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Fixed Income | Capital Management

U.S. Government Debt and Portfolio Allocations:

The Top Five Factors to Watch

Institutional investors, whose portfolios typically include significant holdings of U.S. government debt, have good reason to be concerned about the market impacts of several interconnected developments occurring at the federal level.

Careful assessment of U.S. credit downgrades, government spending, inflationary pressures, interest rate hikes, and so-called "risk-free" returns shows how asset classes have responded on a historical basis, as well as potential strategies for navigating opportunities and risks on the horizon. Here is an overview of these top five factors to watch.

1 U.S. Credit Downgrades

On August 1, 2023, Fitch Ratings downgraded the U.S. Long-Term Foreign-Currency Issuer Default Rating (IDR) from AAA to AA+, due to expected fiscal deterioration over the next three years, a high and growing general government debt burden, and repeated debt limit standoffs and last-minute resolutions between the President and Congress.[1]

The last previous major U.S. credit downgrade transpired on August 5, 2011, when Standard & Poor's cut its rating of long-term federal debt from AAA to AA+. S&P asserted that the effectiveness, stability, and predictability of American policymaking and political institutions had weakened at a time of ongoing fiscal and economic challenge.[2]

Although bond yields declined after the 2011 S&P downgrade, at the time inflation was under the Federal Reserve's 2% goal and the Fed's target interest rate was 0.00% to 0.25%. The first trading day after the downgrade, the S&P 500 and the Nasdaq both fell by approximately 6.8%.[3]

This time bond yields rose after the Fitch Ratings decision in August, when inflation was over 3%, target rates were at 5.25% to 5.50%, and both figures remained exposed to rising further. A day after the Fitch downgrade, the S&P 500 and the Nasdaq both fell by approximately 1%.[4]

The more muted recent stock market response may be a result of investors having already processed the initial U.S. credit downgrade from more than a decade ago. Moody's, the other major rating agency, also has maintained U.S. credit at its top Aaa rating. But additional downgrades could eventually increase interest rates, overall borrowing costs, and government spending.

2 Government Spending

This issue in particular has been a contentious factor that repeatedly has prompted partisan brinkmanship and risked temporary government shutdowns. A portfolio may feel the effects of government spending in various ways, depending on the macro environment and the investment strategy implemented during the relevant time period.

On one hand, government spending that stimulates economic activity can in turn lead to greater consumer spending and corporate earnings, which could boost equities. Of course, often there are time lags between these effects, and government spending rarely if ever benefits all sectors equally. (This is just one reason why portfolio diversification remains essential even during periods of growth.)

On the other hand, since the U.S. government cannot actually control the economy, if a recession still occurs in the wake of excessive government spending, there may be little capacity for further fiscal stimulus as corporate earnings and therefore equities suffer.

U.S. government spending rose from $5.14 trillion and 21% of gross domestic product in 2019 to $7.47 trillion and 31% of GDP in 2020, then dipped to $7.38 trillion and[5] 30% of GDP in 2021 before falling back somewhat to $6.27 trillion and 25% of GDP in 2022. Full year 2023 government spending is estimated[6] to rise to $6.37 trillion and 2024 spending is projected to reach $6.88 trillion.

In addition to collecting taxes through the Internal Revenue Service, debt issuance serves as the other major source of financing for government spending. The U.S. Treasury raised a net $1.0 trillion through securities issuances minus securities retirements in 2019, a net $4.28 trillion in 2020, a net $1.51[7] trillion in 2021, a net $1.21 in 2022, and a net $1.16 trillion year-to-date through July 2023.

3 Inflationary Pressures

While the degree to which government spending influences inflation has long been open to debate, the Federal Reserve itself acknowledged[8] that U.S. fiscal policy in response to the COVID-19 pandemic, such as direct cash payments and relief packages, did contribute to the biggest inflationary environment in decades. Additional factors, such as a tight U.S. labor market and the Russia-Ukraine war, also have contributed to inflation.

The U.S. Consumer Price Index increased 3.0% during the 12 months ending[9] December 2019, 1.4% during the year ending December 2020, 7.0% during 2021, and 6.5% during 2022. During the 12 months through July 2023, the CPI increased 3.2%.

The Personal Consumption Expenditures Price Index excluding food and energy, also known as the core PCE, increased 1.6% during the 12 months ending[10] December 2019, 1.5% during the year ending December 2020, 5.0% during 2021, and 4.6% during 2022. During the 12 months through July 2023, the core PCE increased 4.2%.

All else being equal, inflation tends to exert downward pressure on real returns of fixed income, heighten stock market volatility with growth stocks often underperforming relative to value stocks, and increase the value of real assets such as commodities and real estate. Taken in isolation, inflation also decreases the value of the dollar, which may make holding cash less attractive compared with investing those assets.

However, inflation rarely occurs in isolation for long. Consumer prices rose faster than wages for the two years through April 2023. In part due to its negative impact on consumer purchasing power, rampant inflation historically leads to Federal Reserve interest rate hikes.

4 Interest Rate Movements

The Fed's 11 hikes to the target interest rate, from near zero to 5.50% between March 2022 and July 2023[11], has had widespread effects on markets. Depending on the portfolio, this has led investment managers to make adjustments ranging from tactical rebalancing that includes greater allocations to high-yield money market or saving accounts, to outright strategy revisions.

Last year, the Bloomberg U.S. Aggregate Bond Index fell 13% and the S&P 500 fell 19%, the first time stocks and bonds fell in the same year since 1969. This year, with many market participants having come to believe that the Fed is nearing the end of its rate hike cycle, the Bloomberg U.S. Aggregate Bond Index was up 1.01% and the S&P 500 was up 17.87% through August 31.[12] YTD through August 31, the Bloomberg Intermediate Aggregate Index was up 1.77% and the Bloomberg U.S. Government/Credit Bond Index was up 2.13%.[13]

Meanwhile, by increasing the cost of borrowing, Fed rate hikes have severely hindered the performance of two interrelated sectors: commercial real estate focused on office buildings, and the regional banks that provide loans to those companies. Silicon Valley Bank, Signature Bank, and First Republic Bank all failed earlier this year on deposit flight linked to commercial real estate fears. The KBW Nasdaq Regional Banking Index fell 17.44% YTD through August 31.[14]

Office vacancy rates plummeted during the pandemic as workers switched to remote setups, many of whom have not returned to in-person roles. In response, many companies are downsizing their office space and building owners are struggling to fill vacancies. That makes it difficult for some building owners to repay their loans or refinance in a higher rate environment, elevating the risk of loan defaults.[15]

Approximately $1.5 trillion in commercial mortgage debt will be due by the end of 2025. Yet, according to the CME FedWatch Tool, market participants currently expect the central bank to start cutting interest rates sometime in 2024.[16]

5 'Risk-Free' Returns

Equity markets tend to suffer when fixed income yields begin to rise sharply, because investors may see the so-called "risk-free" returns available from Treasuries as more attractive than dividend-earning value stocks, while higher borrowing costs also weigh on corporate earnings.

As of[17] August 31, 10-year U.S. Treasuries had a yield of 4.09%, compared with 3.13% a year ago.[18] The S&P Municipal Bond Index had a yield of 4.18%, compared with 3.72% a year ago. The S&P U.S.[19] Mortgage Backed Securities Index had a yield of 5.04%, compared with 3.81% a year ago. And the S&P 500 Investment Grade[20] Corporate Bond Index had a yield-to-maturity of 5.61%, compared with 4.62% a year ago.

It's also worth recalling that abnormally low interest rates prevailed for much of the time period between the aftermath of the 2008 Global Financial Crisis and the Fed's rate hike cycle that began last year. As a result, current rate conditions are considered "normal" by historical standards, and therefore unlikely to revert to near-zero levels in the foreseeable future without some unanticipated shock.

Even so, rates do appear to be nearing their peak for this cycle and may fall somewhat over the next two years. That is one reason why growth stocks have performed well in recent months. Certain technology sector growth stocks, particularly for companies active in artificial intelligence, are exhibiting exceptionally high returns. Over time, investors are likely to differentiate between AI growth companies that make useful breakthroughs and those whose stocks have risen on hype.

The prospect of falling rates also suggests that now could be a good time for investors to extend duration and start locking in yield for the longer term. It may be possible to receive coupon payments while holding Treasuries, and then achieve arbitrage a few years later by selling the higher-yielding assets at better prices in a lower-yielding environment – without holding them for the life of the maturity.

From a relative value perspective, credit spreads over the "risk-free" rate of Treasuries may enable some portfolios to capture alpha through mortgage backed securities.[21] The MBS asset class is inexpensive compared with its 10-year median yield of 2.8%. This largely is due to an overall housing market shortage in the U.S., the impact of inflation on home prices, and many would-be sellers who bought their current homes in a low-rate[22] environment refraining from buying new homes at prevailing mortgage rates.

Regarding distressed assets, middle market commercial real estate companies may even present opportunities within the next couple years for investors accessing private credit, which can include the sector along with others in a diversified strategy.

SCM – Advisors for Every Market Environment

The myriad of factors at play in relation to U.S. government debt demonstrates why investors can benefit from maintaining a proactive stance regarding their portfolios that aims to minimize the negative consequences of market swings and capture the upside, while aligning with their long-term objectives and risk tolerance.

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[6] Biden targets crypto, real estate and oil industries, as he unveils his budget

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[8] Fiscal policy and excess inflation during Covid-19: a cross-country view

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[10] Personal Consumption Expenditures Price Index, Excluding Food and Energy

[11] Effective Federal Funds Rate

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[14] KBW Nasdaq Regional Banking Index

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[22] Why Are Mortgage Rates So High, and How Long Will They Stay Up?