

Debt

"Neither a borrower nor a lender be." This was the advice given by Polonius to his son, Laertes, in Shakespeare's play, "Hamlet". Such an absolute position is far-removed from modern-day principles of financial management and investing. Borrowing has facilitated homeownership long before most individuals would otherwise be in position to own. While somewhat controversial today, college funding has helped many attend institutions that otherwise might not have been affordable. Auto loans have helped manage the timing of car purchases as well as increased the range of available enhancements. Borrowing comes with a cost that has trended higher but which simultaneously has meant a better return for lenders. The perspective here provides some thoughts on the use of debt across the economy with its implications for economic activity and financial markets.

PERSPECTIVE

For most of the post-WWII period, the high-water level of federal debt was reached to finance wartime expenses themselves, as seen in [Chart I](#). From there, the debt level declined more as a function of strong growth lifting GDP. Amidst the Great Recession, the debt level moved above its long-term average and has remained well-above ever since. A spike to a modern-day high debt level occurred amidst the pandemic but the subsequent decline has been modest with stabilization at a very high level. The primary sources for financing the federal debt are taxes and borrowing. The electorate likely will tolerate certain levels of both as long as benefits from government programs so funded appear worthwhile. The appetite of foreign investors for ever-increasing U.S. debt issuance poses an important market risk as well.

Most states and localities do not have the debt flexibility of the U.S. government. In fact, most have balanced budget rules that can place a limit on additional debt issuance. As shown in [Chart II](#), the increase in state and local debt moved irregularly higher since WWII, peaking in 2009. A meaningful reduction has occurred since with the debt level comfortably below its long-term average. Two expenditure categories that usually are exempted from the balanced budget rules are capital spending and pension funding. It is no wonder that pensions have become so under-funded as proceeds from debt issuance have been diverted to other priorities. As a result, challenges have grown to continue such funding as borrowing constraints have been reached.

Buy a car or a house, and one likely has incurred debt. Additional sources of recurring debt payments are credit card balances and college funding. The consumer debt burden is measured relative to disposable income as shown in [Chart III](#). A meaningful increase in debt burden occurred from 1993 to 2005. A notable downtrend then prevailed until 2021. An important variable at work now is the rising trend of interest rates. The most recent rise in consumer debt burden is aligned with this rate increase. While further reductions in policy rates are expected, the actual impact on consumer borrowing costs could remain elevated.

INVESTMENT IMPLICATIONS

Whether by the federal government, state and local governments, or consumers, borrowing raises the level of economic activity beyond that which might otherwise prevail. The increase in activity likely cannot continue uninterrupted if the associated borrowing is curtailed either by legal constraints or by the impact of market forces. Lenders may determine that higher costs of borrowing must be enforced. Levels may be reached that are not affordable for borrowers. The scenario could be exacerbated if an outright recession were to develop. At such a time, borrowers and lenders may wish that they were neither.

CHART I

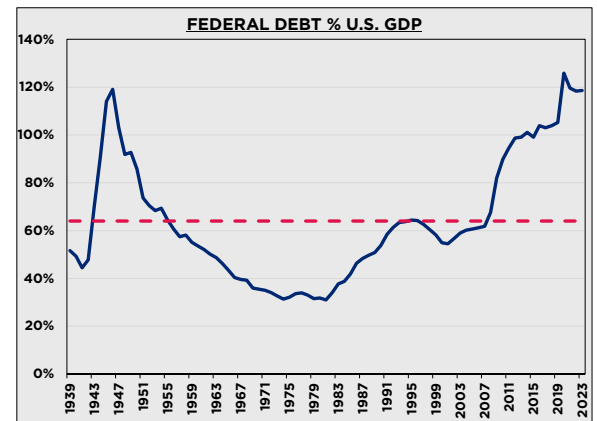


CHART II

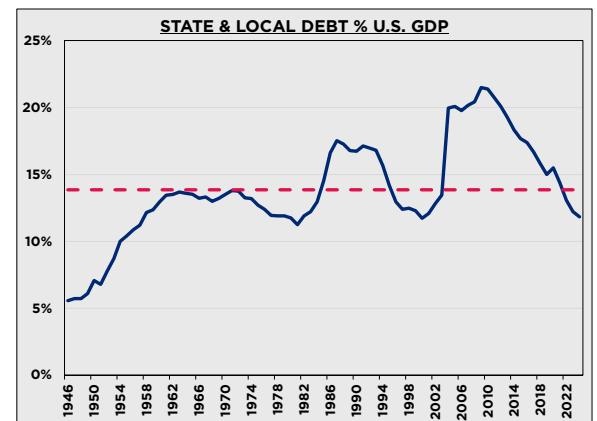


CHART III

