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Ballooning Borrowing—the U.S. Deficit Challenge

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Paul Christopher, CFA
Head of Global Investment Strategy

Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy

Charlotte Woodhams
Investment Strategy Analyst

[1] As of September 30, 2019.

Brian Rehling, CFA
Co-Head of Global Fixed Income Strategy

The federal debt ceiling is suspended through **August 1, 2021**.

The Congressional Budget Office (CBO) estimates that the federal deficit was **$133 billion** in the month of October 2019—about $33 billion more than in October 2018.

Sources: Congressional Budget Office, U.S. Congress, November 12, 2019.

Key takeaways

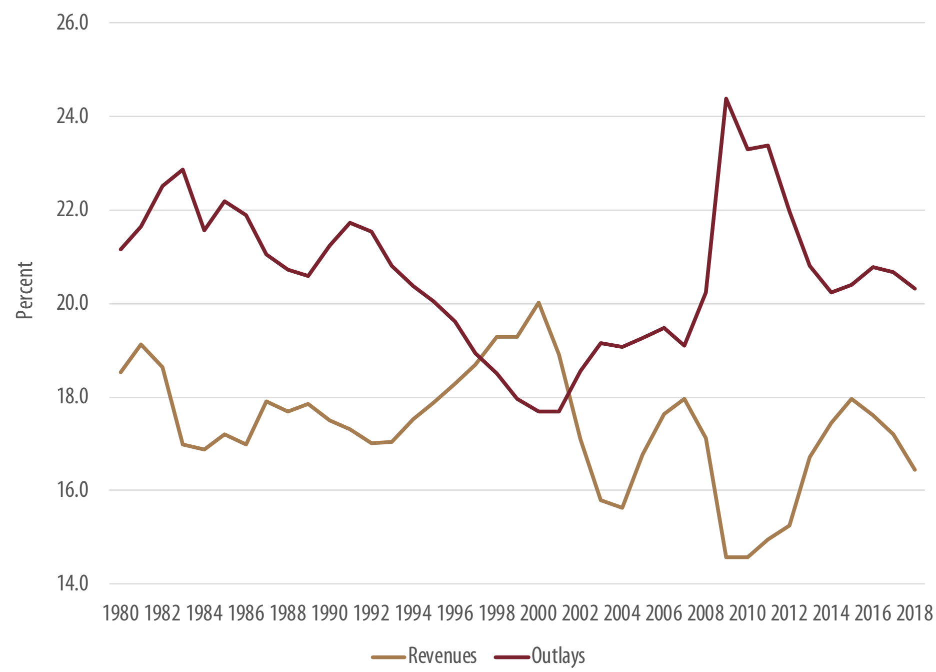
- Decreased fiscal flexibility—An increasing federal debt level could restrict policymakers' ability to respond to unexpected events.
- Crowding-out effect—Large federal debt issuance could lead to a greater portion of private investment spending being diverted to Treasury debt.
- Higher borrowing costs—In the longer term, an increased Treasury debt supply could lead to lower bond prices and higher interest rates.

Deficits are rising dramatically—what does it mean for investors?

Deficits rising

The federal government ended its 2019 fiscal year on September 30. The deficit for the year totaled $984 billion—an increase of $205 billion over the previous year's level. Perhaps more importantly, the deficit was 4.6% of U.S. gross domestic product (GDP), and it is growing at a faster pace than domestic economic growth, a concerning trend. Tax and related receipts in fiscal year 2019 increased by $133 billion, but this increase was not enough to offset the $339 billion rise in federal spending. Hopes that the 2018 tax cuts would boost the economy and be self-financing have not been fulfilled. We expect U.S. economic growth to continue slowing next year, and the federal deficit also is likely to rise in 2020.

Chart 1. Federal government revenues and outlays as a percent of GDP



Source: Congressional Budget Office, November 12, 2019.

Spending details

No single federal spending category is to blame for the rising deficit—as spending increased in all major spending segments. The largest portion of federal budget expenditures comes from mandatory spending requirements—with the majority referred to as entitlement programs.

- Spending for Social Security increased by $56 billion (6% growth) in the 2019 fiscal year, while Medicare and Medicaid spending rose by $39 billion (6% growth) and $20 billion (5% growth), respectively.

The majority of the Social Security increase was driven by higher retirement costs, a trend that is only likely to accelerate.

- The cost to service the expanding national debt rose to $52 billion in the 2019 fiscal year, a 14% increase over the prior year's level. Most of this jump was driven by higher interest rates. Still, it is worth noting that—despite the debt quadrupling over the past two decades—the U.S. spends less to service its federal debt (as a percentage of GDP) than it did in the late 1990s.
- Defense spending rose by $48 billion in fiscal-year 2019, an 8% increase. Military spending was 3.1% of GDP in the fiscal year ended on September 30, an amount that has held fairly steady over the past several years.
- All "other" federal spending outlays increased by $79 billion last year, a 7% increase over the 2018 fiscal year. The biggest increases came from the Department of Education, Department of Veterans Affairs, and Department of Agriculture.

It is unlikely that this concerning deficit trend will change in future years as fiscal hawks in Washington have seemingly lost their platform. Both parties are now willing to spend for priorities they deem to be important, whether it be reduced revenues from tax cuts or increases in military and domestic program spending. The upcoming 2020 election is unlikely to change these priorities, in our view.

Fortunately, we do not see this deficit trend impacting investor confidence in U.S. Treasury securities over the near-, or even intermediate-term, time frame. Public debt to GDP currently stands at just under 79%. We see this as a manageable number that compares favorably to government debt ratios in many other developed countries. It is likely that the United States can support a meaningfully higher debt level than today's level, given the country's dominant global economic position and the dollar's stance as the world's primary reserve currency. With that being said, projected increases in deficits and the federal debt remain troubling. It is impossible to predict exactly how much federal debt the country could bear before investors would 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 significant national debt are likely to be real and far-reaching for citizens and investors.

Paul Christopher, CFA
Head of Global Investment Strategy

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Investment Strategy Analyst

U.S. exports to Mexico as a percent of total U.S. exports in 2018:

15.9% (equal to $256 billion)

Source: Ned Davis Research, June 4, 2019.

Number of legislative days in Congress left in 2019: 13

Source: Congress.gov, as of November 20, 2019.

With full implementation of the U.S.-Mexico-Canada Agreement, dollar amount that U.S. global agricultural exports would increase:

$2.2 billion (estimated)

Source: According to analysis by the U.S. International Trade Commission; Office of the United States Trade Representation, October 2018.

An update on the USMCA

While trade and tariff negotiations between the U.S. and China continue to top media and investment headlines, the USMCA also could have a significant impact on the U.S. economy and Main Street. Yet, the revised agreement has not been ratified by Congress almost a year after it was signed by all three countries on November 30, 2018.

Where does USMCA stand right now?

Mexico already has ratified the agreement. In the U.S., the House of Representatives may be nearing approval. House Democrats and Trade Representative Robert Lighthizer have been negotiating on labor enforcement mechanisms and environmental modifications to the agreement. The Senate likely will approve the new agreement without as much delay once the deal has successfully passed the House. The main roadblock to USMCA passage is that there are only 13 days left in the 2019 legislative calendar.[2] If Congress postpones ratification of the deal into 2020, there is a risk that the ongoing impeachment proceedings could prolong the USMCA ratification process further into next year. Once Congress has ratified the new deal, we expect the Canadian Parliament to pass the agreement without notable delay. At that point, the USMCA would then take effect.

What does the USMCA mean for U.S. growth?

A number of recent studies have forecasted potential changes to the U.S. economy between the old NAFTA (North American Free Trade Agreement) and the new USMCA.[3] Overall, these academic studies have found small, additive impacts on U.S. economic growth (between 0.0% and 0.4% of GDP in the studies cited in the footnotes).[4] We believe that the most reasonable economic forecasts come from models that account for both the change in tariffs and costs of production. These estimates account for higher Mexican wages and U.S. content in manufactured goods that are required by the new deal. One such recent study, by the International Monetary Fund, projects no net benefit to the U.S. economy, as the U.S. trade deficit and manufacturing job losses would offset the gains to sectors such as dairy under the new USMCA deal.[5]

[2] As of November 20, 2019.
[3] "U.S.-Mexico-Canada Trade Agreement: Likely Impact on the U.S. Economy and on Specific Industry Sectors," Serge Shikher and Mihir Torsekar et al., United States International Trade Commission, April 2019.
[4] Ibid.
[5] Mary E. Burfisher, Frederic Lambert, and Troy Matheson, "NAFTA to USMCA: What is Gained?" the International Monetary Fund, March, 2019.

Key takeaways

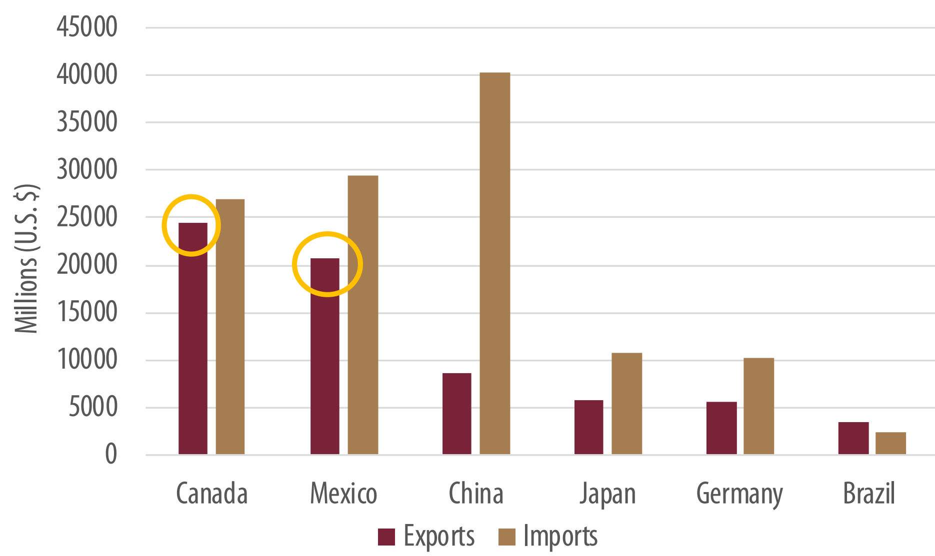
- North American manufacturing firms are eagerly awaiting ratification of the USMCA by the U.S. and Canada. Congress has delayed ratification, in order to verify aspects of the deal's enforcement mechanisms.
- The U.S. is likely to ratify the deal in 2020, and Canada probably will follow with ratification shortly afterward.
- The new deal should benefit consumers by further increasing North American trade, especially in agricultural products.
- However, the agreement also would raise Mexican wages substantially and require additional U.S. content in North American manufactured goods. These changes could increase production costs of automobiles, apparel, and textile goods, and they might drive some production in these sectors out of North America.

Market impact

Since NAFTA was introduced in 1994, North American trade and cross-border investment rose from $290 billion in 1993 to more than $1.1 trillion by 2017.[6] We believe that the USMCA is an important modernization to NAFTA—and that the new plan will continue to build stronger economic linkages between the three participating countries. Financial markets have not responded to the delay in ratification, suggesting to us that there is no particularly strong market upside from the deal's passage. The main financial-market impact, a negative, might occur if the U.S. and Canadian legislative bodies do not join the Mexican Congress in ratifying the deal.

Overall, the deal should benefit consumers by increasing trade flows in most sectors between participating countries, and supporting U.S. farmers. Yet, it is not likely to increase broad U.S. economic output. Following the deal's new requirements, more content of manufactured goods will originate from the U.S.—and Mexican manufacturing wages will rise. Therefore, autos, textiles, and apparel made or assembled in Mexico would become more expensive for U.S. consumers. In our view, these changes could drive further U.S. manufacturing and related jobs overseas.

Chart 2. Importance of Canadian and Mexican markets as a destination for U.S. exports



Sources: U.S. Census Bureau, Bloomberg, as of November 11, 2019. Monthly data is through September 30, 2019.

[6] Ibid.

Charlotte Woodhams
Investment Strategy Analyst

Mayor Pete Buttigieg

Polling average in October 2019:

8.3%

Source: RealClear Politics, 2020 Democratic Presidential Nomination Polling Data averages, conducted October 30 – November 17, 2019.

Mentions on CNN, Fox News, and MSNBC so far this year:

12,033

Source: Data from the Internet Archive's Television News Archive processed by the GDELT Project, as of November 17, 2019.

2019 fundraising total:

$51.5 million

Source: Federal Elections Commission, as of September 30, 2019.

Number of languages spoken by Mayor Buttigieg: 8

Source: Axios, September 19, 2019.

This is the fourth in a series of spotlights on the five highest-polling candidates for the Democratic presidential nomination.

Democratic presidential candidate spotlight—Pete Buttigieg

The youngest of all 18 candidates currently running for the Democratic presidential nomination, Mayor Pete Buttigieg has gained prominence since he entered the field in April 2019.[7] If he were to be elected, Mayor Buttigieg would be 39 years old when he enters the White House. Mayor Buttigieg is a former intelligence officer in the Navy Reserve—and was a consultant before entering politics and serving as the twice-elected mayor of South Bend, Indiana starting in 2012.[8] Mayor Buttigieg has shaped his presidential campaign around the need for generational change in American politics. His policy platforms across issues are more moderate than some of those produced by progressive candidates Senator Bernie Sanders and Senator Elizabeth Warren. As a measure of his campaigning success, Mayor Buttigieg has tallied large fundraising totals in the first half of 2019—and he raised the fourth highest amount in the third quarter (behind billionaire Tom Steyer and Senators Sanders and Warren, respectively).[9]

Health care

Although Mayor Buttigieg advocates for a single-payer health care system, he has clarified that he would not introduce a single-payer framework, such as Medicare for All, immediately. Mayor Buttigieg describes his Medicare for All Who Want It plan as an alternate policy mechanism to reaching national universal health care coverage by extending affordable insurance to those currently uninsured in a subsidized marketplace that includes both private insurance and a public option. His policy plan includes capping premiums at 8.5% of income and out-of-pocket costs for senior citizens, while expanding premium subsidies for low-income individuals and limiting out-of-network care costs.[10] Mayor Buttigieg estimates that his health care plan would cost approximately $1.5 trillion over 10 years and would be paid for by reversing President Trump's corporate tax cuts (providing $1.4 trillion in revenue)—with the remaining cost savings sourced from new legislation allowing the federal government to negotiate lower drug prices with the pharmaceutical industry.[11] Mayor Buttigieg also has published a plan to improve mental health and addiction treatment and care that includes $100 billion in community grants to improve prevention efforts, treatment access, and care integration.[12]

[7] According to RealClear Politics, 2020 Democratic Presidential Nomination Polling Data.
[8] Reid J. Epstein, "2020 Candidates: Pete Buttigieg," The New York Times, updated November 22, 2019.
[9] Beatrice Jin and Maggie Severns, "Fundraising and Campaign Finance Tracker," Politico, data is current as of October 15, 2019.
[10] PeteForAmerica.com, "Medicare for All Who Want It White Paper," as of November 8, 2019.
[11] Ibid.
[12] PeteForAmerica.com, "Healing and Belonging in America," as of November 8, 2019.

Key takeaways

- In our view, Mayor Buttigieg's Medicare for All Who Want It plan would disrupt the health care industry, but it would not do so as drastically as a single-payer system, such as Medicare for All (which would effectively eliminate private health insurance).
- Mayor Buttigieg has said that he would roll back the recent federal tax cuts and reform the capital gains tax to fund key policy initiatives. These measures likely would increase taxes for investors and high-earning individuals.
- Like most other Democratic presidential candidates, Mayor Buttigieg's climate-change plan includes the goal of reaching net-zero emissions. His platform includes significant investment and research and development in green technology—which would, in our view, benefit sectors such as renewable energy.

Taxes

Although Mayor Buttigieg has said that he supports the implementation of a higher marginal income tax and the expansion of the estate tax, he has not published a comprehensive tax plan. In his Economic Agenda for American Families plan, Mayor Buttigieg outlined an enlargement of the Earned Income Tax Credit that could provide increased income for 35 million families (of $1,000, on average), according to his estimates.[13] Mayor Buttigieg's campaign said that he would pay for the affordable housing, child care, and education initiatives in his Economic Agenda by reforming the capital gains tax for the top 1% of individuals.[14] This plan contrasts with Senators Warren and Sanders' proposals to implement a wealth tax on high-earning individuals. Mayor Buttigieg also has expressed interest in the introduction of a financial transaction tax.[15]

Climate change

Like most other Democratic presidential candidates, Mayor Buttigieg supports the implementation of the Green New Deal in order to reach net-zero emissions by 2050. Mayor Buttigieg's climate change proposal has three components, which are titled: Build a Clean Economy, Invest in Resilience, and Demonstrate Leadership.[16] Similar to policy plans put forward by other Democratic candidates, Mayor Buttigieg's proposal sets a comprehensive framework for emissions target goals and large scale federal actions to achieve them. This includes doubling clean energy production domestically by 2025 and net-zero emissions for all new passenger vehicles by 2035.[17] The released policy plan includes the funding of $200 billion in federal clean energy research and development over the next 10 years to incentivize clean energy technology and deployment; the establishment of an American Clean Energy Bank to provide clean energy loans and grants; and initiating a carbon tax. Internationally, Mayor Buttigieg's plan includes seeding a $250 billion Global Investment Initiative fund to provide developing nations with green technologies made in the U.S. Mayor Buttigieg also has stated his plan to eliminate subsidies for polluters, to issue U.S. climate action bonds to help pay for his green initiatives, and to legislate new federal tax incentives, affordable electricity access plans, and energy standards.

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[13] PeteForAmerica.com, "An Economic Agenda for American Families," as of November 8, 2019.
[14] Forbes, "Pete Buttigieg Releases $1.6 Trillion Plan for Affordable Housing, Colleges, and Child Care," November 8, 2019.
[15] CNBC Interview with John Harwood, April 12, 2019.
[16] PeteForAmerica.com, "Climate Plan White Paper," as of November 8, 2019.
[17] Ibid.

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