CONGRESS ASSET
MANAGEMENT COMPANY, LLP

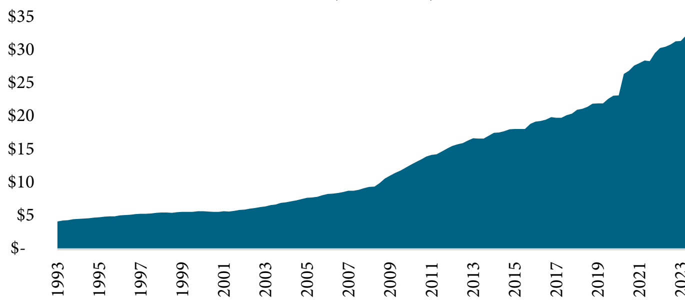
September 2023

The Great Experiment

Do deficits matter? They do for the average person or entity. Over the next few years, we'll find out how they impact the U.S. economy.

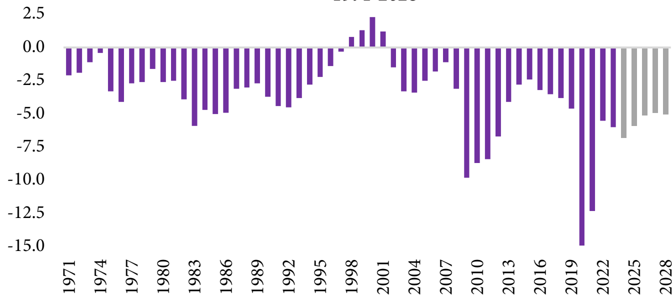
Yogi Berra once said, "You can observe a lot by just watching." The gradual increase in our federal deficit, driven by years of deficit spending, became an avalanche during the pandemic. The pandemic required extraordinary fiscal measures to ensure economic sustainability, but the government's debt appetite remains insatiable, and there is now a colossal debt burden to be paid by future generations. The Congressional Budget Office forecasts annual deficits far into the future, exacerbating a vicious cycle of debt accumulation and ever larger interest payments.

US Federal Debt
1993-2023 (in Trillions)



Source: US Department of the Treasury

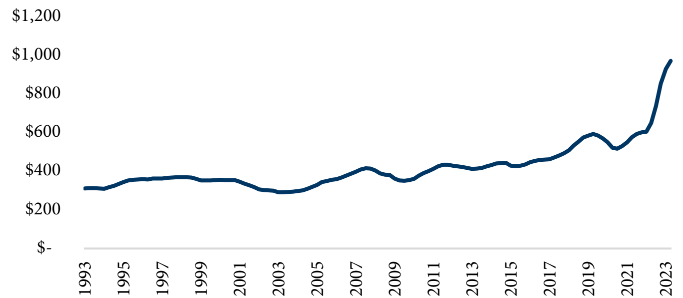
US Federal Budget Balance % of GDP ***(with CBO Forecasts)***
1971-2028



Source: US Congressional Budget Office

Rating firm Fitch recently downgraded the U.S. Treasury to AA+ based partially on these firmly established trends. By Fitch's reckoning, interest alone will eat 10% of government revenues during 2025. The Fitch report also calls out the "erosion of governance" regarding fiscal and debt matters over the past 20 years. Until something changes, we will be living in a world of higher interest rates caused by unusually high levels of government debt, not inflation.

Interest on US Federal Debt
1993-2023 (in Billions)

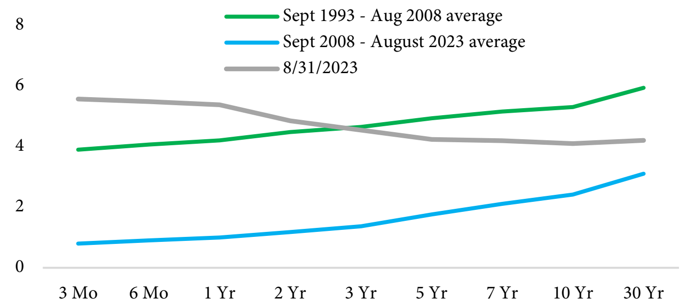


Source: US Department of the Treasury

Today's conventional wisdom suggests interest rates will follow the anticipated path of inflation - down. However, deficits of the magnitude anticipated cause structurally higher interest rates, raising borrowing costs for all entities and impacting stock valuations. Over the past 15 years, with few exceptions, investors could largely ignore interest rates. That ended in 2022 with the Federal Reserve's (Fed) policy shift to fight inflation by increasing their policy rate 11 times beginning in March 2022.

Regardless of inflation's path, interest rates are likely to stay elevated, more akin to the rates that existed prior to the Great Financial Crisis (GFC) of 2008, rather than the 2010s. The return to a more "normal" yield curve, upward sloping with longer rates higher than what we've become accustomed to, has implications for stock and bond investors alike. High debt and continued deficit spending have two immediate impacts: the crowding out of private investment due to higher Treasury rates, hindering economic growth, and redirecting valuable fiscal resources toward interest payments because of the higher cost of capital.

Treasury Yields



Source: Bloomberg

Investor recognition of this structural shift in government financing and interest rates is happening. The implications for stock and bond investors are similar in that company balance sheet and funding abilities are taking on greater importance than during the sustained low interest rate period after the GFC. Profitable companies with strong balance sheets and cash flows should be able to better weather a higher interest rate environment. They will have better funding dynamics and return on capital. Companies that are unprofitable and/or with excess leverage are likely to struggle.

Over the next few years, as corporate bonds mature, companies will face higher funding costs. The maturity wall epitomizes the potential challenges faced by issuers and investors alike. While debt maturities are expected to remain relatively benign through 2024, this amount jumps to over $1 trillion per year starting in 2025. The current median coupon for investment-grade and high-yield debt is ~40% below current market financing rates. As low interest rate obligations are replaced by higher ones, interest expense will increase, sapping corporate resources. Over-levered companies or those with cash constraints will face heightened risk.

A similar dynamic faces stock investors. Higher bond yields will provide more competition for stocks, requiring a higher level of return. Established companies with strong balance sheets and consistent cash flow prospects should continue to draw interest. Transformational technologies such as artificial intelligence will compete for scarce investor resources as will companies that can improve operational efficiencies. Additionally, companies with effective research and development programs that can provide innovative solutions to societal issues, like the current development of glucagon-like peptides (GLP's) for diabetes and obesity, offer attractive potential.

The overwhelming focus for many today is the Federal Reserve and inflation. We have, however, entered an era where fiscal policy and government management of public resources should take priority. At what point our current deficit spending habits really bite the economy with negative repercussions for all Americans is uncertain. What is certain is that without a realistic approach to matching tax revenue with spending initiatives, interest rates will stay higher than optimal for all.

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