There Is Something We Should All Agree on After This Election Season

The most contentious presidential election of our lifetimes is now behind us, but any notion that there will be a healing process or "coming together" moment soon to help a terribly divided nation rally around its new president seems naïve. What most likely lies ahead is more political division, gamesmanship and gridlock on Capitol Hill, where bipartisanship has become a dirty word in recent years and all politics is viewed as a zero-sum game.

Financial markets may favor gridlock to keep Washington distracted or paralyzed, but the deep ideological divisions and narrow majorities in Congress could allow our nation's most pressing challenges and problems to remain unresolved, and perhaps even unaddressed. In 2023, the first session of the 118th Congress easily was the least productive in over 50 years in terms of bills passed.[1] Public trust in the federal government to "do the right thing most of the time" or "just about always" continues to scrape along near historic lows — in the low 20% range, where it has resided since the Great Recession of 2008.[2] Even getting routine budget-related legislation passed has become a charade of continuing resolutions and threats of government shutdowns. Divided government is nothing new in Washington politics, but the business of governing used to get done nonetheless before creeping dysfunction began to set in, which is a development of the last 15 years. Who can blame Americans for their eroded trust in the Washington political class?

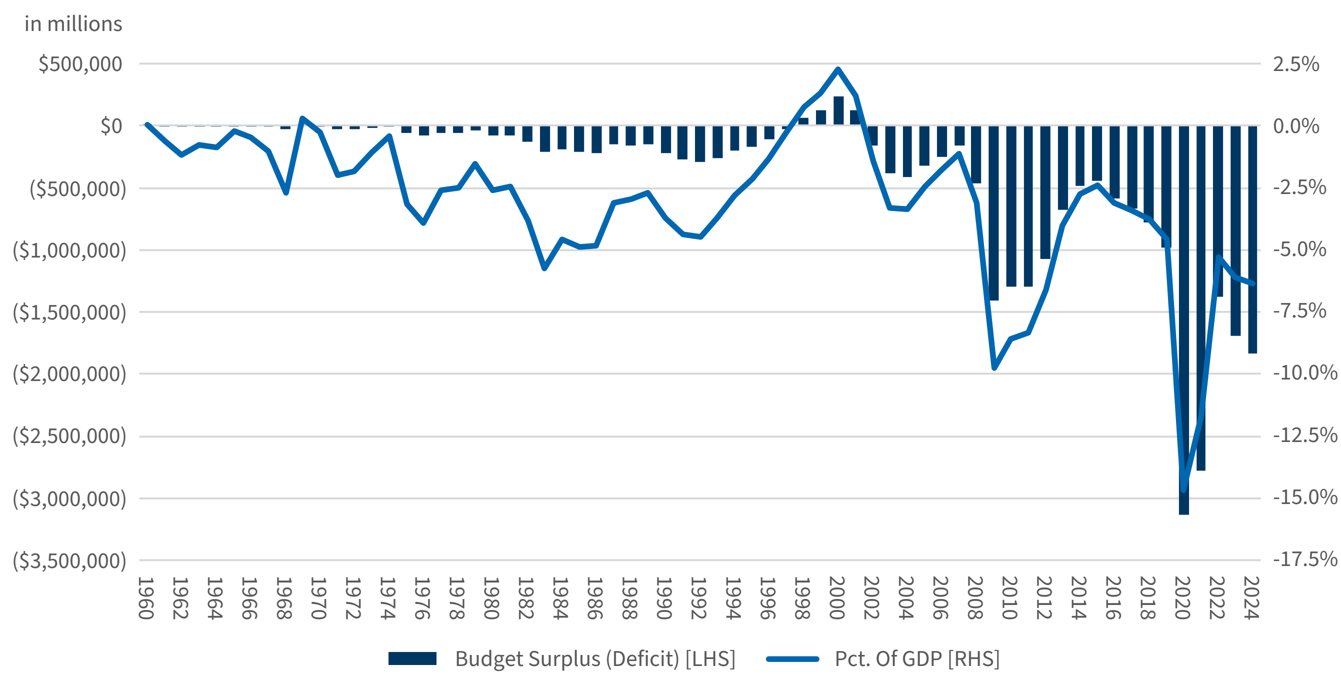
What became unmistakably clear throughout the campaign season is that the candidates were not willing to engage in substantive discussions on some controversial topics that would rankle a sizable portion of the electorate if articulated with specificity, such as the U.S. role in the ongoing Middle East crisis. Similarly, there was virtually no discussion by the candidates or their proxies the entire campaign season about how to address our nation's widening budget deficits and soaring national debt. The topic was virtually ignored. This is willful blindness. Girding the American people for challenging times ahead or asking them to prepare for any shared sacrifice to address this white elephant would be considered an act of political suicide these days, and neither party will go there, not in campaigning nor governing.

One could convincingly argue that there is no political will or incentive in Washington to tackle the budget deficit and national debt issues, only a political cost — and so that discipline will have to be imposed by financial markets at some point when they begin to shun U.S. Treasuries or demand higher returns to buy them. Arguably, that moment is here. Interest rates on 10-year Treasuries have increased by 60 bps since the Fed's rate cut in September, which is counterintuitive. Those who believe this uptick in Treasury rates reflects renewed debate in credit markets over whether we get one or two more rate cuts by the Fed in 2024, or fewer cuts than expected in 2025, are off the mark. Rather, it likely reflects the realization by credit markets that federal budget deficits are poised to widen further, perhaps substantially, and that deficits may be approaching a tipping point where they become untamable, with neither political party willing to publicly acknowledge the prospect of tax hikes and spending cuts, both of which will be needed to get the budget under control. (We'll dismiss Elon Musk's claim that he can take a Twitter-like blowtorch to federal spending and reduce it by $2 trillion, or approximately 33%.)

There was a time not too long ago when liberal economists, most notably Paul Krugman, lectured the "deficit scolds" about overdramatizing the danger of federal deficits and maintained that they weren't problematic relative to the size of our national economy, and also that they overlooked American exceptionalism afforded us by global investors who give the U.S. a free pass on any measures of fiscal prudence that are expected of other major sovereigns. Those "deficits don't matter" columns stopped appearing a couple of years ago, and instead there are ever more cautionary articles from other economists and market watchers warning that, much like global warming, this problem may become insoluble if decisive action isn't taken soon.

Budget deficits and federal debt outstanding exploded during the COVID-19 years, with the latter soaring by more than $6.0 trillion (or 26%) during those two years. But deficits remain shockingly large some three years after the pandemic ended. Let's appreciate just how concerning the U.S. fiscal situation has become in the last few years after COVID-19: The federal budget deficit for the fiscal year just ended on September 30, 2024, widened to $1.83 trillion from $1.67 trillion a year ago and $983 billion in 2019 (**Figure 1**). (If ever a picture said a thousand words, it is **Figure 1**.) Total federal spending exceeded revenue by 28% in 2024, while net interest expense soared by 35% over 2023 and will top $1 trillion in 2025. At 6.4% of GDP, the 2024 federal deficit represents the largest (as a percentage of GDP) of the postwar era during a non-recession year. This was the third

Figure 1 - U.S. Federal Budget Surplus (Deficit)



Source: FRED, the Federal Reserve Bank of St. Louis consecutive non-recession year with a deficit exceeding 5.0% of GDP — the traditional "red line" for outsized deficits — and occurred against the backdrop of a solid growth year for the U.S. economy. Cumulatively, U.S. federal budget deficits since 2000 have exceeded $22 trillion. There is no indication that any of this will come under control in the years ahead. The Congressional Budget Office ("CBO") forecasts annual budget deficits exceeding 5.5% of GDP every year through 2034 in its baseline projections, staying above 6.0% after 2030 and topping 7.0% by 2033.[3] Another $21 trillion is expected to be added to the national debt by 2034. The boiling frog analogy seems appropriate here.

It gets worse, as a new administration is expected to take deficit and national debt projections even higher. The Committee for a Responsible Federal Budget, a nonpartisan watchdog group, recently issued a "U.S. Budget Watch 2024" report which estimated that, under its base-case scenario, a Trump presidency would add $7.5 trillion to the national debt above the CBO's baseline projections by 2035, while a Harris presidency would have added $3.5 trillion.[4] The Peter G. Peterson Foundation, another nonpartisan organization dedicated to bringing attention to the nation's fiscal challenges, has also been sounding the alarm about soaring deficits and national debt. So far, the alarms mostly have fallen on deaf ears in Washington.

Admittedly, it is tough to be a Chicken Little on this issue given years of minimal consequences to the country for its profligate behavior on fiscal issues, but there is a distinct sense that some accountability is at hand. If Washington refuses to take up this issue, credit markets will make us pay a price for that neglect in the form of higher interest rates on Treasury securities, and ultimately corporate borrowing rates. This process may already be underway. Potentially, this has huge spillover effects for a private sector that has also become engorged on debt. Good luck with all that, Mr. President!

Endnotes

1 Andrew Solender, "Capitol Hill Stunner: 2023 Led to Fewest Laws in Decades," Axios (December 18, 2023).

2 "Public Trust in Government: 1958-2024," Pew Research Center (June 24, 2024).

3 "Budget and Economic Data, June 2024," Congressional Budget Office (June 2024).

4 "US Budget Watch 2024," Committee for a Responsible Federal Budget (October 7, 2024).

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