THE THREAT OF FISCAL DOMINANCE IN THE US AND IMPLICATIONS FOR INVESTORS

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After a double whammy of negative returns for both equity and bond investors in 2022, many investors anticipating a US recession this year thought 2023 may turn out to be the Year of the Bond. But in stark contrast, the US stock market has rallied strongly, and US bond investors are staring at losses over the year to date. Long-dated yields having surged, with the 10-year yield moving to its highest level since 2007 and the 30-year yield to its highest level since 2011, with bond prices falling in turn. The reason most widely quoted for this is the US economy's surprising resilience in the face of Fed rate hikes of more than 5 percentage points over the past 18 months. But behind the higher-for-longer story, there is another probable cause for sagging US long bonds: a surge of long-dated Treasury issuance needed to plug federal deficits, and the continued deterioration of the US debt trajectory.

Governments issue bonds to raise money, and currently the United States has extensive borrowing needs. This quarter alone, the US Treasury Department said it planned to borrow over $1 trillion – which is $250 billion more than it forecasted a few months ago. US Government Debt to GDP, which has averaged 65.2% since 1940 reached an all-time high of 129% in 2022. Higher yields mean a higher interest rate burden for government, which is already spending more than it earns, with the US budget deficit set to rise to over 6% this year, double what it was for 2022, with little prospect of improvement thereafter. Increased fiscal spending is a big part of the reason why the US economy has remained so robust. But if we are already seeing such large deficits in the US when the unemployment rate is still at historically low levels, what happens to the deficit if the economy starts to markedly slow? With the recent lifting of the debt ceiling until 2025 having paved the path for further aggressive fiscal spending - how sustainable is this debt path and what are the implications of a continued deterioration?

On 1 August 2023 Fitch cut its sovereign credit rating for the US by one notch, to AA+ from AAA, citing the anticipation of a deteriorating fiscal situation over the next three years, the significant and increasing government debt load, and the decline in governance that led to debt limit disputes with eleventh-hour resolutions. Many fear that current US policy is unsustainable and may ultimately result in an economic condition known as 'fiscal dominance'.

Typically, central banks employ monetary policy to manage inflation by raising interest rates as a means of safeguarding the economy against the harmful effects of inflation. However, fiscal dominance occurs when the accumulation of government debt and continuing government deficits produce increases in inflation that 'dominate' central bank intentions to keep inflation low.

Many in the financial world are downplaying Fitch's recent downgrade and the warnings about rising government debt. They argue that since the US dollar is the world's primary reserve currency, the US can simply print more money to cover its expenses. But increased money supply doesn't come without consequences – namely higher inflation. Higher inflation causes nominal GDP to be higher, and the real value of debt to decline – thus making it more affordable for governments to pay off.

With debt levels rising to historic extremes, the budget deficit widening, spending pressures rising but tax revenues at risk if the economy slows, the prospect of fiscal dominance occurring in the US is no longer far-fetched, with the most notable impact being structurally higher inflation over the longer term. Therefore, although inflation is likely to continue to fall over the *cyclical* horizon, higher inflation risks remain on the *secular* horizon. For this reason, we continue to prefer businesses that are able to withstand or even benefit from an inflationary environment. We prefer inflation-linked government bonds over nominal government bonds, where we can earn attractive real yields but are protected against inflation. Prudent portfolio positioning, combined with careful and considered security selection, is key.

Our commitment to investors has always been two-fold: to protect their capital steadfastly, and to grow returns meaningfully ahead of inflation over time. Over more than 40 years we are proud to say that our process has delivered on both. At present, given the many risks on the horizon, it remains judicious to continue to position portfolios conservatively. Above all else, a level-headed and pragmatic approach continues to lead our way.

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