead to banks and other financial institutions coming under pressure and large movements in equity and FX markets as well as in bonds. The upcoming election could increase focus on the public finance problem, but it is important to stress that we have no reason to expect imminent financial turmoil. US public finances have been problematic for many years and there are no fixed thresholds for market reactions.

According to the new projections from the Congressional Budget Office (CBO), the federal deficit will equal 7% of GDP this year, decline to 5.5% in 2027 and then increase again to 6.9% in 2034, based on current policies. Debt held by the public will increase from 99% of GDP in 2024 to 122% in 2034. These projections are of course highly uncertain as policies can change and the underlying economy surprise. However, the long-term deterioration is primarily due to increasing "mandatory" spending on things like social security and healthcare that are driven by demographic changes and will be hard to change, as well as by higher interest payments caused by the rising debt. It will likely require major reforms of entitlements (for example higher retirement age) and/or significant tax hikes to stabilise the debt-to-GDP ratio.

However, the ratio can also be stabilised through higher nominal GDP growth. One way to achieve that is through high inflation which could result from financing of the budget deficit by money creation at the Federal Reserve. It is to prevent this from happening that the Fed is politically independent, but if the situation becomes bad enough, the government has the option on leaning on the Fed. Even though there would be a large price to pay for doing that in the form of lost credibility, it is better than outright defaulting on debt, which is therefore very unlikely in our view.

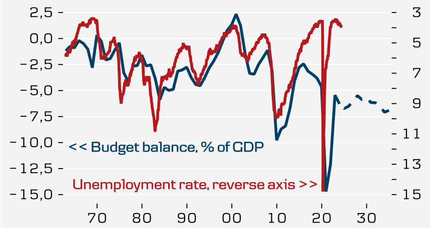
Interest expenses for the government are now equivalent to 2.4% of GDP and will rise to 4.1% over the next decade in the CPO projection. Some, including Treasury Secretary Janet Yellen, argue that this is not the true picture of the burden on public finances from the debt, as there is also a hollowing-out of the debt from inflation – so that the real interest payment is actually negative currently. In the projections, this real interest payment will rise to 2% of GDP in 2034. These projections are based on lower future interest rates than are priced in the market – if we instead use the market rates, the number will approach 3% (see *Reading the Markets USD – Unsustainable debt meets uncertain politics*, July 2).

Debt is high and rising



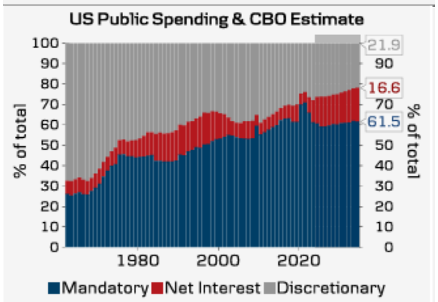
Source: Congressional Budget Office (CBO), Macrobond Financial

Large deficit despite strong economy



Source: Congressional Budget Office (CBO), Macrobond Financial

Spending is increasingly "mandatory"



Source: Congressional Budget Office (CBO), Macrobond Financial

Chief Economist
Las Olsen
laso@danskebank.com

How it can go wrong

If investors begin to fear a hollowing-out of the value of bonds through high inflation, they will demand a risk premium which in itself will make government finances worse by rising the cost of borrowing. There is no agreement about at what level of debt that will happen – Japan's net government debt (by IMF's definition) is 155.9% of GDP, with much lower bond yields than in the US. However, as the deficits continue and there does not seem to be political will to change that, the risk increases year for year.

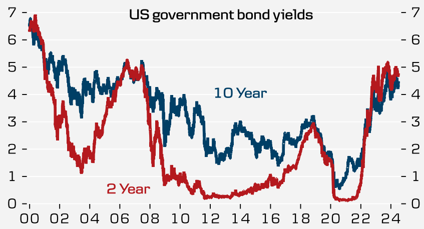
So far, there is little evidence that markets are in fact reacting to the unsustainable budget situation. Government bond yields have risen substantially over the last three years, but that seems to be driven by higher market expectations for future interest rates, not an increased risk of high inflation or government default. Market pricing for future inflation remains broadly consistent with the Fed sticking to its 2% inflation target, and the so-called term premium, which should capture an increase in the risk (and duration) compensation, remains low according to model estimates. The increase in interest rate expectations could very well reflect a (justified in our view) expectation that government debt and deficits are driving up the natural level of interest rate, although that rate is also affected by many other factors. The loose fiscal policy is likely an important part of the reason why it is proving difficult for the Fed to get inflation all the way down to its target, despite maintaining interest rates that are much higher than its own assessment of the neutral level.

The US public sector deficit is partially financed by a savings surplus in the private sector (primarily households), but there was still a current account deficit in 2023 equivalent to 2.8% of GDP, and that deficit is forecasted to remain around a similar level over the coming years. However, there is clearly foreign interest in investing in US assets and make up this difference with net investment flows, as is also evident from the strong USD. US government debt is widely considered a "safe asset" domestically and globally, and foreigners bought debt securities worth USD 1.1tn, or 4.0% of GDP, last year. Current account surplus countries such as China and Japan have to be net buyers of foreign assets, and it is difficult to find other markets than the US large enough to absorb the flows.

As long as both US and foreign investors are willing to soak up the bonds and bills that the US government is issuing without a large risk premium, there is no immediate problem. There are also ways for the government to dampen market pressure for higher long term bond yields if we start to see that, including shortening the maturity profile of new debt issuance like it has already done since the debt ceiling resolution last year But the risk is that at some point markets will start to price in a high probability of high US inflation due to the unsustainable fiscal situation, which would lead to significantly higher bond yields and a significantly weaker USD. This in turn could course financial disruptions elsewhere, for example like we saw in 2023 where higher bond yields created losses in the portfolios of a few banks large enough to force them to be rescued. More widespread financial problems of this sort could further undermine confidence in public finances and the inflation outlook, as markets might price in a risk that either the government or the Fed would need to fund rescues of financial institutions.

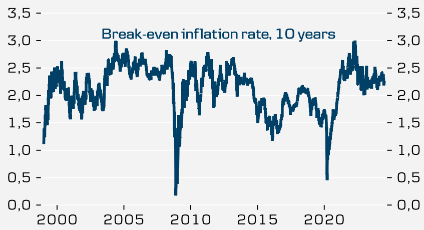
Politics is an obvious place to look for triggers of such a loss of confidence. Although the comparison is far from perfect, the crisis around UK government debt in 2022 was triggered by a new government presenting plans that would increase an already large deficit. We have also seen a modest market reaction over the last month based on fears that the French election might worsen the already unsustainable fiscal situation there. However, it is far from obvious that the upcoming US election will cause budget fears to surface in the market

Bond yields have risen substantially...



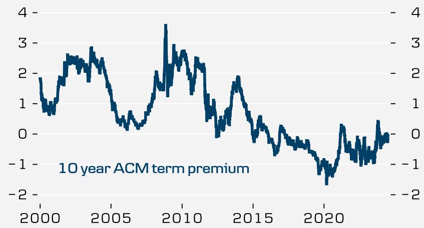
Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial

...but not because markets are pricing a big rise in inflation...



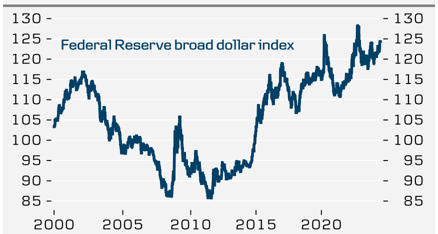
Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial

...or a much higher term premium



Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial

No weakening of the dollar



Past performance is not a reliable indicator of current or future results. Source: Macrobond Financial since no result should be a big surprise, given the uncertainty over the outcome that polls and predictions have been showing for months.

However, we would highlight that political decisions could be triggers for bond market movements or even a crisis over the coming years, given how frail the situation already is for government finances. For example, effective action to stop immigration and expel a large number of recent immigrants could undermine GDP growth and government revenue, and large spending increases or tax cuts could prove to be the last straw in terms of market confidence, even if the measures are intended to improve the US economy. Another occasion for budget fears to strike markets could be when the debt ceiling will need to be raised during 2025. Some form of economic recession or crisis would of course also be negative for government finances. It is difficult to say what event, if any, will trigger problems in the bond market, but as the debt increases relative to the size of the economy, the risk increases with it.

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank').

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Danske Bank is authorised by the Prudential Regulation Authority in the UK. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

Danske Bank's research reports are prepared in accordance with the recommendations of Capital Market Denmark.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates: ad hoc

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank A/S's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 04 July 2024, 12:00 CET

Report first disseminated: 04 July 2024, 12:45 CET