WELLS FARGO
Investment Institute

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Paying America's bills

What investors should know about how the U.S. government manages its finances

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Key takeaways

- At over $34 trillion, the federal debt is staggering but currently manageable. What's troubling is the prospect for its continued growth over the long term.
- We believe the Treasury has done a good job of managing the debt expense, and investors have shown no reservations about buying Treasury securities. Lower rates over the past decade helped keep funding costs low, but higher interest rates are already expected to cause interest expense to grab a bigger bite of the budget.
- Although it's unlikely that investors will feel the most damaging effects of America's fiscal challenges soon, some repercussions have already started to trickle down to financial markets. Wells Fargo Investment Institute (WFII) is already factoring near-term impacts into our investment guidance.

A factual look at U.S. debt, deficits, and entitlements

The Congressional Budget Office (CBO) expects that the budget deficit will rise to near $2.0 trillion in 2024. The deficit is projected to increase to $2.9 trillion in 2034. Rising interest costs and greater spending for programs that provide benefits to elderly people are expected to increase the deficit to 6.9% of gross domestic product (GDP) by 2034 — significantly more than the 3.7% that deficits have averaged over the past 50 years, according to the CBO.

The bottom line is many of the current trends are unsustainable over the long run (10+ years). Fortunately, we think there is still time to make corrections before a crisis emerges. The necessary changes are likely to be more drastic the longer the U.S. waits to act. In the past the U.S. has been adept at dealing with crisis. Will the U.S. be just as adept at preempting one? We believe there is danger that the steps required may be too great to instigate action before a crisis occurs.

Our country is not alone in facing these challenges; the U.S. is unique, however, in that we remain in a position of strength globally. Our economy is the world's largest and most diversified, and the U.S. dollar is the globe's primary reserve currency. While that's still the case, can our political parties work together to enact sweeping changes to correct our long-term trajectory?

Any discussion of America's debt and budget is often politically charged. In the following pages, we provide a nonpartisan presentation of our nation's fiscal trends. At the conclusion, we look at how we have adapted our investment guidance as a result of these trends and make some portfolio suggestions for you to consider.

$34.6[1] trillion
Total U.S. debt

$7.06[1] trillion
Portion of U.S. debt borrowed from government sources

$50.6[2] trillion
Projected total U.S. debt in 2034

$3.1[2] trillion
Projected 2024 spending on Social Security and major health care programs

3.27%[1]
Current average rate government pays to finance the debt

1. "Debt Position and Activity Report," TreasuryDirect.gov, May 31, 2024

2. "An Update to the Budget and Economic Outlook: 2024 to 2034," Congressional Budget Office, June 2024. Federal debt held by the public excludes debt held by government entities.

Cutting through the federal budget fog

Why doesn't the federal budget balance?

Like any budget, the federal budget is merely a plan for revenues and expenditures for the fiscal year. While that may sound simple enough, there's often a cloud of confusion around the federal budget.

Lawmakers have little wiggle room to reduce expenditures. Although cutting federal spending to help balance the budget is frequently a matter of intense debate, the fact is only about one-quarter of government expenditures are discretionary — meaning they can be easily reduced. These comprise spending that lawmakers control through annual appropriation acts and can be broken down somewhat evenly between defense and nondefense expenditures.

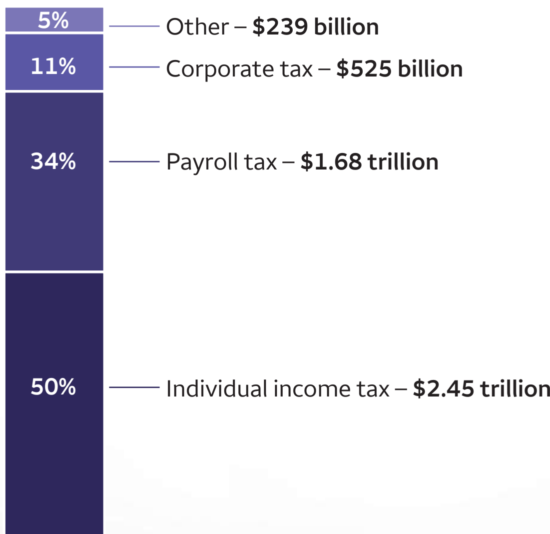
The bulk of government spending is actually considered "mandatory," which is somewhat of a misnomer. These "entitlement" expenditures can, in fact, be reduced, but doing so would be extremely difficult (and probably unpopular).

Government spending exceeds revenue

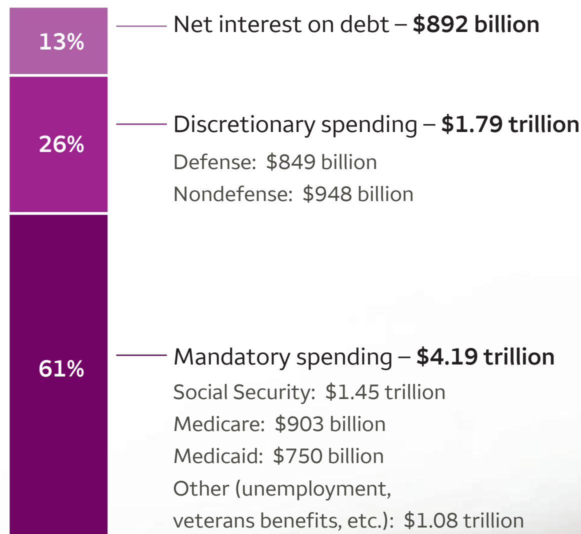
When a business or family does budgeting and subtracts expenditures from revenues, the goal is usually to end up in positive territory. When the federal government does it, the result often is a negative number, or a deficit.

While politically unpopular, “entitlement” expenditures can, in fact, be controlled by lawmaker action. However, we see no real intention from our leaders to tackle these issues in the near term. At the current pace, by 2034, outlays for Social Security, the major health programs, and interest will account for 68% of projected spending, according to the CBO.

Projected 2024 revenue: **$4.9 trillion**



Projected 2024 spending: **$6.9 trillion**



Revenue		Spending		Deficit
$4.9 trillion	—	$6.9 trillion	=	$2.0 trillion

Source: “An Update to the Budget and Economic Outlook: 2024 to 2034,” Congressional Budget Office, June 2024

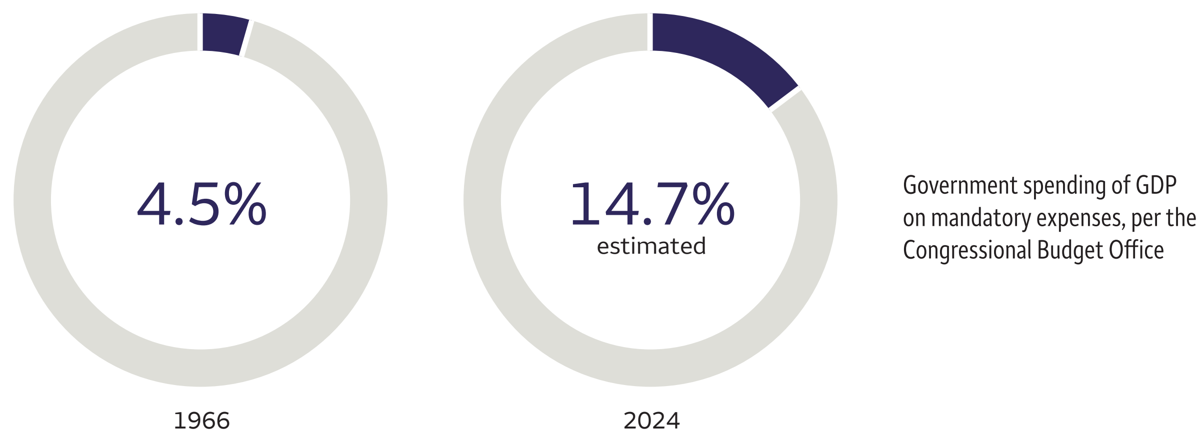
Taking a closer look at spending

Why is the shift in spending a concern?

With a greater proportion of spending going toward mandatory expenses, policymakers could face challenges down the road.

For some historical perspective, the government spent 4.5% of GDP on mandatory expenses in 1966. In 2024, the CBO projects that mandatory spending will approach 14.7% of GDP and rise toward 15.3% of GDP in 2034 if entitlement program payout formulas remain unchanged. Two underlying trends, the rising average age of the population and growth in federal health care costs per beneficiary, contribute to that increase.

The significant increase in mandatory expense outlays over time presents the possibility that the government may lack fiscal flexibility when it comes to dealing with future economic challenges. Legislators seem adamant to increase deficit spending in both good and bad economic environments. Lawmakers chose to decrease tax revenue in 2017 during a relatively healthy economy. More recently, spending was substantially increased in response to a steep decline in economic output due to the coronavirus pandemic. Some level of deficit spending is likely sustainable, but as the population ages, a greater burden will likely be placed on the government budget and resources — resources which may have otherwise supported economic growth to support increased costs for social programs. Interestingly, high debt levels and difficult demographic issues have not yet led creditors to demand higher yields. In fact, interest rates across the globe still remain at relatively low levels when compared to history, despite the increase in interest rates over the past two years due to elevated inflation.

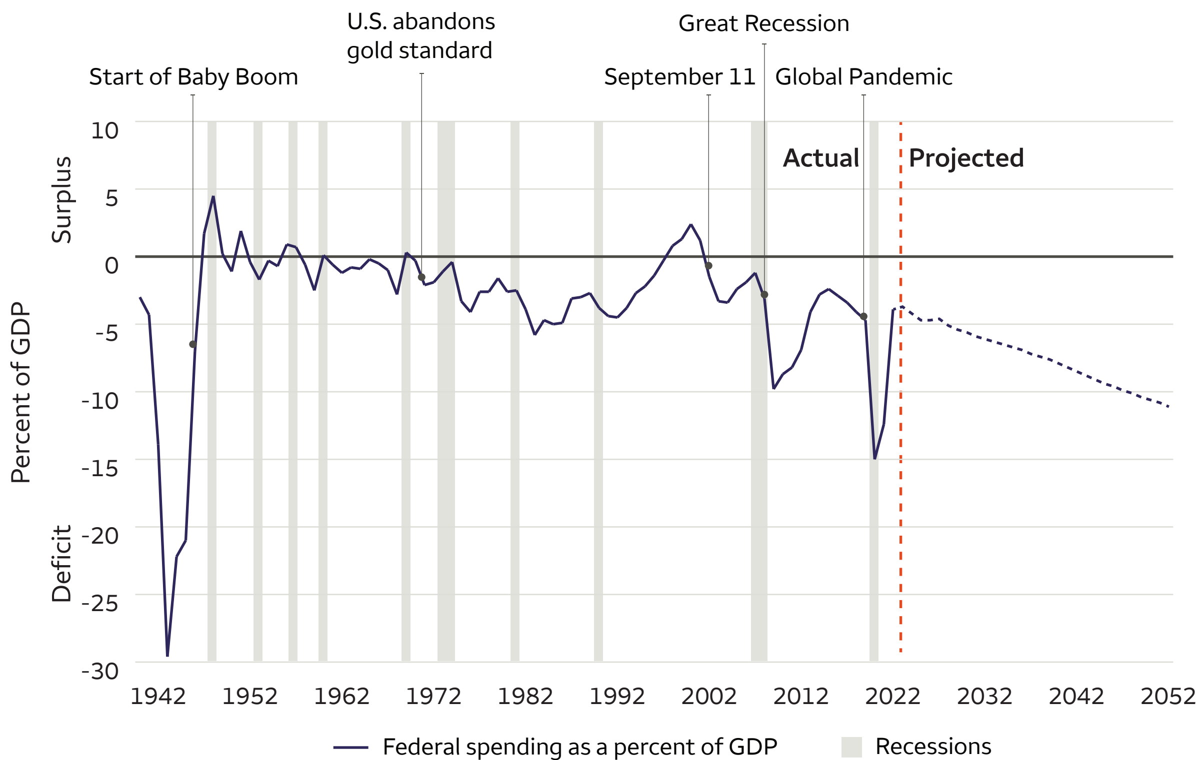


Government spending of GDP on mandatory expenses, per the Congressional Budget Office

Deficits — not necessarily a bad thing

While federal deficits are definitely a concern, keep in mind that they are an important part of managing through economic cycles. In theory, deficits grow during recessions as the government increases spending to help stimulate economic activity while tax receipts decline. During better times, the opposite should occur, potentially resulting in surpluses. However, as the chart shows, the government has run deficits on a fairly consistent basis — in both good times and bad — going back to 1929.

Deficits and surpluses as a percentage of GDP



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

Going behind the debt numbers

Why is there so much talk about the debt?

At more than $34 trillion, the federal debt's size is indeed staggering. But keep in mind that the raw numbers do not tell the full story.

When consuming debt statistics, investors should understand how debt numbers are being calculated. Total debt numbers often include debt the government owes itself. Government-owned debt is similar to you taking a loan from yourself — a default on a loan to yourself would not result in a default to your creditors and does not need to be financed in the public debt markets.

The U.S. government holds its own debt in various trust funds, such as the Social Security and highway trust funds. We have included Treasury debt held by the Federal Reserve (Fed) in debt owned by the public to align with how the CBO calculates its debt growth projections and statistics (such as the debt as a percent of GDP).

Who owns the debt?

U.S. investors hold the largest portion of debt (latest available data as of December 2023)

Owned by the U.S. government		Owned by the public			
		U.S. investors		Foreign countries	
21.7%		54.5%		23.8%	
Social Security trust fund	$2.6T	Federal Reserve	$5.2T	Japan	$1.15T
Medicare trust fund	$191B	Depository institutions	$1.65T	China	$770B
Other trust funds	$4.5T	State and local governments	$1.68T	Others	$6.1T
		Private pensions	$614B		
		Mutual funds	$3.7T		
		Others	$5.5T		
Total: $7.3 trillion		**Total: $18.3 trillion**		**Total: $8.0 trillion**	
		Total owned by public: $26.4 trillion			
Grand total: $34 trillion					

The government currently owes more than $26 trillion to public investors. Out of the total held by public investors, foreign investors hold over $8 trillion in Treasury securities — a level that increased dramatically throughout the past two decades.

Source: "Treasury Bulletin," U.S. Department of the Treasury, Bureau of the Fiscal Service, June 2024. Data as of December 2023.

How does U.S. debt measure up?

A country's public debt-to-GDP ratio is one measure of its government's ability to pay its debt. If a country's debt was equal to its annual GDP, the ratio would be 100%. In 2020, the U.S. ratio surpassed 100%, the highest level since World War II, and although it has declined to 97% since, it is still a dramatic increase from the 50-year average of 48%.

While the U.S. currently has a debt level that's very high from a historical perspective, we feel the danger zone is not in the near term but over the long term, given that the debt burden is projected to continue to grow.

According to CBO projections, the U.S debt-to-GDP ratio is poised to reach 116% in 2034 and 166% in 2054. We believe a high debt-to-GDP ratio increases the risk that investors might, at some point, begin to doubt the government's ability or willingness to pay off the public debt. That could result in benchmark interest rates rising and drastic spending (austerity) measures being necessary to maintain creditor support of the government's debt.

But debt-to-GDP does not tell the full story regarding creditworthiness — after all, Japan's debt-to-GDP is estimated to be over 250%, yet it still enjoys some of the lowest borrowing costs in the world. Other factors to consider include:

- **Who are the bond buyers?** When a country's own citizens purchase the majority of the government's debt, the likelihood that selling pressures or a buyers' strike could materialize is small. As a result, a higher debt-to-GDP level may be manageable and perhaps sustainable.
- **How healthy is the economy?** Countries with higher economic growth and more diverse economies historically have had a greater ability to pay back debt, and the market may bear higher debt-to-GDP ratios.
- **How is the debt being managed?** Countries with high debt-to-GDP levels that have implemented reforms such as those listed below may gain investors' support:
  - Cutting spending
  - Raising revenues through higher taxes
  - Implementing policies to increase economic growth

What does it cost to finance the debt?

Although the debt has ballooned, the cost of financing it is actually slightly less than the all-time high, and although it still appears manageable, it is also starting to get worrisome.

The percent of the federal budget needed to finance the debt had declined from a high of 15.4% in 1996 to a recent low of 5.3% in 2020. However, since the federal debt has grown considerably over the past three years, interest outlays are expected to increase toward a projected 13.0% of the federal budget in 2024, according to the CBO. Continued fiscal spending will also expand the deficit to almost $2.0 trillion in 2024. Couple this with a larger amount of debt outstanding and higher interest rates and it is not difficult to see why some alarm signals are starting to go off.

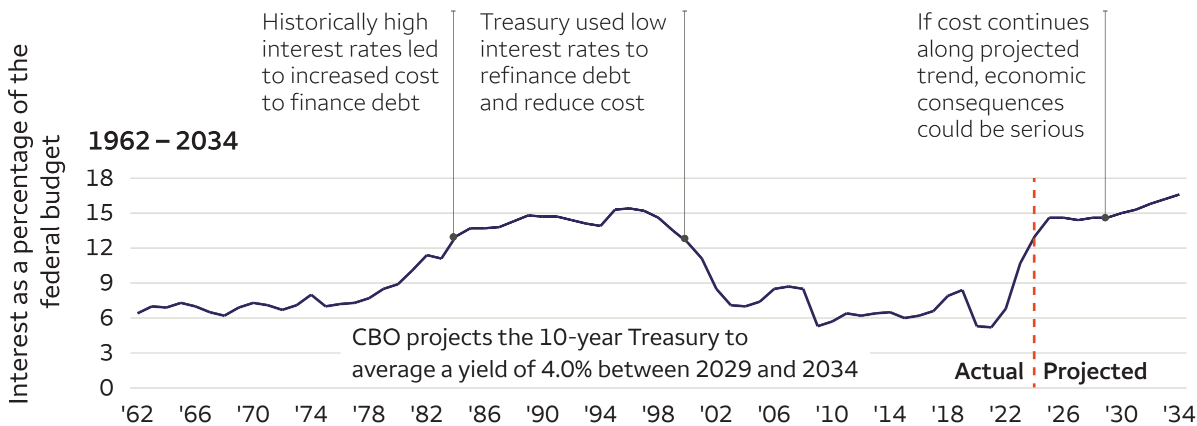
Current CBO baseline projections show the debt service increasing to over 16% of the federal budget by 2034. Under this scenario, interest expense costs would remain manageable. However, additional economic shocks or a continued increase in interest rates could be concerning.

Steadily falling interest rates over the past decade afforded the United States a significant amount of fiscal flexibility despite the significant increase in total debt. However, the expectation of a longer-term trend of increasing interest expense could have serious economic implications.

$818 billion

Additional cumulative interest expense over 10 years that the CBO estimates on its projections as a result of increased debt and modestly higher interest rates.[1]

U.S. net interest as a percentage of the federal budget



Sources: "An Update to the Budget and Economic Outlook: 2024 to 2034," Congressional Budget Office, June 2024, and Wells Fargo Investment Institute.

1. Assuming all other economic variables remain unchanged. Forecasts are not guaranteed and are based on certain assumptions and on views of market and economic conditions, which are subject to change.

Dealing with the debt ceiling

Even as debt costs remain manageable, markets with some regularity concern themselves with the debt ceiling. The Treasury can issue debt only if Congress and the president have given it authority to do so; this authority has become synonymous with the debt ceiling. Failure to raise the debt ceiling when necessary could result in the U.S. government defaulting on its obligations, which it has never done. Currently, Public Law 118–5 suspended the statutory debt limit through January 1, 2025.

Raising the debt ceiling does not directly alter federal spending going forward — debt is issued only when the Treasury needs funds to cover spending that Congress has already authorized. Legislative uncertainty over raising the debt ceiling has, at times, forced the Treasury to take extraordinary measures and brought about market uncertainty, rating agency downgrades, and intense political wrangling.

Political brinkmanship is likely to continue to dominate future debt-ceiling deadlines, yet we expect the U.S. government will continue to take the steps needed to pay its bills in a timely manner. Investors should not be overly concerned as this inevitable deadline once again approaches. Maintaining investment exposure and taking advantage of any market dislocations should be investors' focus.

Debt ceiling through the years

1917	Congress establishes the debt ceiling
2011	Debt-ceiling issues, in part, lead to the very first credit-rating downgrade
2023	In June 2023, a joint resolution from Congress (Public Law 118–5) suspended the statutory debt limit through January 1, 2025
78x	Since 1960, the debt ceiling has been raised 78 times* — 49 times under Republican presidents and 29 times under Democratic presidents

***Source:** Treasury Department, July 2024

Looking ahead

Potential warning signs of a debt problem

It is likely that the U.S. can support a higher debt level than today given the country's dominant global economic position and the dollar's stance as the world's primary reserve currency.

Even if the country can sustain a higher debt level, projected increases remain concerning. Keep in mind it is impossible to predict exactly how much federal debt the country could bear before investors lose faith in the government's ability or willingness to pay, potentially pushing borrowing costs higher and the nation into a fiscal crisis.

Even if a crisis is not imminent, the consequences of a significant national debt size are likely to be real and far-reaching for citizens and investors. Before any true financial crisis occurs, investors should watch for potential effects of a growing debt, such as:

Crowding-out effect

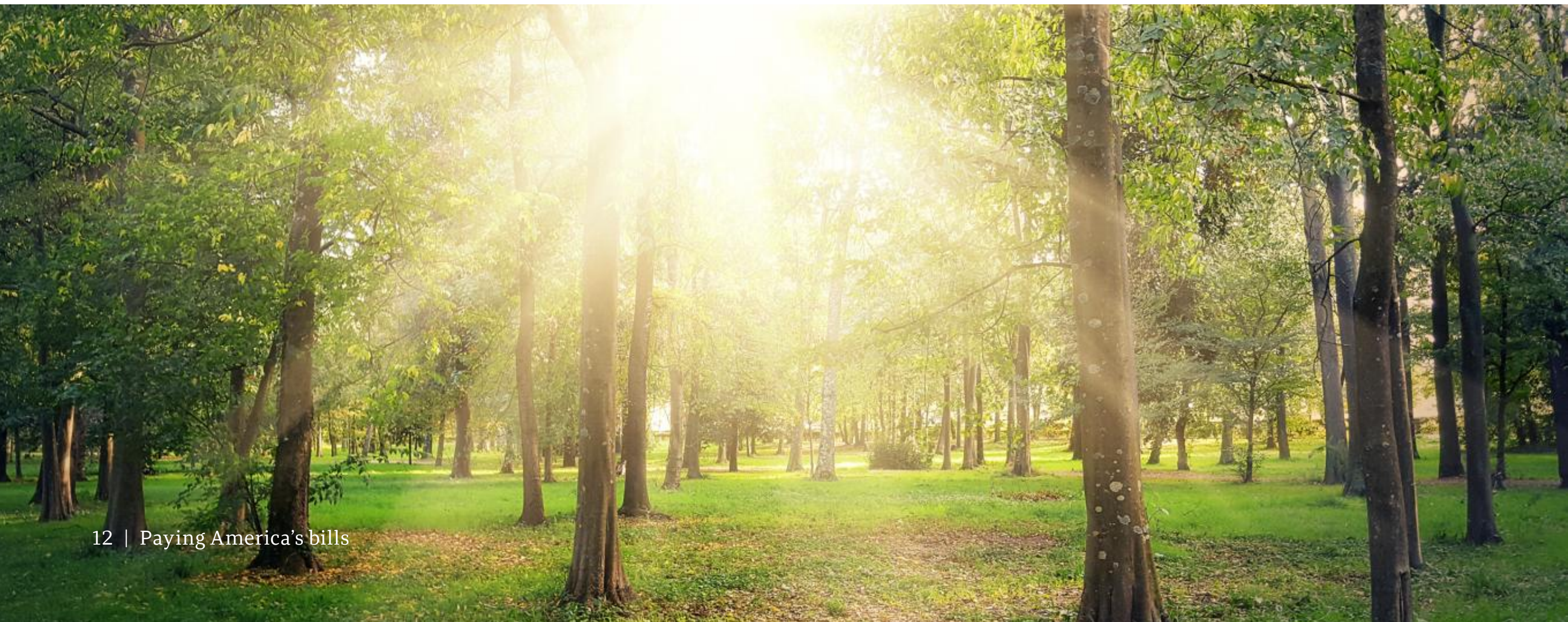
A large amount of federal debt issuance could lead to a greater portion of private investment spending and consumption being diverted to Treasury debt, shrinking the pool of capital available for private investment. This would likely result in lower economic output, lower incomes, lower investment of capital, and lower investment returns.

Higher borrowing costs

In the longer term, the laws of supply and demand imply that an increase in debt supply will lead to lower bond prices and higher interest rates — assuming all else remains equal. If rates rise materially, the added cost would require increasing government revenues, reducing spending, or implementing some combination of the two.

Decreased fiscal flexibility

An increasing debt level would restrict policymakers' ability to respond to unexpected events. Future shocks may have a more significant negative economic impact as lawmakers might lack flexibility to deal with them fiscally.



Addressing the challenges

To put the federal budget on a sustainable long-term path, lawmakers would have to make major changes to tax policies, spending policies, or both. However, when it comes to these issues, Congress typically finds itself stuck between a rock and a hard place.

On the one hand, these are politically challenging positions to advocate for in legislation given a politician's incentive to be popular and electable during election cycles. On the other hand, the sooner these issues are addressed, the less drastic the size of such changes would be required. The ultimate size and scope of the changes that would be required would depend on the amount of federal debt that lawmakers consider appropriate. Given the choice between taking potentially unpopular action and "kicking the can down the road," Congress has generally opted for the latter.

When, if ever, our lawmakers do act, there are several schools of thought, overviewed below, for them to debate regarding debt management and appropriate fiscal policies.

What can be done?

Spending cuts

Given the budget's makeup, a significant portion of any cuts would likely need to come from popular social programs, which would be politically challenging.

Tax increases

Much like spending cuts, tax increases would likely be unpopular — at least with some segments of the population. In addition, they would go counter to recent policy, which is to simplify the tax code and to extend tax cuts.

Higher economic growth

Arguably the best way to reduce debt-to-GDP is to grow GDP. But based on CBO estimates, it appears unlikely the U.S. will be able to reach and maintain a growth rate in excess of mandatory spending increases over the next five years.

Negative real rates

An inflation rate greater than the interest rate paid on the debt could help manage an increasing debt load and aid in any deficit reduction efforts. While the Fed can help manage interest rates, there is no guarantee that the Fed would allow inflation levels to be above its long-term target.

Inflation or debt renegotiation

Printing dollars to pay off maturing debt or renegotiating outstanding bonds would likely erode investors' and citizens' savings and make it difficult to borrow again and should be used only as a last resort.

Waiting to act will likely compound the problem and necessitate more significant measures in the future. We believe acting sooner rather than later by implementing slow, planned spending-reduction and revenue-growth policies would help the U.S. reduce its reliance on unsustainable debt trends.

Implications for investors

Economic trends factor into our investment guidance and strategy

Although it's unlikely that investors will feel the most damaging effects of America's fiscal challenges soon, some repercussions have already started to trickle down to financial markets. Wells Fargo Investment Institute (WFII) is already factoring near-term impacts into our investment guidance.

Modest inflation assumptions

High government debt levels historically have had a deflationary effect as funds that may have otherwise been used toward investment and consumption must be diverted to service a growing debt burden. However, we believe that long-term inflation levels will trend closer to the Fed's 2% target level, but with periods when the rate fluctuates around that level by more than in past decades.

- When building your investment plan, keep in mind that bouts of rising inflation can increase your expenses but also can increase investment returns and vice versa.

Higher yields (lower bond prices) and more Treasury issuance

Firmer inflation along with more Treasury issuance will cause longer-term rates to remain higher than they were over the prior decade. Some restraint on yields may come from increased demand for fixed-income securities by an aging population, insurers, and pension plans, but it won't be enough to outweigh the interest burden.

We continue to create and offer innovative income-oriented strategies to help replace traditional income sources.

- Talk to your investment professional to determine whether our diversified income approaches are right for you.

Lower return assumptions

Fiscal trends and an aging demographic make it more likely that asset-class return expectations will be lower in the future than we have experienced historically. We do not anticipate that interest rates will fall abruptly, except in the case of an outright economic recession or crisis.

- Lower long-term return assumptions may require that you revisit your investment plan to help ensure that you are on track to meet your goals.

Investment actions to consider

Fixed income

Higher-for-longer interest rates and mounting debt to pay for benefits such as Social Security will most likely cause the Treasury to increase issuance over the next decade. The issuance increase from the pandemic response has already impacted many fixed-income indexes, which now include a larger percentage of government debt.

- Corporate bonds and securitized bonds should continue to pay a premium over U.S. Treasuries. Moving down the credit spectrum is a viable strategy to increase yield but must be done so with caution. We recommend investors use active management when purchasing lower-quality investments.
- Investors may consider holding emerging market fixed-income securities. The higher yield available in this asset class would be attractive, especially those issues denominated in local currency should markets be concerned with U.S. fiscal trends and the resulting impacts of a weaker U.S. dollar down the road.

Equity markets

Equities are likely to remain volatile as investors question the outlook of future economic and earnings growth in a challenging fiscal environment. However, we believe equities may remain a better source of return than bonds.

- Fiscal and monetary support are likely to be implemented congruently should a future crisis arise. These actions tend to lift financial asset prices, with equities markets being a significant beneficiary.

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Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

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Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

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