The Trump administration is headed for a gigantic debt headache

Jeff Cox August 2, 2018

Swelling government debt levels are shaping up to be the biggest economic challenge for President Donald Trump, a problem that could spill into the stock market.

This week's Treasury Department announcement that it would have to increase the amount of bond auctions over the next three months was a low-key reminder that the government IOU is only getting bigger and will start influencing interest rates sooner rather than later.

As more product comes to market, investors could be expected to demand higher yields to snap up all the supply. And those higher yields mean higher costs at a time when taxpayers already have shelled out nearly half a trillion dollars this year in debt service.

Put it all together and it raises questions about how long the spurt in economic growth will continue, what will happen the next time the economy falls into recession and what impact it all will have on financial markets.

"We're applauding strong growth — yet have no choice but to borrow the largest amount of money since the financial crisis a decade ago," **Bernard Baumohl, chief global economist at The Economic Outlook Group,** said in a note. "And that's just the start, the US will [be] running trillion dollar deficits as far as the eye can see."

The price tag keeps growing

The total U.S. debt just passed the $21.3 trillion mark, of which $15.6 trillion is owed by the public. The Treasury announced Wednesday that it will be adding $1 billion each to auctions of 2-, 3- and 5-year debt over the next three months, and $1 billion each for 7- and 10-year note and 30-year bond auctions in August. In addition, the department is issuing a new two-month note to help assure liquidity in the fixed income market.

The changes will add $30 billion to the debt issuance for the quarter. On the overall, the Treasury said it expects to borrow $769 billion in the second half of the year, a projected 63 percent increase from 2017.

Markets reacted to the move, as the 30-year bond yield climbed more than 3 percent for the first time in nearly two months and rates moved higher for most durations.

Over the short term, the debt issue likely will be superseded by other news, particularly the strong burst of growth and the tariff battles the U.S. has launched against its trading partners around the world. Ironically, the Trump administration has promised that breakout economic performance will help take care of the rising debt load brought on by tax cuts and higher spending, but the early results don't seem to bear those hopes out.

Booming economic growth has not been sufficient to lower the budget deficit — in fact, the deficit and Treasury borrowing are headed sharply higher, and virtually no one in Washington seems to care," Greg Valliere, chief global strategist at Horizon Investments, said in his daily note Thursday.

Indeed, the Congressional Budget Office projects the deficit to be just a shade under $1 trillion in 2019 and then pass that level in 2020 and eclipse $1.5 trillion by 2028. The cost to finance all that debt has continued to grow, hitting $458 billion in fiscal 2017 and already at $415 billion in 2018 with three months left in the fiscal year.

Revenue receipts, meanwhile, are lagging.

Tax and withholding payments from individuals and corporations have come in at $1.752 trillion in calendar 2018, about $17 billion below the

same point in 2017, a difference of about 1 percent, according to DataTrek Research. That's also below the 0.2 percent gain in revenue the government had projected.

The market impact

The debt increase and push on interest rates is coming as companies report near-record growth, with profits for S&P 500 companies tracking 24 percent higher year over year for the second quarter of 2018.

Corporations also happen to have more than $9 trillion in outstanding debt. At some point, investors may wonder when higher financing costs will start cutting into profitability.

"Pulling this discussion back to US equity prices, we have one question from all this: are markets ready for higher US Treasury rates if they are caused by incremental issuance and (perhaps) overly optimistic revenue estimates?" Nick Colas, DataTrek's co-founder, said in a note. "Long-term rates are important mechanisms that allow the economy to self-correct in a recession. And whenever that comes, deficits will be larger than during any other non-recessionary period in history."

All of these factors will have to be weighed by the Federal Reserve, which has been raising interest rates and is expected to take its benchmark target rate a half point higher before the end of the year. The central bank voted Wednesday to hold the line on rates, but an increase is expected in September and again in December.

Central bank officials have privately discussed the debt issue, and Chairman Jerome Powell on multiple occasions has said the fiscal trajectory is "unsustainable."

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