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MARKET SIGHT LINES

Troubling Forces Converge: We're Headed to a Fiscal Transition

By Michael O'Keeffe, *Chief Investment Officer*

As my team and I analyze the current environment to make sense of market performance and develop views looking forward over the short, medium, and long term, we often focus on various topics individually that, taken together, provide further insight. We recently discussed four headwinds negatively affecting stocks, including higher rates and political debate around spending. This followed articles on the new higher rate regime, the U.S. government's fiscal challenges, and the related implications of a downgrade in U.S. government debt. Finally, our most recent *Investment Strategy Brief* includes a discussion on the buildup of debt since the Great Recession.

In this Sight|Lines, we discuss various fiscal forces that, taken together, could spell trouble.

THE TAKEAWAY: MORE DEBT AND HIGHER RATES MEANS FISCAL DISCIPLINE IS NEEDED.

With increased debt and higher rates, a change in fiscal practices is coming. In summary:

- The combination of household, non-financial corporate, and U.S. government debt has increased $36 trillion since the Great Recession.
- Data and investor sentiment are signaling we may well be in a higher rate regime, significantly increasing the cost of this higher debt going forward.
- Market forces will drive businesses to adjust how they manage debt, with fiscally weak companies failing, and strong companies potentially thriving.
- Consumers will be forced to manage debt more carefully, with the increase in loan defaults and individual bankruptcies causing pain for some individuals and potentially slowing the economy.
- Political debate will continue, with fiscal topics like spending, deficits, and debt coming more into focus.
- All told, market forces appear to be guiding us toward an important fiscal transition for all three of the players in our economy – the consumer, businesses, and our government.

We remain optimistic that as a country we'll get through this fiscal transition stronger. But how much pain will we experience through the process, and when?

IN-DEPTH: DEBT HAS INCREASED MEANINGFULLY, AND WE'RE IN A HIGHER RATE REGIME, TOGETHER SETTING US ON A COURSE FOR AN IMPORTANT FISCAL TRANSITION.

When interest rates were low, debt increased meaningfully. Now that interest rates are rising, fiscal discipline is needed. We expect to see a fiscal transition across all three segments of our economy. Going deeper:

- Since the Great Recession, debt levels have increased:
    - U.S. household debt has grown from $12 trillion to $17 trillion, an increase of $5 trillion.

- U.S. non-financial corporate debt has risen from $6 trillion to $13 trillion, up $7 trillion.
- U.S. government debt has increased from $9 trillion to $33 trillion, a rise of $24 trillion.

- We're in a higher rate regime, signaling that the cost of our debt will be rising:
  - Today's yield curve is signaling the 10-year Treasury yield could remain above 4.5% for decades.
  - Investors in Treasury bonds are demanding higher yields for technical reasons (less demand as the Federal Reserve is no longer buying bonds) and fundamental reasons (wanting compensation for increased risk of fiscal mismanagement, as reflected in a downgrade of U.S. government debt).
  - While much of our debt is fixed rate, as this debt matures and new debt is issued, the cost of debt will rise given the higher market rate environment.
- Market forces will drive businesses to adjust how they manage debt:
  - Companies unable to handle increased costs of debt will fail, causing pain for their employees and investors.
  - Strong companies that survive may be well positioned to compete, potentially thriving.
- Consumers' fiscal management will come into further focus:
  - People will have to better manage debt, with attention on earning income and/or spending less.
  - Some will experience loan defaults and bankruptcy, causing further pain for these individuals.
  - Lower spending will slow the economy, spreading some pain to other businesses and individuals.
  - The federal government may provide some relief by, for example, canceling some student loans. But arguably since this relief would be funded through an increased deficit, this simply shifts the burden to the government, and therefore the U.S. taxpayers more broadly.
- Political discourse may well be shifting to a focus on fiscal discipline:
  - The debt ceiling debate in May brought the increasing debt into focus.
  - The risk of a government shutdown remains, as the most recent continuing resolution to keep the government running expires in mid-November, bringing the topic back into focus.
  - House Speaker Kevin McCarthy was removed in an action to "vacate the seat," triggered by fiscal debate among House Republicans, with some wanting less spending and more discipline.
  - Fiscal discipline (less spending, higher taxes, and/or lower deficits) remains politically unpopular, implying that the greatest pain may ultimately felt from the government's fiscal transition.

CONCLUSION

Market forces are bringing into focus the meaningful increase in debt over the last 15 years or so, with higher rates set to increase the cost of that debt. Those same forces will guide businesses and consumers to adjust their debt management, with some pain along the way. For our government, this process will take longer and create more pain. But, we remain optimistic that as a country we'll get through this fiscal transition stronger.

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