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Planning in an Indebted World

How Much Debt is Too Much?

For people, it is a fairly easy answer because it's based on our income, assets, and expectations. Lending companies have decades of data about borrowers to make their credit decisions. We're certainly here to help any time you want to discuss your personal situation.

What about countries, though? More importantly for our purposes, what role does government debt play in the future expected returns of our investments? This is a hotly debated issue that we won't be able to answer, but we're going to lay out what researchers have found and how we should think about it when doing our long-term planning.

First, let's put the issue into perspective by considering how much debt we have. The national debt of the U.S. is currently about $22 trillion, or about 108% of the country's production or GDP (Gross Domestic Product). It's higher than in recent memory, but not as high as it was after World War II when it was 119% of GDP.

In contrast, Japan's national debt is equal to about 200% of its GDP. While the U.S. has been mostly stuck in a slow-growth mode lately, Japan has had virtually no growth. Many arguments can be made for Japan's lack of growth (aging demographics are frequently cited), but the level of debt could be one of the problems.

In 2010, just after the financial crisis, a pair of Harvard professors wrote a book that looked at the national debt levels of major and emerging economies over the last 200 years[1]. They updated their analysis in 2012. What they found was generally that countries whose debt levels are in excess of 90% of their GDP have lower growth, by about 1% to 4% per year. Notably, they also found little correlation in inflation rates and debt levels.

Given this, we know that the level of debt may be a problem for future economic growth. That debt, of course, requires interest payments, so let’s take a look at what happens when interest rates increase.

A recent study by BCA Research (a Canadian economics research firm) showed that minor increases in interest rates generally would not have a negative effect on economic growth[2]. The primary reason being that the U.S. debt has an average maturity of about 8 years and it would take time for higher interest rates to noticeably effect the government’s interest costs. However, a sudden spike in interest rates, say 3% or more, would cause enough issues in our economy that the debt burden could in itself slow down growth. It isn’t just governmental debt that can be a burden to future growth, but total debt. More money going to make interest payments is less money spent to increase production.

When we think long-term, the economic effects of debt also depend on what the debt has funded. Improving transportation systems, for example, is generally more productive than building bombs (although there are good reasons for having bombs, they are generally the antithesis of economic productivity). It’s important that governments make the right decisions about why debt is incurred, but that subject really is separate and again, hotly debated.

Finally, it can be important as to who holds a country’s debt. Although Japan has one of the highest debt levels in relation to its GDP, the country isn’t exactly in shambles. It is important to keep in mind that the Japanese tend to be big savers and most of Japan's national debt is held by her citizenry. If Japan needed or suddenly wanted to reduce debt it could raise taxes, requiring her citizens to liquidate their savings to pay them.

In contrast, many entities hold large amounts of U.S. debt. About 40% of our debt is held by government agencies (like Social Security) and the Federal Reserve. The U.S. public holds about 30% through savings in places like mutual funds, pensions, etc. The remaining 30% is held by foreign governments with major holdings by China and Japan. Therefore, we theoretically couldn't reduce our debt as quickly as the Japanese, but we don't have their level of debt, either.

To summarize, the U.S. may have some vulnerability given its level of debt and diversified holders. However, this is all subject to many variables and lots of disagreement among economists.

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[1] Carmen M. Reinhart & Kenneth S. Rogoff, 2010, *Growth in a Time of Debt*

[2] The Bank Credit Analyst, Special Report, January 2017, *Global Debt Titanic Collides With Fed Iceberg?*

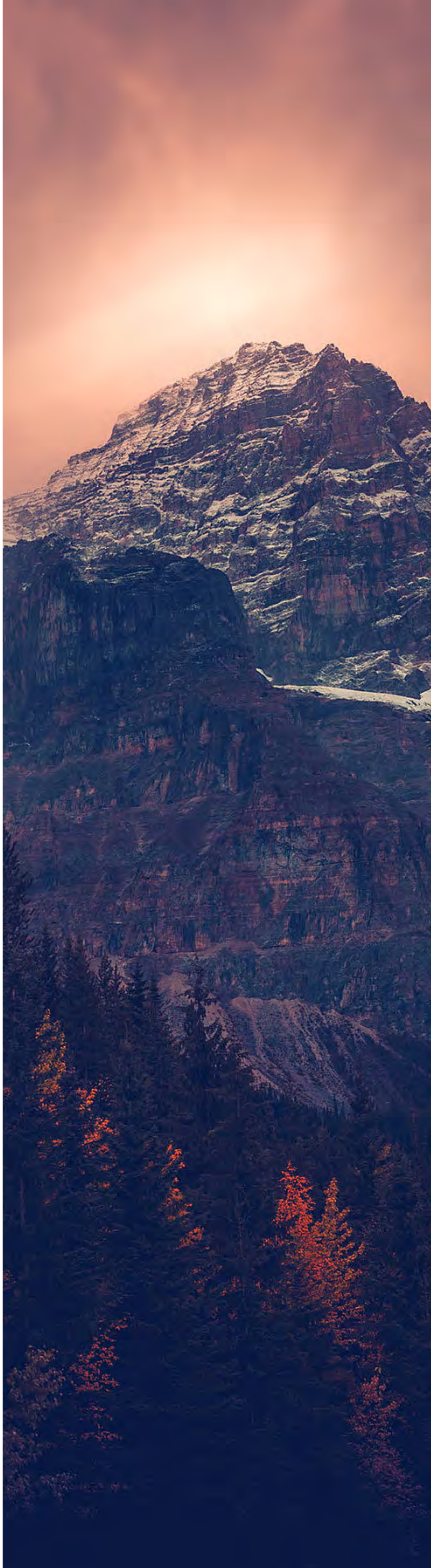
Nation's Debts and Your Personal Financial Plan

What does all of this mean for our portfolios and planning?

Our portfolios are designed to capture market returns (plus premiums for Value and Small Companies) as tax-efficiently and cost-effectively as possible. The future effect of high debt levels has little to do with that goal since all investment returns, including from stocks, bonds, real estate, etc. are broadly dependent on growth. If increased debt levels mean lower overall returns, it will be for all investments, not just from one asset class or another.

How this translates to our expectations for planning is different, though. Just as we need to be aware that when stock markets are at their highs future appreciation will most likely be subdued for a while, high government debt levels can also reduce economic growth. Over long time periods this can in turn effect our planning.

While we don't take this directly into account when projecting returns for 10, 20, 30 or more years, we do make conservative return assumptions overall. We want to make sure you have adequate money to fulfill your important goals, such as buying a new home, funding education, retirement, etc. so we're careful not to over-estimate future returns.



Our return estimates are based on historical data over the last 30 years. Why 30 years? Because that's the time period we have clean data for all on our asset classes (including Emerging Markets). When we look at the past 30-year investment returns in the U.S., however, they tend to look high when compared to longer-term data. We therefore compare the 30-year returns to the most recent 10-year returns for each asset class and weight our projected returns to the more recent past.

For example, let's look at Vista's all-stock portfolio:

- Over the last 30 years, it returned 10.3% per year, after all expenses.
- Over the last 10 years, it has returned 6.4% per year.
- The return we use in our financial planning is 7.7% per year.

Let's also look at Vista's all-bond portfolio:

- Over the last 30 years, it returned about 5.0% per year, after all expenses.
- Over the last 10 years, it has returned 2.6% per year.
- The return we use in our financial planning is 3.4%.

We aren't taking the most favorable, nor the most unfavorable periods but instead looking at both periods and drawing a conservative estimation.

As Yogi Berra said, "it's tough to make predictions, especially about the future." As we've written in the past, we're bombarded with market predictions, both short- and long-term. The accuracy of these predictions has proved to be abysmal and we won't attempt to gaze into any crystal balls, either. However, we can base future returns on long-term values and temper them with a healthy dose of conservatism in order to increase the probability that you will be able to meet your financial goals.

Thanks

We hope you found this worth your valuable to time read, and we always appreciate hearing from you.

Thank you for the trust you've placed in Vista.

Your Vista Wealth Management Team