

# Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

April 22, 2021

## Have Interest Rates Topped Out? (and What About the Deficit?)

Please see this week's *Rate Sheet* and *Yield Curve Opportunities*.

The interest rate selloff we have experienced since late last year is significant, but is it possible it may be running out of steam for this year? While there is no guarantee that history will repeat itself, it is hard to ignore the comparable response of the interest rate complex to past sell-offs of similar magnitude.

Since last August the 10yr Treasury has sold off by almost 125 bp. The last three times (2010, 2013 and 2016) that rates moved higher by more than 125 bp the sell-off petered out (Figure 1) and after hitting a maximum level, interest rates began to consolidate/drift lower.

During the 2010 and 2013 episodes, interest rates drifted sharply lower for more than a year. During the 2016 occurrence, rates resumed their upward trend, but not before consolidating/moving lower for about 9 months.

The recent departure from 2021's rising rate trend is suggesting a similar pattern of consolidation may be unfolding. If history repeats itself we may have seen the highest yields (or close) for the rest of 2021. Certainly anything is possible. If the case can be made for interest rates to either rise or fall, the most prudent balance sheet managers must prepare their institution for both possibilities.

### The US Deficit

The 2021 US deficit is estimated at 15.6% of GDP, making it the largest shortfall since WWII. Total debt has outpaced the size of the economy and is expected to hit 108% of GDP in FY 2021. Given the notable improvements in the labor market, the US deficit should be running closer to 4% not 16%. Debt accumulation promotes economic growth, but beyond a certain threshold high levels of debt have a negative effect on long term growth. Every additional dollar of federal debt in the early 1970s boosted GDP on average by more than 4 dollars, but now each additional dollar of debt is increasing GDP by only 70 cents. There is no pre-determined point at which a fiscal crisis is readily discernable, however with each extra dollar of debt the risks become greater.

### Deficit Hits New Highs

In the first six months of the 2021 fiscal year, the deficit surged to a record \$1.7 tn, almost \$1 tn more than the deficit accumulated during the same period last year (Figure 2). Most of that difference arises from spending in response to the coronavirus pandemic, which besides Economic Impact Payments (i.e. \$1400 stimulus checks),

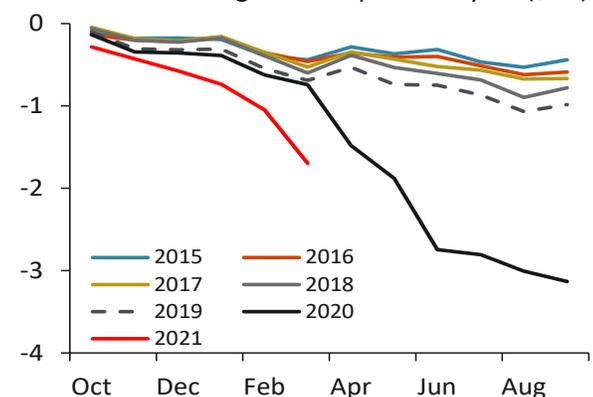
Figure 1: The US is on track to run record deficits for two consecutive years



Source: CBO, Piper Sandler

Figure 2: The US is on track to run record deficits for two consecutive years

Cumulative US budget deficit per fiscal year (\$ tn)



Source: CBO, Piper Sandler

also includes Unemployment Compensation and Small Business Administration Aid. Including the last stimulus bill that was passed (i.e. the American Rescue Plan Act) the Committee for Responsible Federal Budget (CRFB) is projecting the 2021 deficit to total \$3.4 tn, which is higher than last year's record of \$3.1 tn. The US is now on track to run record deficits of over \$3 tn for two years in a row. While it use to take years for the US government to borrow \$1 tn, now it takes only months.

As a percentage of the economy, the 2020 US deficit was 14.8% and it is projected that in fiscal year 2021 the deficit will total 15.6% of GDP, making it the largest shortfall since WWII (Figure 3). By comparison, deficits over the last 70 years have averaged just 2.5% of GDP and even during the Great Recession, the largest deficit recorded (fiscal year 2009) was only 9.8% of GDP.

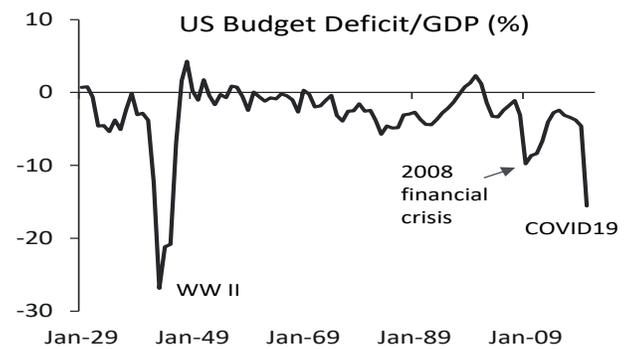
**MMT: The Law of the Land?**

Unfortunately, reducing fiscal deficits hasn't been a priority for either political party, with lawmakers from both parties legislating as if Modern Monetary Theory (MMT) is the law of the land. Indeed, prior to the virus outbreak, the United States fiscal imbalance was widening despite a sustained run of economic growth. Under President Trump, Congress passed a handful of measures that widened the budget gap, including two bipartisan budget deals that bypassed previously enacted spending caps, despite unemployment falling to its lowest level in 50 years. Running a large deficit is reasonable during an economic downturn, but it should not happen in a booming economy.

Topping \$22 trillion, the country's marketable debt is now estimated to have outpaced the size of the economy, coming in at nearly 100% of GDP for FY 2020 and is expected to hit 108% of GDP in FY 2021 (Figure 4). Debt hasn't been this high since 1946 when it hit 106% of GDP as the US government was funding years of military operations on two fronts to help end World War II. With this level of debt, the U.S. has now joined a "select" club of nations with debt levels that exceed the size of their economies, including Japan, Italy and Greece.

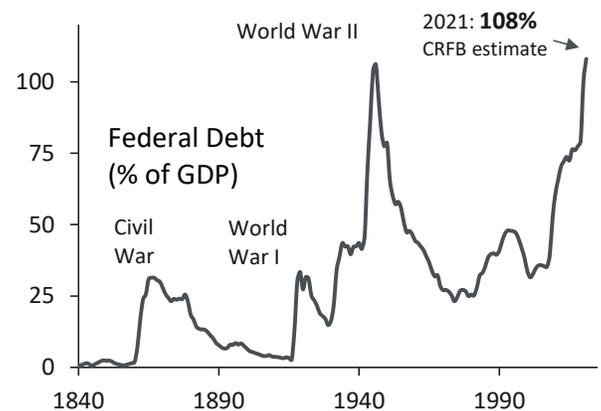
While the pandemic did bring needed borrowing of epic proportions in 2020, many critics charge that spending under the third round of stimulus (i.e. the American Rescue Plan) was unnecessary. Indeed, given the notable improvements in the labor market, the US budget deficit should be running closer to 4% not 16% (Figure 5). Although we should spend

**Figure 3: The budget deficit has posted its largest shortfall since WWII**



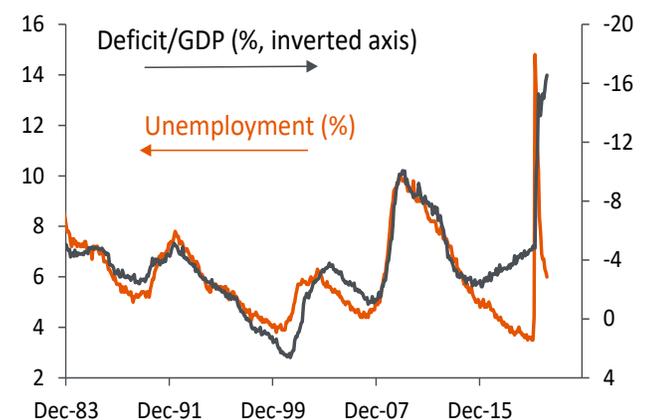
Source: Federal Reserve, Piper Sandler

**Figure 4: The country's total marketable debt is now estimated to have outpaced the size of the economy**



Source: CBO, CRFB, Piper Sandler

**Figure 5: From a historical perspective the US deficit should be closer to 4% not 16%**



Source: BLS, Federal Reserve, Piper Sandler

Although we should spend

money to help those most impacted by the pandemic and support the economic recovery, we cannot pretend there will be no consequences.

### The Cost of Debt Addiction

The law of diminishing marginal returns states that after some optimal level, the addition of larger amounts of a particular factor of production will inexorably lead to diminished per-unit incremental returns. In the US economy, debt can be viewed as a factor that has been consistently over utilized to produce GDP growth. Initially, additional government debt resulted in multiple times more GDP growth, but since that time more debt has progressively resulted in less GDP growth (Figure 6). Between 1966 and 2021 federal debt increased from \$321 bn to \$27 trillion and the level of GDP per unit of debt has been declining, suggesting the US economy has been steadily getting less bang for its buck. While every additional dollar of debt in the early 1970s boosted GDP on average by more than 4 dollars, in 2020-21 each additional dollar of debt increased GDP by only 70 cents.

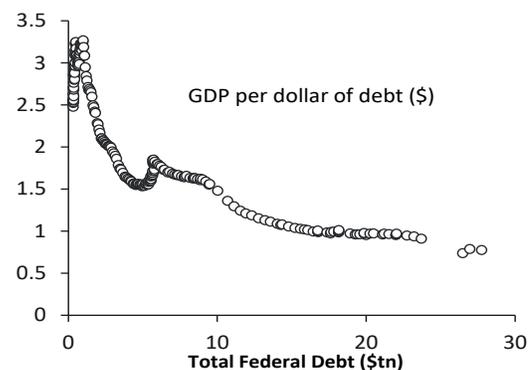
Besides diminishing returns, the larger the debt grows, the more sensitive it will become to small rate increases, crowding out public investment dollars and depressing economic growth. Indeed, elevated levels of public debt will result in larger amounts of debt servicing, leaving less capital available for productive investment, including infrastructure and R&D.

### The Endgame

There is no pre-determined point at which a fiscal crisis is readily discernable or interest payments as a percentage of GDP become unsustainable. However, with each additional dollar of debt the risks become greater. Several studies suggest that beyond a certain threshold high levels of debt start having a negative effect on long term growth. The tipping point has been identified to occur around 90-100% of government debt and the US has just crossed that level. For now the Federal Reserve is keeping interest rates low, thus reducing borrowing costs and easing concerns that growing debt levels could create a fiscal crisis. However, a country with high debt levels may be already in a precarious fiscal position, but it will not be realized until the next crisis exposes the country's fiscal weakness. Ultimately we do not know which way any of this will play out. But a more flexible Balance Sheet is certainly prudent, either way.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at [PSFS@psc.com](mailto:PSFS@psc.com). For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at [FSG-Derivatives@psc.com](mailto:FSG-Derivatives@psc.com).

**Figure 6: More debt has progressively resulted in less GDP growth per dollar spent**



Source: Federal Reserve, Piper Sandler

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## CONTACTS

### Scott Hildenbrand

Managing Director  
 Head of Balance Sheet Analysis and Strategy  
 Head of Piper Sandler Hedging Services  
 212 466-7865

### Jim Armstrong

Managing Director  
 212 466-7978

### Jean Bonatucci

Managing Director  
 212 466-7793

### Matt C. Brunner

Managing Director  
 913 345-3371

### Demitrios Delis, Ph.D.

Managing Director  
 312 267-5158

### Mary Marshall

Managing Director  
 212 466-7890

### Justin Hoogendoorn, CFA

Managing Director  
 312 267-5162

### Jorge Puente

Managing Director  
 212 466-7835

### Ryan Smith

Managing Director  
 212 466-7966

### Leah J. Viault, CFA

Managing Director  
 212 466-7769

### Al Cappelli

Director  
 704 342-7811

### Wei Min Li, CMT

Director  
 312 267-5166

### Peter Stettler

Director  
 312 267-5187

### Kris E. Johnson, CFA

Vice President  
 612 303-0608

### Kelly Hughes

Assistant Vice President  
 212 466-7856

### Kevin Wanke

Assistant Vice President  
 212 466-7988

### Sarah De Vries

Associate  
 612 303-0616

### Hill Fleet

Associate  
 212 466-7825

### Mark Clancy

Analyst  
 312 267-5069

### Matt Earley

Analyst  
 212 466-7816

### Jacob Singer

Analyst  
 646-887-4057

## Meet our Team

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