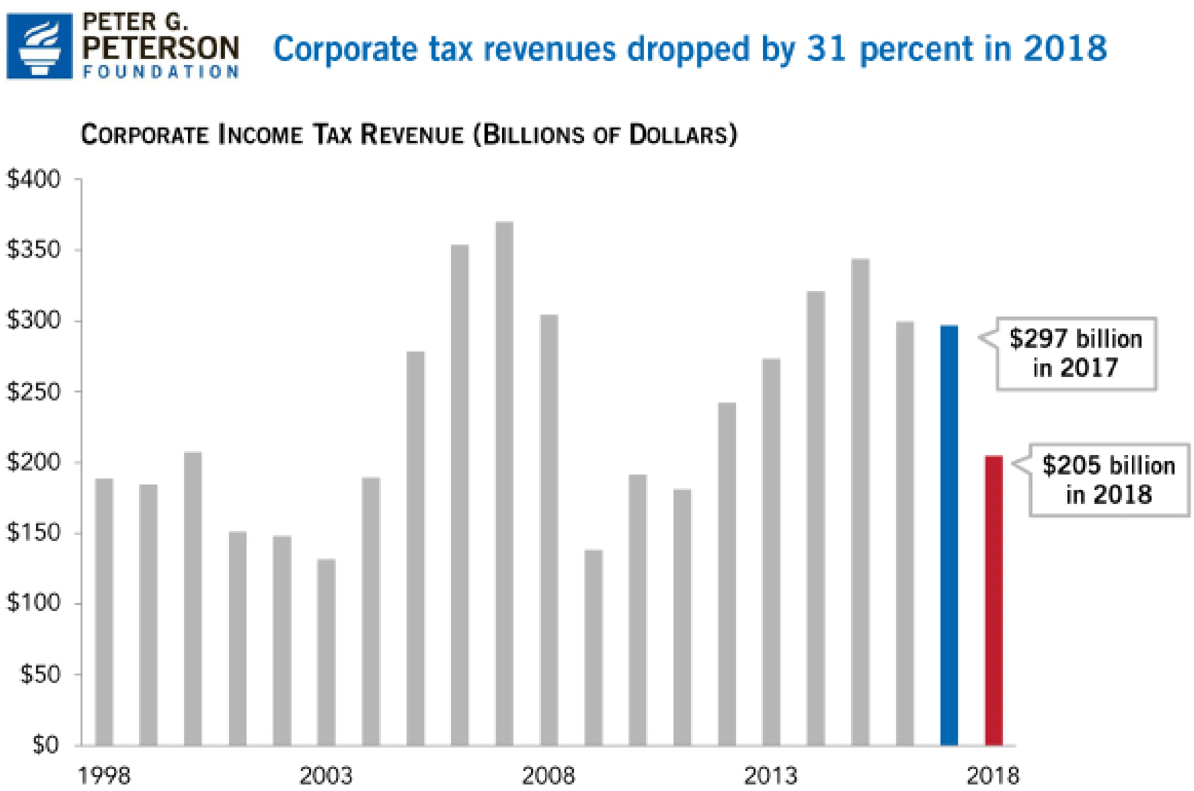
Lynx Investment Advisory

Higher Government Debt Means Lower Economic Growth

On Feb 11, 2019 the US federal debt crossed $22 trillion and not too many voices in Congress expressed any concern. Congress and policy makers have stopped even paying lip service to the unsustainable level of borrowing and therefore the federal debt keeps growing. Most of the recent increase in the debt is due to the 2017 tax law which significantly cut both personal and corporate taxes. The projections of increased revenue as the proponents of the Laffer Curve* implied have not come true. The US corporate tax receipts in 2018 are 31% less than in 2017 (see chart below).



SOURCE: Congressional Budget Office, *The Budget and Economic Outlook: 2018 to 2028*, April 2018; and Department of Treasury, *Monthly Treasury Statement*, issue for September 2018. Compiled by PGPF.

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According to the CBO, if the current laws governing taxes and spending generally remain in place, the amount by which the government's outlays exceed its revenues would rise from $779 billion in 2018 to about $1.2 trillion in 2025 and $1.4 trillion in 2028 and 2029. By 2029, federal debt held by the public will go up from about 78% in 2018 to around 93%. Further projections for next the 30 years are even scarier; by 2049 the figure will jump to 147% (see chart below).

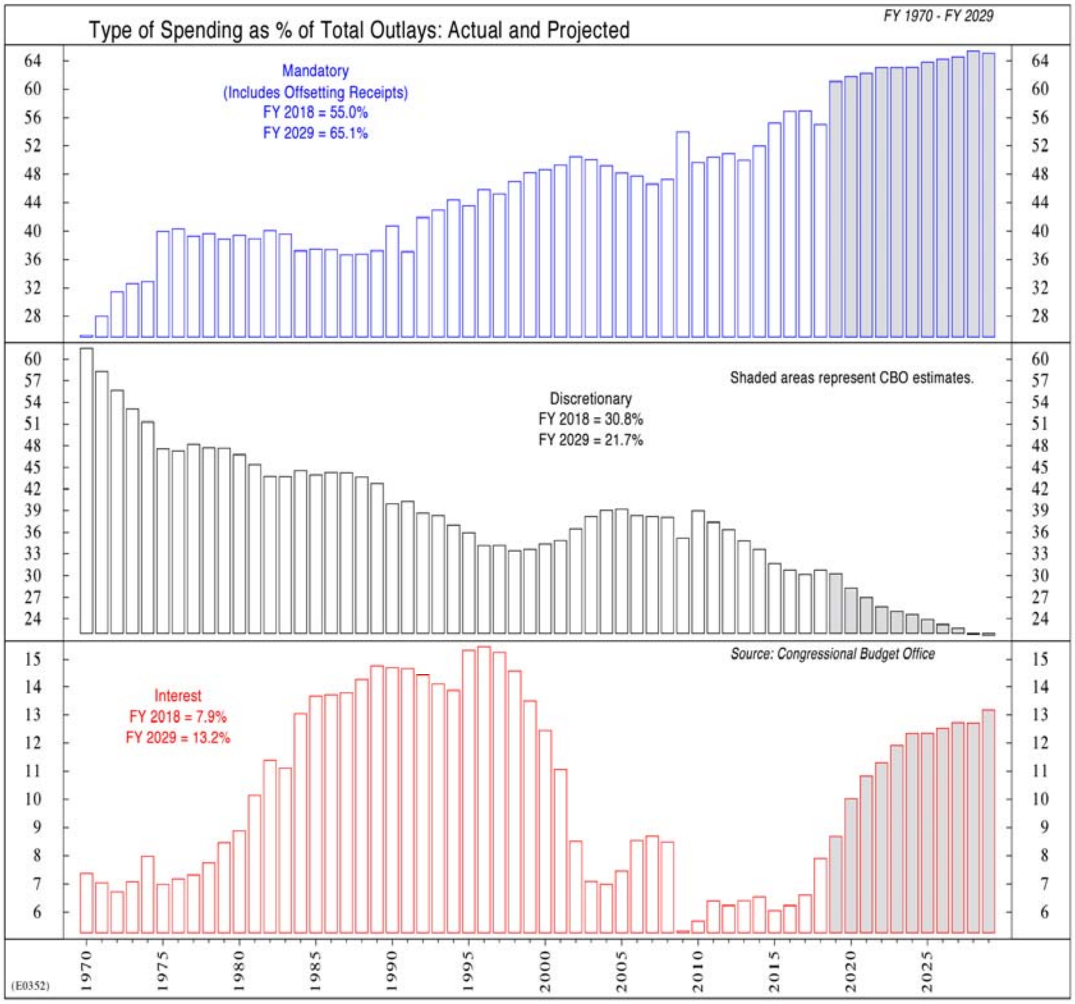
Federal Debt Held by the Public

Source: Congressional Budget Office.

The extended baseline generally reflects current law, following CBO's 10-year baseline budget projections through 2029 and then extending most of the concepts underlying those baseline projections for the rest of the long-term period (in this case, through 2049).

The above chart from the CBO is concerning but the question is what does this mean for US economic growth and capital markets? We believe the increased government spending will not only crowd out private investment, the government itself will spend much of its money in servicing debt. The net interest outlays in the federal budget which are already growing, will go from 7.9% in 2018 to 13.2% of the budget by 2029. On the other hand, the discretionary spending which includes all the government spending on defense, cabinet departments and agencies will decrease from 30.8% in 2018 to 21.7% in 2029 (see chart below).

In our opinion, this increase in interest outlay combined with higher supply of treasuries crowding out private investment will lead to slower economic growth over the long run. In the short run though, the unprecedented fiscal stimulus created by the large increase in federal funding during 2018 and 2019 especially when the labor conditions are tight is likely to boost the economy and equity markets while keeping the treasury yields low. We do, however, believe that this boost comes at the cost of future economic growth. The lower growth is likely to give way to higher allocations to international markets provided the economic conditions outside the U.S. are more disciplined. We know we are presenting a more cautious outlook for future economic growth, but we also know that there will always be opportunities for nimble investors. We at Lynx will continue look for such opportunities and bring them to your attention as we have done in the past.



Many thanks for your business and support.

*Laffer Curve (Source: Wikipedia): Illustrates a theoretical relationship between rates of taxation and the resulting levels of government revenue. It illustrates the concept of taxable income elasticity—i.e., taxable income changes in response to changes in the rate of taxation. The Laffer curve assumes that no tax revenue is raised at the extreme tax rates of 0% and 100%, and that there is a rate between 0% and 100% that maximizes government taxation revenue.