First Trust
Monday Morning OUTLOOK
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The Growing Deficit

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The U.S. federal government reported last week that it ran a deficit of $214 billion in August, the fifth largest deficit for any single month in US history.

The Congressional Budget Office thinks these numbers are consistent with a budget deficit of about $800 billion for Fiscal Year 2018, which ends September 30. If so, that would be the largest annual deficit in raw dollar terms since FY 2012. This deficit is roughly 4.0% of GDP, which would be the highest since FY 2013.

For many, this growing deficit is a dagger to the heart of the tax cut enacted in late 2017. They say the tax cut was irresponsible. However, economic growth has picked up because of the tax cut, and growth is the key to higher fiscal receipts down the road – in fact tax receipts are still hitting record highs.

Between 2010 and 2017, the U.S. passed two large tax hikes, yet the deficit was still $665 billion in FY 2017, which was not exactly a model of fiscal purity. As a result, we call "politics" on all those now fretting about deficit spending only when a tax cut is involved.

It's important to recognize that the tax cut has, so far, reduced revenue compared to how much the federal government would have collected in the absence of the tax cut. But, total federal receipts are likely to end the current Fiscal Year up slightly from last year and at a record high. Next year, according to the CBO, revenue should be up 4.6% and at another record high.

In other words, the tax cut didn't lead to an outright reduction in revenue, it just slowed the *growth* of revenue.

Spending is the problem. Total federal spending will rise about 4% this year and is scheduled to rise about 8% next year. In spite of an acceleration in economic growth, government spending is rising faster than GDP.

While this is a long-term problem, it will not turn the U.S. into Greece overnight. No fiscal crisis for the nation is at hand. Last year, net interest on the federal debt amounted to 1.4% of GDP. The Congressional Budget Office projects that net interest will hit 2.9% of GDP before some of the tax cuts theoretically expire in the middle of the next decade.

That is a large increase, but net interest relative to GDP hovered between 2.5% and 3.2% from 1982 through 1998. The U.S. paid this price and the economy still grew more rapidly than it has in the past decade. The U.S. didn't become Greece.

Compare two economies of equal size. One spends $500 billion, but with zero taxes, the other spends $2 trillion, but taxes $1.5 trillion. Both have $500 billion deficits, but the first economy would be more vibrant and could finance the debt more easily. It's not that deficits don't matter, but deficits alone are not a reason for investors to run for the hills.

And when deficits are partly caused by more federal spending on interest payments you know who will hate it the most? The politicians.

Here's why. Politicians like to deliver things their constituents are grateful for, things that make voters more likely to vote for them rather than someone else. Tax cuts help politicians get more votes, at least from those who actually pay taxes. Government programs can also help incumbents corral votes. Pass out government checks and you can get more votes, too. But bondholders have no gratitude for politicians when they receive the interest they're owed on Treasury securities.

Higher net interest payments will eventually "crowd out" future tax cuts and government programs, making it tougher for incumbents to get re-elected. As net interest payments rise, more politicians will start obsessing about the deficit again, just like in the 1980s and 1990s.

The true threat to long-term fiscal health is spending. If left unreformed, entitlement programs like Social Security, Medicare, and Medicaid will take a ceaselessly higher share of GDP, leading to a larger and larger share of American production being allocated according to political gamesmanship rather than individual initiative, in turn eroding the character of the American people.

Unless we change the path of spending, last year's tax cuts - and the boost to economic growth they've already provided - risk getting overwhelmed in the long run. But, for investors, this isn't an immediate problem. After all, deficit fears have been around for decades and equities still rose. Stay bullish, for now.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-17 / 7:30 am	Empire State Mfg Survey – Sep	23.0	**23.8**	19.0	25.6
9-19 / 7:30 am	Housing Starts – Aug	1.235 Mil	**1.253 Mil**		1.168 Mil
9-20 / 7:30 am	Initial Claims – Sep 15	210K	**208K**		204K
7:30 am	Philly Fed Survey – Sep	15.8	**21.1**		11.9
9:00 am	Existing Home Sales – Aug	5.380 Mil	**5.380 Mil**		5.340 Mil