Russell Investments

Is the ballooning U.S. government debt sustainable?

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On the latest edition of Market Week in Review, Quantitative Investment Strategist Dr. Kara Ng and Julie Zhang, director, North America sales enablement, discussed the sustainability of the U.S. government debt. They also chatted about the potential for changes to the U.S. tax code, fourth-quarter earnings season and the current state of the global economy.

U.S. federal debt swells. Should markets be concerned?

The topic of U.S. government debt made headlines the week of Jan. 18 when Janet Yellen, U.S. President Joe Biden's nominee for Treasury secretary, advised Congress to "act big" and pass the newly installed president's proposed $1.9 trillion relief package, Ng said.

"With the nation's total public debt already at $28 trillion, there's been some concern that further spending will make the debt unsustainable," she noted. Ng said that while high government debt isn't sustainable on a permanent basis, in the short-term, it might make sense.

"In my opinion, the benefit of additional debt today is high, while the cost is low," she remarked, explaining that current low interest rates make it cheaper for the U.S. government to borrow money. With the wintertime rise in COVID-19 infections leading to renewed lockdown measures, the nation's economy continues to be hamstrung by the virus—and additional stimulus would help struggling businesses and households stay afloat until vaccines can be widely deployed, Ng said.

"The resurgence of the virus has clearly stalled the labor-market recovery," she added, noting that the U.S. shed 140,000 jobs in December, with many of the losses coming from the leisure and hospitality sectors.

Ng said that she expects short-term interest rates to remain low for a few years for two reasons: Low inflation and the U.S. Federal Reserve (the Fed)'s recent adoption of more stringent criteria for raising rates. "Following a recession, inflation pressures typically take a while to build," she explained, pointing to the three most recent U.S. economic expansions, where inflation remained low for long periods of time despite a robust labor market. In addition, the Fed's shift last summer to an *average inflation targeting* approach means that the central bank will allow inflation to overshoot its 2% target for periods of time, in order to make up for past inflation undershoots, Ng added.

"These two factors should keep interest rates accommodative for years, which in turn will make high government debt more sustainable," she concluded.

When could the Biden administration tackle tax increases?

Turning to taxes, Ng said that President Biden, who was sworn into office on Jan. 20, is unlikely to propose tax increases in the short-term. Although the new president has talked about rolling back half of the 2017 corporate tax cuts, it's unlikely such a measure would be implemented until 2022, Ng said.

"Politically, it's very unpopular to broach the topic of tax increases when the economy is still in a recovery phase," she explained. Ng added that, should Congress ultimately decide to unwind half of the 2017 tax cuts, Russell Investments' corporate earnings model projects that 2022 earnings-per-share (EPS) growth could take a hit of roughly 5%.

Transitioning to the current earnings season, Ng said that so far, over 90% of U.S. companies that have reported have beat expectations for fourth-quarter earnings. While earnings growth for S&P 500 companies is tracking roughly -6%, Ng noted that Russell Investments' medium-term outlook for earnings is very positive.

Europe, UK at risk of double-dip recession

Preliminary manufacturing and services PMIs (purchasing managers' indexes) for the U.S., Japan, the UK and Europe were released the week of Jan. 18, Ng said—and the results were a bit of a mixed bag. Despite the uptick in COVID-19 cases, January PMIs for both the U.S. manufacturing and services sectors showed expansionary conditions, she stated. However, on the other side of the coin, flash PMIs from Europe and the UK showed that economic activity in both regions is struggling—particularly on the services side, Ng said.

"These numbers suggest that the UK and Europe are at risk of a *double-dip* recession, primarily due to the impacts the new lockdown restrictions are having on economic activity," she stated. While Ng still expects European equities to benefit from a global reopening, the latest data illustrates that even with the deployment of vaccines, the path to recovery can still see some hiccups, she said.

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