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MARKET STRATEGY VIEWPOINT

CBO - Tax Benefits and Debt Red Flags

April 27, 2018

The Congressional Budget Office's latest Outlook points to a lift in GDP expectations over 10 years, but again warns of debt risks on the horizon.

CBO Forecast: Good and Bad

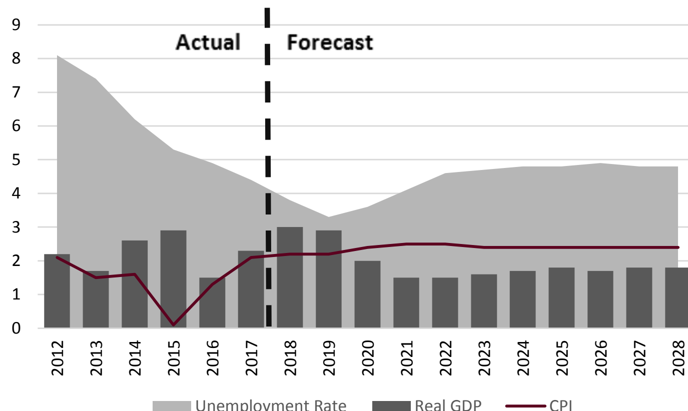
In its latest Budget and Economic Outlook, the Congressional Budget Office (CBO) forecasted key metrics regarding the federal budget and the economy over the next ten years; some good, some bad. The CBO's outlook included a positive U.S. GDP impact from the Tax Cuts and Jobs Act, below 2% potential real GDP in the out years, and a debt/deficit albatross that may crowd out private investment, given its estimated trajectory. In this annual edition, the CBO forecasted U.S. real GDP of 3.0% for 2018 (calendar year), but indicated the gravity of slower potential U.S. growth overall would pull GDP down to 2.9% and 2.0% in 2019 and 2020, respectively. The CBO expects the new tax plan to be an annual 0.7% real GDP benefit in the years 2018-2022; and the plan may offer ongoing growth benefits during the 2023-2027 timeframe.

While the forecasted GDP numbers provide some good news economically, the CBO again warns about the negative ramifications of the growing federal debt pile. Since the financial crisis, the CBO has been consistent in calling out the risks of higher federal debt. And indeed, the new tax plan and 2018 budget is expected to further degrade the U.S. government's balance sheet. The CBO projects federal debt held by the public to increase 95% from $14.7 trillion in 2017 to $28.7 trillion in 2028.

The CBO's inflation and interest rate forecasts are relatively muted when compared to the apparent worry present in today's market.

Meanwhile, the CBO forecast shows a relatively muted expectation for inflation and market interest rates, which may come as a surprise to some given recent talk and market activity. The current CBO forecast is calling

Figure 1: CBO Key Economic Forecasts
Source: Congressional Budget Office



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for the Fed funds rate to peak at 4.0% in 2021 before falling again as the Federal Reserve reacts to a potentially slowing economy. According to the CBO, the 10-year Treasury yield year-end peak is expected to reach 4.2%, also in 2021.

The CBO, and other forecasters, project the average annual GDP benefit as a result of the new tax plan.

Table 1: 2017 Tax Plan - Average Annual Effects on U.S. Real GDP
Source: Congressional Budget Office, Moody's, International Monetary Fund

	2018-2022	2023-2027	2018-2027
Moody's Analytics	0.3%	0.3%	0.3%
International Monetary Fund	0.9%	0.3%	0.6%
Congressional Budget Office	0.7%	0.8%	0.7%

Tax Plan Ignites GDP; But Fails to Restore Growth Pace of Old

Crowding Out - An economic theory stating that personal consumption of goods and services and business investment are reduced because of increases in government financing, thus draining available financial resources and raises market interest rates.

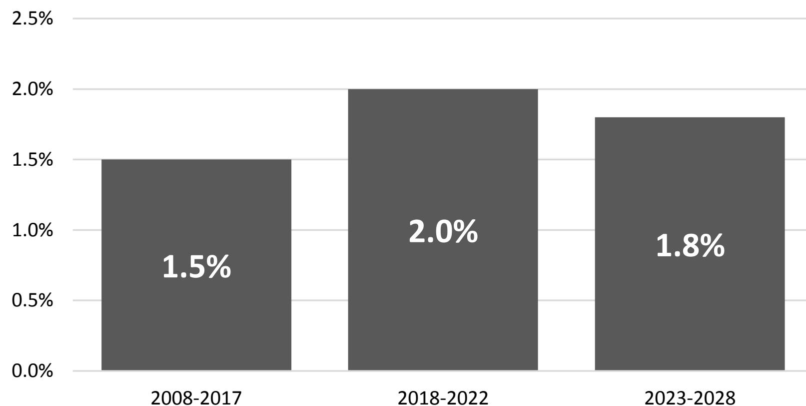
While the CBO is clear in highlighting benefits of the new tax plan, the agency also cautions on the negative growth ramifications of growing U.S. debt levels. For this warning the CBO turns to Economics 101 and the crowding out theory:

"The agency estimates that greater federal borrowing ultimately reduces private investment below what it would have been without additional borrowing." - CBO: Budget and Economic Outlook, April 2018

"In the longer term, the net decline in national saving (resulting from higher federal borrowing) *would tend to reduce the stock of capital – and thus GDP – below what it would have been without the increased federal borrowing."* - CBO: Budget and Economic Outlook, April 2018

Figure 2 indicates that the CBO does not believe the U.S. can sustain a 3% GDP growth rate, given current and forecasted fiscal and economic conditions.

Figure 2: CBO: Average Annual Potential Real U.S. GDP
Source: Congressional Budget Office

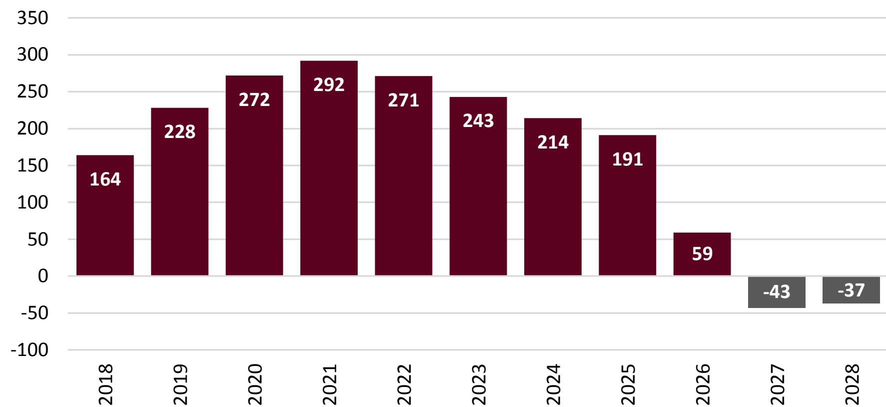


It seems the CBO's forecast for rising debt levels and their anticipated negatives for the economy are notable in holding down the agency's projection for GDP in the out years. While the next five years may more distinctly feel the tax plan boost, the CBO's annual potential GDP growth estimates again fall below 2% in 2023-2028. The agency also cites the shrinking working age population as material to its relatively dreary average annual estimates. Evidently the CBO is telling us consistent 3% growth rates are a thing of the past.

Figure 3: 2017 Tax Plan - Effects on Annual Federal Deficit ($ billions)
Source: Congressional Budget Office

The 2017 tax plan is expected to contribute, on average, approximately $215 billion to the annual federal deficit over the next nine years.

Sunset of the tax cuts in 2026 is expected to cause a deficit reduction in 2027 and 2028.



CBO Consistent With A Debt-Risk Message

Since the post-crisis rise in debt and deficits, the CBO has been steady with its warning over such developments. Unfortunately, few politicians have heeded the counsel. Meanwhile, the CBO is now projecting that federal debt held by the public could rise from an estimated 78% of GDP in 2018 to 96% of GDP in 2028. According to the CBO: *"Such high and rising debt would have serious negative consequences for the budget and the nation."* And the agency cites several reasons for this statement:

- *"Federal spending on interest payments on that debt would increase substantially, especially because interest rates are projected to rise over the next few years."*

- *"Because federal borrowing reduces total saving in the economy over time, the nation's capital stock would ultimately be smaller, and productivity and total wages would be lower."*

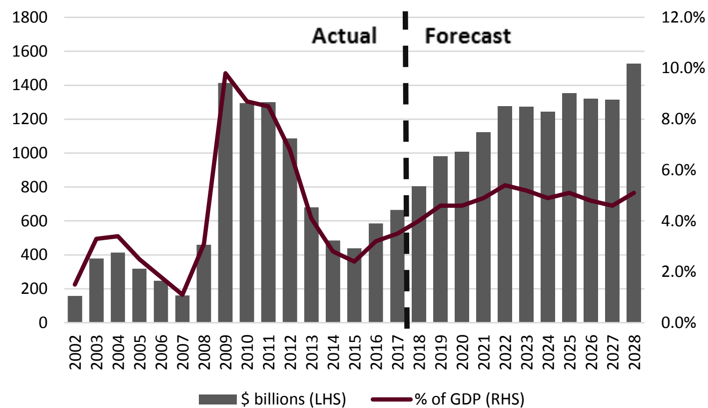
- *"Lawmakers would have less flexibility to use tax and spending policies to respond to unexpected challenges..."*

- *"The likelihood of a fiscal crisis in the United States would increase. There would be greater risk that investors would become unwilling to finance the government's borrowing unless they were compensated with very high interest rates; if that happened, interest rates on federal debt would rise suddenly and sharply."*

From our point of view, failure to correct the debt trajectory could indeed have adverse effects on our outlook for economic and market conditions and the U.S.' ability to recover from the next downturn. Moreover, we believe the lack of fiscal discipline can effect the investment and spending tendencies of businesses and consumers as both brace for the likelihood of future tax consequences and/or the next crisis. Absent the current debt trajectory, we believe lawmakers would be getting the investment they claim to want rather than corporations hoarding cash, or returning that cash back to shareholders in some form. In our view, the U.S. government can correct a manageable debt problem today with modest amounts of pain. Stalling will only magnify the problem and make the clean-up materially more uncomfortable.

Figure 4: U.S. Government Budget Deficit - Dollars and % of GDP

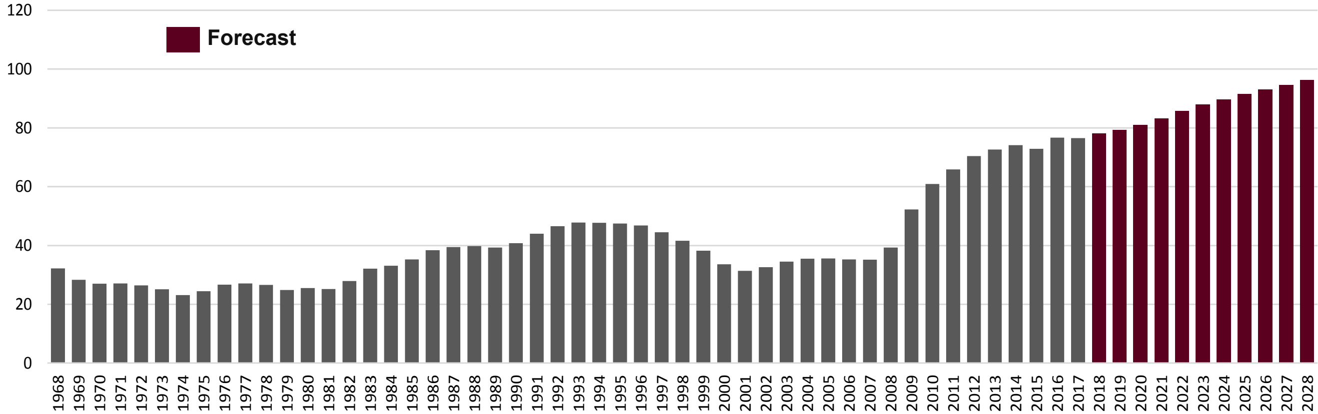
Source: Congressional Budget Office



Implications for Investors

In all, we believe the CBO's forecasts for GDP, debt, and deficits can provide valuable insight for investors as they assess their strategic allocations and appetite for risk. In our view, the latest CBO outlook may make the average investor more cautious with their allocation approach, all else equal. A lower-growth, higher debt U.S. economic environment - and one with less fiscal flexibility - may help set an allocation tone for investors that is less risky than it may have been a decade or two ago.

Figure 5: U.S. Government Debt Held by the Public - % of GDP
Source: Congressional Budget Office



Questions?

Please contact us should you need further detail on this analysis and/or our general market view. We will be glad to have a discussion as to how these and other circumstances may effect your asset allocation or portfolio strategy.

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