



Written by [Bob Adelman](#) on May 22, 2018

U.S. Fiscal Outlook “Not Good,” Says Goldman Sachs’ Chief Economist

In his newsletter to Goldman Sachs’ clients published on Monday, Jan Hatzius, the investment banking firm’s chief economist, [wrote](#), “An expanding deficit and debt level is likely to put upward pressure on interest rates. While we do not believe that the U.S. faces a risk to its ability to borrow or to repay, the rising debt level could nevertheless have [serious] consequences.”



Borrowing from the Congressional Budget Office’s analysis following the passage of the tax reform act, the two-year budget deal in February, and the massive “omnibus” spending bill in March, Hatzius projected that annual deficits will shortly exceed a trillion dollars a year, pushing the national debt close to \$30 trillion in less than 10 years. He warned:

The current fiscal expansion ... must at some point give way not just to a neutral stance, which we expect by 2020, but to a tightening of fiscal policy that could restrict growth.

That’s a nice way of saying that the Federal Reserve, in its determination to quash incipient inflation, could raise interest rates so high it would choke off the present economic expansion and trigger a recession. Hatzius issued another warning: With the national debt approaching \$30 trillion, in a recession “lawmakers might hesitate to approve [new] fiscal stimulus in the next downturn,” turning that recession into a depression.

John Mauldin, a *New York Times* best-selling author and publisher of *Thoughts From the Frontline*, thinks the recession could easily morph into a depression and not just because of rising interest rates that the government would have to pay to entice buyers to purchase its bills, notes, and bonds. As he noted in his newsletter dated May 11, Mauldin explained that “access to easy credit drives consumer spending and business investment. Take [that easy credit and low interest rates] away and they decline. Recession follows.”

The problem is that it isn’t just the government that must continually seek buyers of its debt, it’s the gargantuan corporate debt held by American companies that also must be serviced. In the next five years, wrote Mauldin, more than \$4 trillion of corporate debt will need to be refinanced. Add to that the “new class” of investors left over from the Great Recession: those who took their savings out of banks and invested them in high-yield bonds for their higher returns. They are not only individual investors but corporate bond ETFs (electronically-traded funds) and bond mutual funds.

Mauldin is especially concerned about the high-yield bond market, which alone is \$2 trillion in size. As interest rates rise, investors will see the value of their bond holdings dropping. At some point those



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holding high-yield bonds will want to cut their losses, triggering a potential avalanche of selling. Said Mauldin: "I don't have enough exclamation points to describe the disaster when high-yield funds, often purchased by mom-and-pop investors in a reach for yield, all try to sell at once, and the funds sell anything they can at fire-sale prices to meet redemptions. In a bear market you sell what you can, not what you want to ... the picture is not pretty."

The ripple effect is predictable: As redemption demands increase, bond managers will find it impossible to offload those high-yield bonds and will then start to liquidate the rest of their portfolios to meet those demands. The value of those portfolios will decline while risks increase, triggering downgrades. Those downgrades will then trigger further selling due to covenants under which the managers operate, and the wholesale liquidation in bonds begins in earnest.

Just how bad could it get? In his latest newsletter Mauldin tells his readers:

As in the Biblical book of Revelation, the initial credit crisis stemming from the fall of high-yield bonds will be merely the beginning of woes. Illiquidity will spread as lower-end corporate bonds fall to junk ratings. Legal and contractual constraints will then force institutions to sell, pressuring all except the highest-grade corporate and sovereign bonds. Treasury and prime-rated corporate bond yields will go down, not up (see 2008 for reference on this). The selling will spill over into stocks and trigger a real bear market — much worse than the hiccups we saw earlier this year.

Mauldin saved the worst for last:

I give the probability of the credit crisis in the high-yield junk bond market somewhere close to 95%. For the record, nothing is 100% certain, as we don't know the future. But I think this is pretty much baked in the cake.

His timing? Said Mauldin, this credit crisis "is coming in the next 12-18 months ... [and] a worldwide debt default is likely in the next 10-12 years."

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