Higher Interest Rates, Rising Debt and Wider Deficits Magnify September

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It's been 10 days since Fitch downgraded the U.S. sovereign debt rating from AAA to AA+. The downgrade itself isn't cause for concern, but the underlying reason should grab the attention of political leaders.

The reason is embedded in the July budget review from the Congressional Budget Office (CBO). According to the CBO report, the U.S. budget deficit for the first 10 months of the current fiscal year has swelled to $1.6 trillion, *more than double the shortfall over the same period a year ago.* Given the resiliency of the U.S. economy, financial deterioration of this magnitude seems counterintuitive . . . until you sift through the details.

The widening deficit has resulted from both lower revenue (-$418 billion) and higher spending (+$473 billion). The revenue shortfall is due almost entirely to lower income tax collections from individuals, which were down a staggering $442 billion from the same period last year. This drop reflects the miserable stock market performance of 2022.

On the expense side, the explanation is multifaceted, *but inflation has played a consistent role*. The biggest increase is a sharp rise in interest expense as the Fed tightened from a zero rate environment to the highest overnight funds target in over two decades. Net interest outlays have risen $146 billion to $572 billion, a 34% increase.

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Social security benefits were $111 billion higher, due to the biggest cost-of-living adjustment since 1981, along with a continued rise in the number of retirees. Spending on Medicare (+$104 billion) and Medicaid (+$29 billion) has increased along with the rising cost of medical services.

Spending by the Department of Education was $91 billion higher, mainly due to the Administration's new income-driven student loan repayment program. Outlays by the FDIC were $52 billion higher as major bank failures tapped into the federal deposit insurance fund.

Obviously, there were other contributors to the widening deficit, along with reductions relating to fading coronavirus spending, but under current assumptions, annual deficit spending never drops below $1.5 trillion during the 10-year CBO forecast period. The deficit for the fiscal year ending in September is projected to be $1.7 trillion, or 6.5% of the nation's GDP.

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This all points to a historic budget battle in September. Congress is currently out of session but will return mid-September with just three weeks to agree on a new federal budget. If they fail to pass 11 separate spending bills and are unwilling to accept a continuing resolution, the U.S. will be facing yet another government shutdown on October 1st.

Debate will focus entirely on the spending side of the equation, and any significant funding cuts that emerge this fall would negatively impact economic growth – *just another reason for the Fed to take a breather at next month's FOMC meeting*.

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There are several reasons to expect a somewhat brighter budget picture next year, regardless of congressional action. In fact, most of the factors that pushed the deficit higher this year have either reversed course or are expected to do so in 2024. The inflation rate has plunged, stock market performance has flipped, and the Fed is expected to cut rates at some point next year. That being said, the long-term fiscal path of the U.S. is clearly unsustainable. A healthy debate may not be possible in the current political environment, but it's long overdue.