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Where Are the Vigilantes?
Government Debt in the Modern Era

April 27, 2020

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Key Takeaways

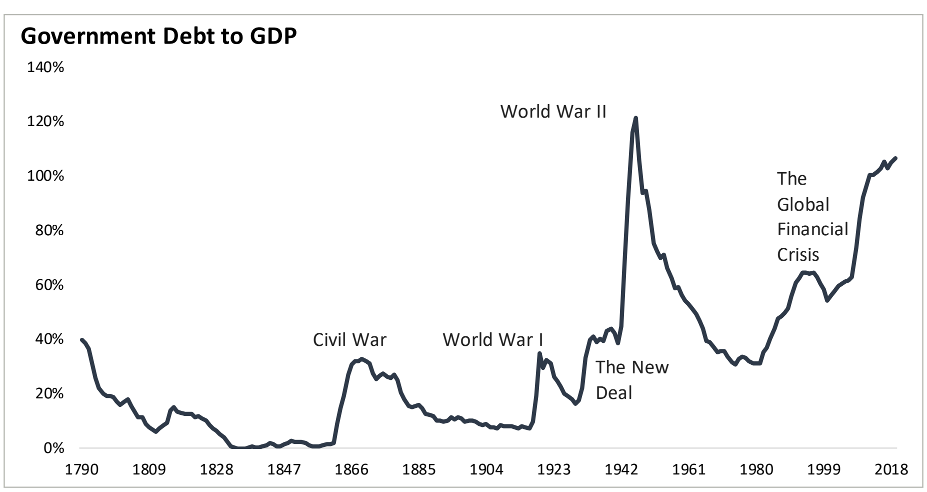
- The level of government debt will rise as a result of the fiscal response to offset the economic damage of COVID-19.
- Real interest rates, inflation and the dollar all point to minimal short-term market risk from the increased government debt.
- With deflation a more likely threat in the next 12 months, government yields are unlikely to rise substantially.
- Down the line, the size of government debt may matter again, but today is not that day.

In the 1980s, strategist Ed Yardeni referred to investors who sell government bonds to force tighter fiscal policy as "bond vigilantes." These individuals were the gatekeepers of responsible government spending. But now, by all accounts, they seem to have disappeared. Over the past two decades, the vigilantes have remained on the sidelines despite soaring government debt.

Before the Global Financial Crisis of 2008-2009, economists and politicians worried that foreign investors, who accumulated Treasury debt, would eventually tire of the persistent trade deficits and dump the debt. After the European Debt Crisis in 2010-2011, where the vigilantes moved across the Atlantic to drive up rates on Greek, Italian and Spanish bonds, fears emerged that the U.S. would also face a government debt crisis. Yet, the vigilantes never came.

Growing U.S. Debt

The sustainability of government debt is once again in the spotlight thanks to the current COVID-19 financial crisis. At the beginning of the year, the Congressional Budget Office was already forecasting a $1 trillion federal budget deficit for 2020. The Committee for a Responsible Budget now estimates the deficit will reach $3.7 trillion due to the multiple stimulus packages needed to address this crisis.



Source: Carmen M. Reinhart, FRED
Note: data from 1790-1965 uses the data from Rogoff & Reinhart, data from 1966 onwards uses FRED

One way to effectively measure the fiscal burden is to look at outstanding government debt relative to Gross Domestic Product (GDP). GDP measures the entire income for the U.S. economy. In theory, the higher the ratio, the less sustainable the debt burden. With government debt to GDP already over 100%, Treasury issuance in 2020 will likely cause the ratio to surpass the peak level during World War II. A good portion of debt sits on the Federal Reserve's balance sheet, and the expansion of Quantitative Easing means the Fed will continue to absorb a sizable portion of the new issuance.

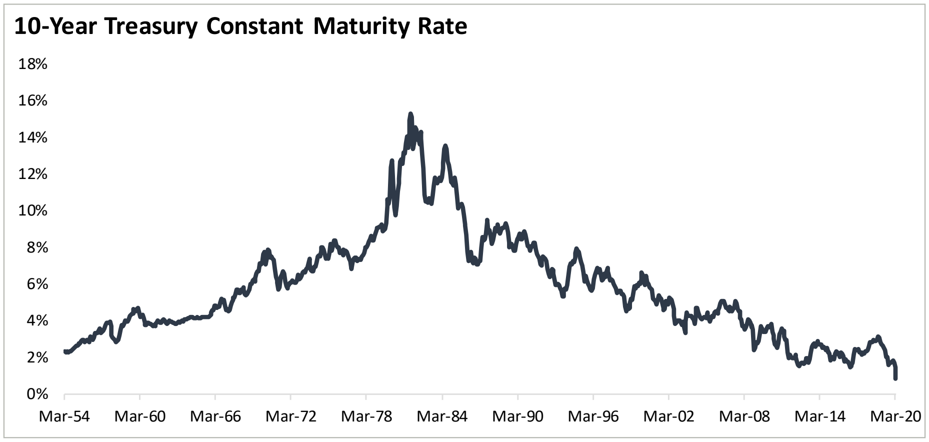
Does This Growing Debt Matter?

With interest rates at historic lows and government debt levels close to record highs (as a % of GDP), should we worry about the budget deficit? In the short run, we believe the fiscal stimulus measures are necessary to support the economy. That said, this increased level of government debt has three potential implications:

- **Crowding-Out Effect.** In classic economic theory, government borrowing can crowd out private investment. The crowding-out effect works by pushing real interest rates higher, raising the cost of borrowing for governments, private companies, and individuals. Current fiscal spending and monetary policy are targeted to fill the hole created by the economic stoppage in Q1 and Q2. It is a big hole to fill, and there are few indicators that the government will crowd out private investment in the near term. Real interest rates – proxied by using 10-year Treasury Inflation Protection yields - are now negative, signaling plenty of room for government spending.
- **The Return of Inflation.** In countries that can issue their own currency, such as the U.S., inflation is the real constraint to government spending. While the U.S. can print an unlimited amount of currency to finance fiscal spending, there are consequences to increasing money supply. Spending can distort prices and increase inflation, which in more extreme cases, can run out of control. Right now, core inflation is running at 2.1% year over year, and current measures show little reason to be concerned. Any unexpected spike in inflation would negatively impact both the bond and equity markets.
- **Dethroning the Dollar.** Government debt and the dollar play a vital role in the global financial system. Investors demand dollars and U.S. government debt for the safety and diversification benefits. Banks use government debt as a source of collateral and to satisfy regulatory capital and liquidity requirements. If the renminbi or a basket of currencies replaced the dollar system, the usefulness of U.S. government debt would diminish, leading to a massive repricing. We see no signs of this happening.

How are The Markets' Reacting to the Growing Debt?

With deflation more of a worry than inflation in the short-term, rising government debt is unlikely to concern the markets. Turning to the economic experience in Japan, where despite government debt to GDP rising to well over 200%, interest rates remain tethered to zero. The Japanese experience over the past two and half decades provides a window into the modern economic environment, where absent inflation pressure, governments can borrow with minimal (short-term) cost. As the developed world was experiencing disinflation, central banks turned their attention to staving off deflation, not inflation. The Fed and global central banks are now more sensitive to volatility in asset prices as the vigilantes have found a new cause. In a world more frightened by the prospects of deflation, the vigilantes have moved into risk assets. When sell-offs in equities and corporate credit occur, they now cry for monetary authorities to loosen financial conditions to alleviate the pressure. The long-term chart of the 10-year Treasury shows markets are much more worried about slowing growth than the increasing issuance of government debt.



Source: FRED

Will Vigilantes Return to the Government Debt Market?

Absent any inflationary pressures or large-scale movement to dethrone the dollar, fiscal and monetary authorities are likely to journey into new frontiers that today only exist in the pages of textbooks or op-eds of newspaper articles. Quantitative easing in 2008 and 2009 was an unconventional monetary tool that is now a conventional policy in the central bank's toolkit. Fancy economic terms like debt monetization and "helicopter money" may become mainstream over the next decade. Eventually, pushing the boundaries will have consequences. That said, the forces that would cause the government debt burden to impact the market are currently broken. We will continue to watch for signs of change, but for now, the vigilantes have other matters with which to concern themselves.

For additional economic and market insights, contact a Cerity Partners advisor or visit ceritypartners.com.

Tom is a Partner in the New York office and has more than five years of experience in various investment management roles. He is a member of the firm's Investment Committee, Investment Manager Selection Sub-Committee, the Compliance Sub-Committee, and the Performance Monitoring Sub-Committee. Tom is a Chartered Financial Analyst (CFA).