Morgan Stanley

Monthly Musings

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In this Musings, I'll cover the following:

- The continued growth of US government debt is reaching levels that are beginning to concern some investors
- We will need some political will to begin tackling the issue before it becomes a crisis
- Investors should expect continued volatility

How do you eat an elephant? The traditional answer is…"one bite at a time". If our national debt of $36 trillion+ is the elephant, the current administration initially appeared to be taking a "throw it in a massive blender and chug it" approach with the formation of DOGE, etc.[1] Unfortunately, with the new Republican-led proposed budget bill, we now seem to be headed for continued massive deficit spending and more debt. The Committee for a Responsible Budget estimates the current version of the budget could add several trillion dollars of debt and Moody's expects federal deficits to widen to near 9% of GDP by 2035.[2,3] In fact, Moody's just downgraded the rating of US government debt on 5/16/25 to Aa1 from AAA. Regardless of how we ultimately tackle this debt issue, it is time to eat and let's hope everyone is really hungry.

Some Stats:

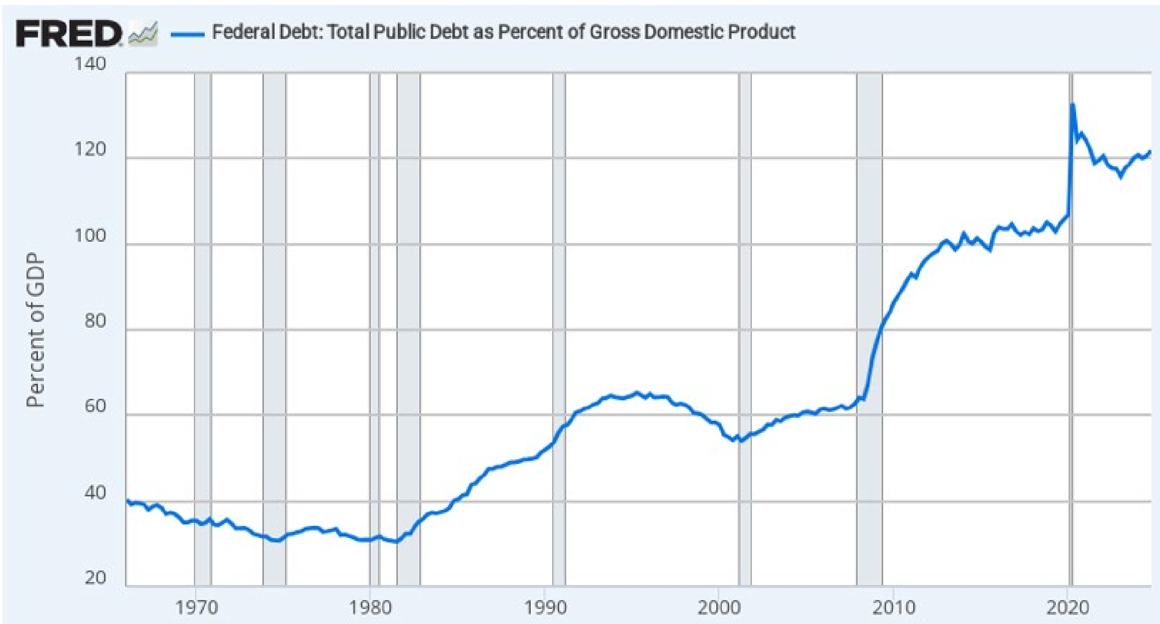
- At $36.5 trillion, our federal debt is now more than 120% of our national GDP…this same percentage was below 40% as recently as the mid-1980s (see graph below).[4]
- With the exception of the late 1990s, we have been running annual budget deficits

since the 1970's…with the size of the deficits increasing significantly in recent years (see graph below).[5]

- Our federal debt level is more than 6 times larger in 2025 vs. 2000.[6]

- The interest cost alone now makes up approximately 20% of tax revenues and these interest payments are now growing faster than our GDP (see graph below).[7]

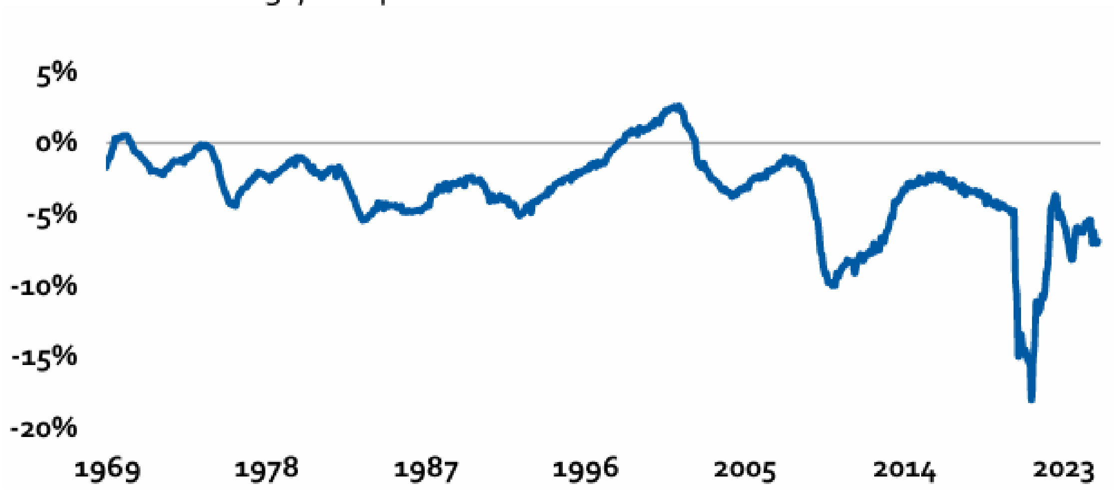
- Net interest spending on our government debt now exceeds the US Defense budget.[8]



Source: Federal Reserve Bank of St. Louis; U.S. Office of Management and Budget via FRED

US Treasury Deficit or Surplus as a Percent of Nominal GDP

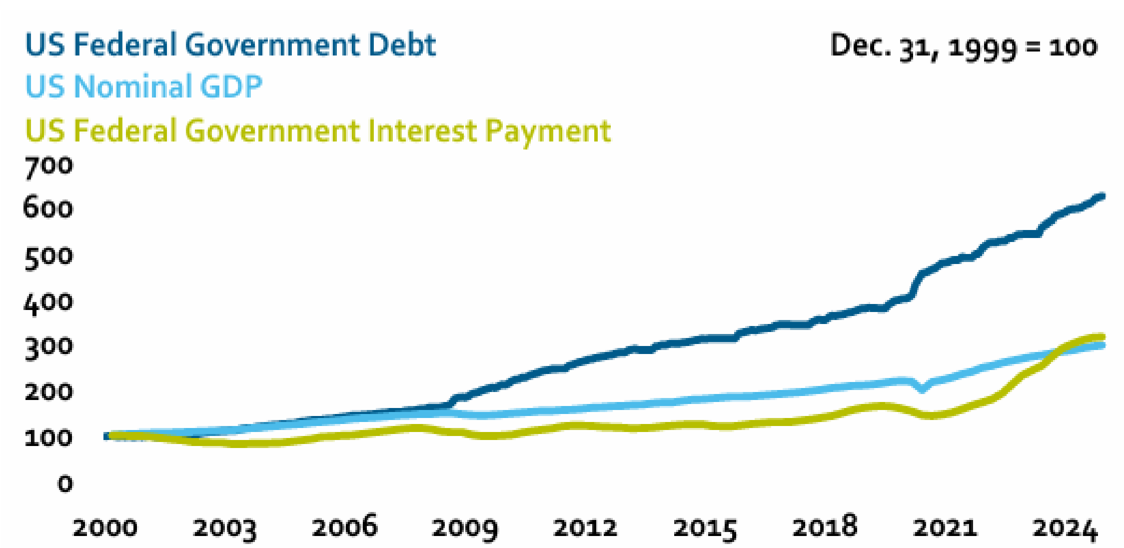
As of December 31, 2024



Source: www.strategas.com

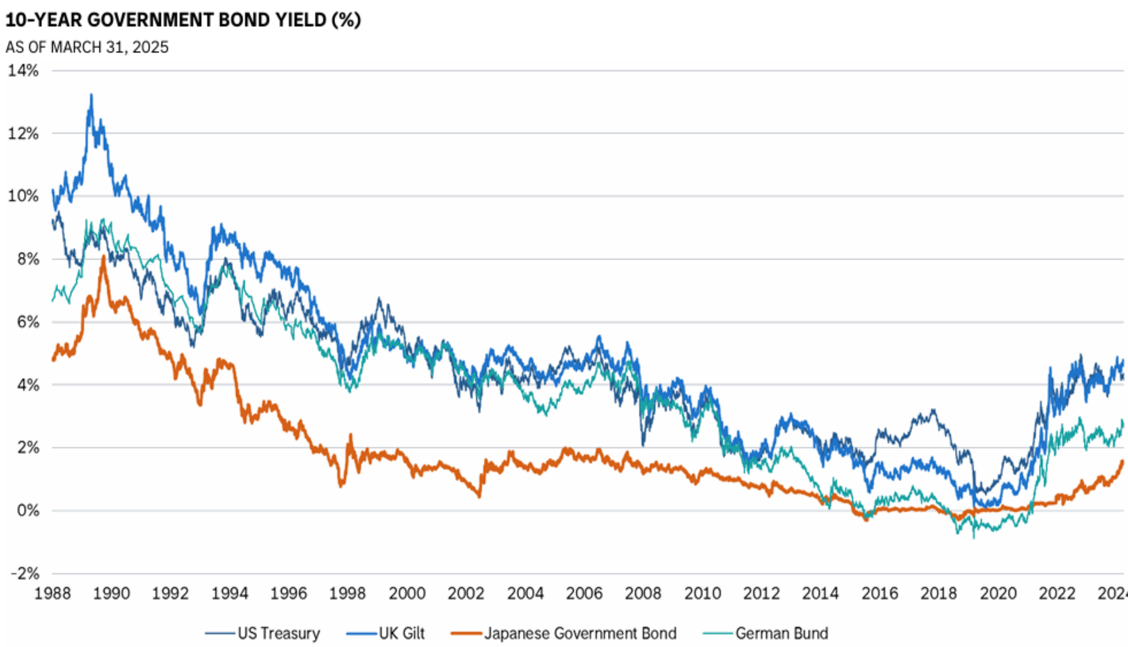
US Govt. Interest Payment Growth Eclipsed GDP Growth

As of December 31, 2024



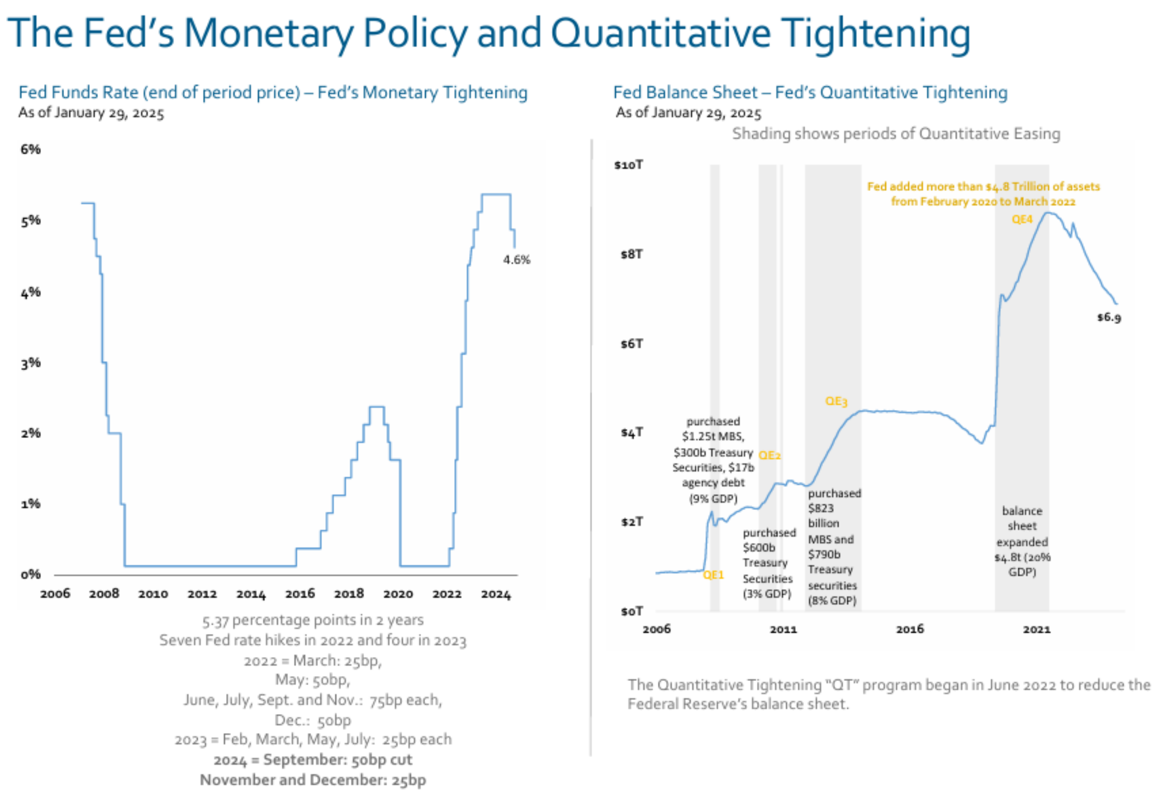
Source: www.strategas.com

The growth of our federal debt has been a problem for many years but, the Zero Interest Rate Policy (ZIRP) that ran from 2008 – 2022 effectively hid the issue as the cost of servicing the debt remained low even as the overall debt level grew dramatically. Unfortunately, this ostensibly low cost may actually really turn into significant costs…just costs that were pushed to a later date. While interest rates have increased a lot from the artificially low rates, we are just getting back to normal levels, in my opinion (see graph below). For example, if the real rate (nominal minus inflation) for the US 10-Year has historically been in the 1 – 3% range during normal times and assuming a 2.5% inflation rate, the 10-Year nominal yield should be between 3.5% – 5.5%...we're currently around 4.5%. So, we don't need to blame concern about our fiscal situation for the recent up-tick in rates, just normal fundamentals, in my opinion. It's a bit scary that we could climb to 5.5% and still be in "normal" territory without another inflation scare or a fiscal stability scare. Where might the yield go if we got either one of those scares…or both? The math gets ugly…



Source: Morgan Stanley ChartBook (See disclosures below)

One could argue that it has been the lack of political will that has gotten us to this point…if so, we will need to find some political will to start addressing the problem. There are basically three interconnected levers that can be used: (1) Increase revenue (2) decrease spending and (3) increase economic growth. If one or both of the first two approaches are used, economic growth would be expected to be slower, at least in the short-term. And, if you try door # 3…or the "grow our way out of it" approach, It would typically require lower taxes and increased federal spending. In fact, Bloomberg estimates that it would require nominal GDP to rise to 7% from 5% just to stabilize our *ratio* of debt to GDP and this includes some assumptions.[9] Ultimately, I believe the U.S. will have to live with some degree of austerity on the fiscal spending side for a period of time. And, for those monetarists, we've already tried to juice the economy with massive monetary easing and look where that got us…including a large swath of US Treasury securities that are still on the Fed's balance sheet (see graph below). Pure efficiency drives and select de-regulation would likely be more beneficial.



Source: Morgan Stanley ChartBook (See disclosures below)

I think investors should expect higher-for-longer interest rates and a volatile, trading-range and rotational type of equity market where active portfolio managers could add some value…and, I'll just throw this out there as food for thought…the "risk free" asset class (i.e., U.S. Treasuries) no longer has any rating agencies grading it AAA. We are now really dependent on "faith".

***See My Previous Investment Commentaries here*:**
https://advisor.morganstanley.com/benedict-mcloughlin-group

***Tactical Allocation Strategies in my Global Core, Global Value Opportunities and Global High-Income Model Portfolios:**

Overweight	Underweight
Global Value Equities, Long/Short Equity Strategies, Quality Dividend Paying Global Equities, Emerging Market Consumer Equities, Total Return Strategies, Shorter-term Corporate Bonds	High P/E technology/growth stocks, Mid and Long-Term Fixed Income

* These weightings do not consider each client's unique profile, preferences and/or constraints and

therefore may not be applicable to you.

* The Global Core and Global Value Opportunities strategies are designed to achieve growth via investments in global equities. The Global High-Income strategy is designed to achieve above average income via investments in bonds, ETFs, closed end funds and dividend paying equities.

The Benedict-McLoughlin Group always strives to use sound judgment…at every decision point.

We bring experience, credentials, and tenacity which we expect to continue to enable us to help achieve our clients' goals over time.

Regards,
Chris

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The Benedict-McLoughlin Group – *"Institutional Caliber Portfolio Management, Customized to Your Personal Situation"*

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NMLS #1278939

Notes:

1. Bloomberg News, 12/26/24.
2. Bloomberg News, 5/17/25.
3. Bloomberg News, 5/15/25.
4. www.fred.stlouisfed.org.
5. www.fred.stlouisfed.org.
6. www.fred.stlouisfed.org.
7. Bloomberg News, 4/24/25.
8. www.strategasrp.com.
9. Bloomberg News, 4/24/25.

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Past performance is no guarantee of future results. Actual results may vary. Diversification does not assure a profit or protect against loss in a declining market.

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Chartbook Source: FactSet, Morgan Stanley Wealth Management GIC. (1) The cyclically adjusted P/E ratio (CAPE), also known as Shiller P/E ratio, uses a 10-year average of inflation-adjusted earnings to value the stock market. Historically, cyclically adjusted price-earnings ratios have led subsequent returns with a 10-year lag. Recent price earnings levels suggest equity returns could be better going forward than they have been over the recent past, assuming the statistical relationship holds. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean. Past performance is no guarantee of future