Unstoppable government debt – consequences for investors

The cost-cutting efforts surrounding Elon Musk's DOGE in the US have been unsuccessful. Instead, the Trump administration has increased the budget deficit further by passing the 'One Big Beautiful Bill', thereby accelerating the rise in US debt. However, we are seeing a rise in government debt not only in the US, but worldwide. We argue that a further increase in government debt, particularly in the US, is almost unstoppable at present. We describe the implications for the economy and financial markets and derive specific consequences for investors. Structural inflation, rising bond yields, devaluation of the US dollar and the search for real assets and alternative hedges are likely to be the defining trends of the coming years. Investors should urgently take these into account in their strategy.

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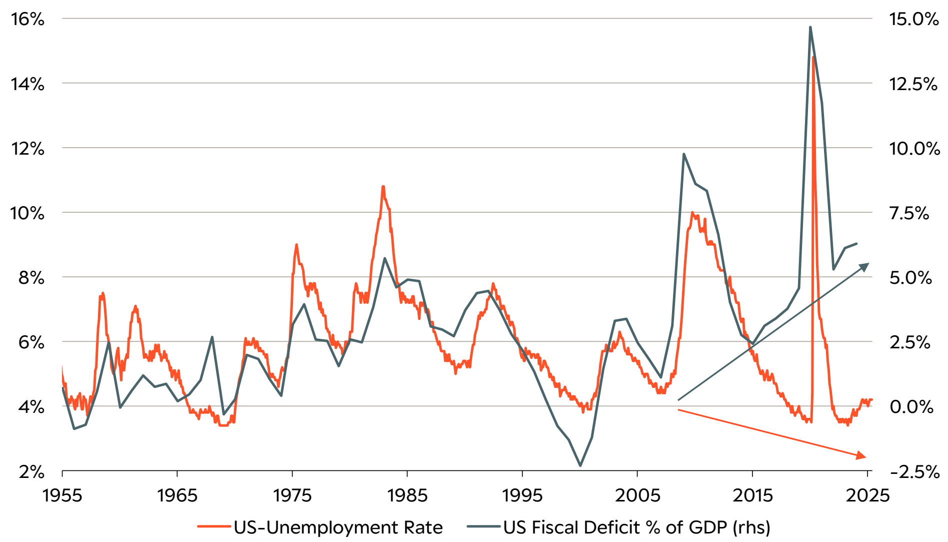
Economic development and fiscal deficit in the US are decoupling due to increasing procyclical fiscal stimulation

Historically, there has been a close relationship between the size of the budget deficit and economic growth in the US

The United States has had a budget deficit almost every year since the 1960s. Historically, however, there has been a close correlation between the size of the fiscal deficit and economic developments, such as unemployment (see Figure 1). During recessions, unemployment and deficits rise. In better times, unemployment and deficits are low. The late 1960s during the Vietnam War were a brief exception. In recent years, however, a decoupling has taken place. Although unemployment is falling and remains low, deficits have risen to six to seven per cent of economic output (gross domestic product, GDP). This phenomenon has been amplified during the pandemic. With the 'One Big Beautiful Bill' passed on 4 July 2025, the budget deficit in the United States is likely to rise to seven to seven and a half percent in the coming years, even with a continuing robust economy and low unemployment rate.

Fig. 1: Since the financial crisis, the US fiscal deficit has been high and rising, despite a solid economy



Time period: 01/01/1955 – 01/05/2025

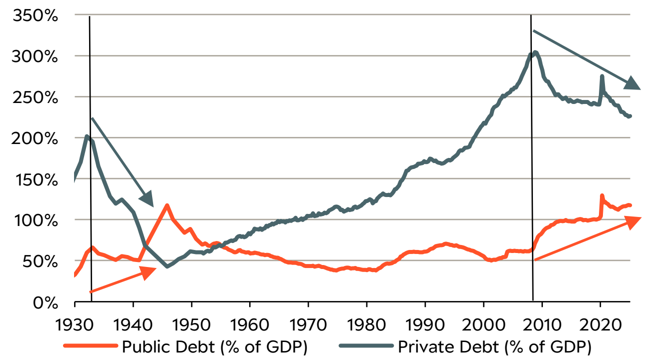
Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

This decoupling began with the financial crisis of 2008/2009: until then, it was primarily private sector debt that had risen in the United States, i.e. debt owed by private households and companies – from around 50% of economic output at the end of the 1940s to approximately 300% in 2008/2009 (see Fig. 2). In light of this debt and the loss of assets caused by the bursting of the real estate bubble, the private sector lost its willingness to take on further debt despite historically low interest rates. To secure growth and avoid deflation, the government responded by massively increasing its spending. Since then, government debt has been growing significantly faster than private debt. Over the past 15 years, private debt relative to GDP has fallen by around 70 percentage points, while government debt has risen by around 60 percentage points (see Fig. 2). The private debt bubble of the financial market crisis was essentially replaced by a massive increase in government debt. A similar development occurred in the 1930s and 1940s because of the Great Depression and World War II. Total debt, i.e. the sum of private sector and government debt, has risen steadily over the last 100 years and now stands at more than 100 trillion US dollars (see Fig. 3). Only in the four years following the Great Depression (1931-1934) and in 2008, when the US real estate bubble burst, did total debt decline.

The private debt bubble of the financial market crisis has been replaced by a massive expansion of government debt.

Fig. 2: Up until the financial crisis, private sector debt tended to rise. Since then, it has been shrinking, while government debt has been growing

A similar development was seen in the 1930s and 1940s as a result of the Great Depression and the Second World War

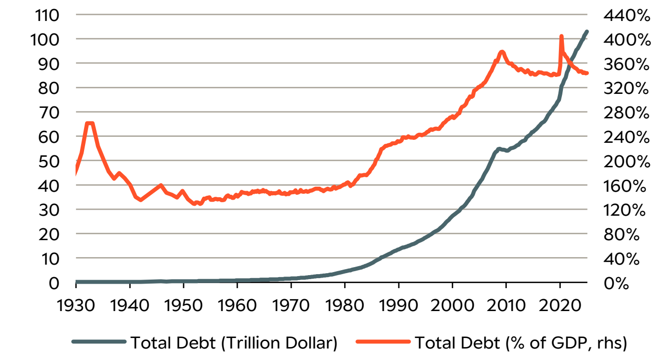


Time period: 01/01/1930 – 31/03/2025

Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

Fig. 3: Total debt in the United States (private sector + government) has risen steadily over the past 100 years

In relation to economic output, debt has only fallen after the Great Depression, the financial crisis and the pandemic



Time period: 01/01/1930 – 31/03/2025

Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

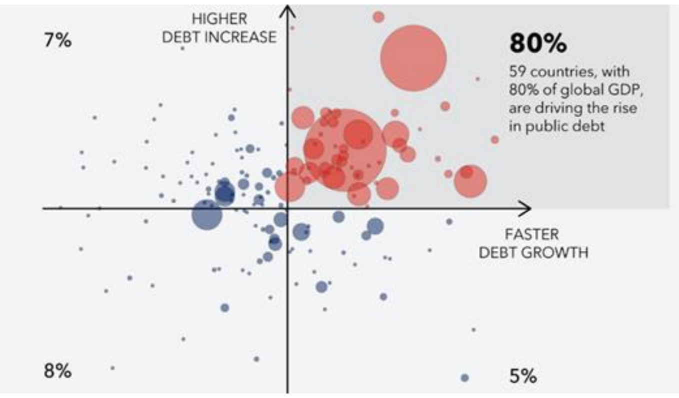
The unstoppable rise in debt: declining effectiveness of central bank policy and fiscal dominance

A further increase in debt seems almost inevitable, not least because the last 100 years show that growth in the US is based on continuously rising debt. Moreover, an accelerated increase in government debt is a global phenomenon. The IMF recently emphasised that in countries accounting for 80 percent of global GDP, government debt is higher than before the pandemic and the increase is accelerating (see Fig. 4). There are many reasons and examples for this, such as the costs of an ageing population and the associated rise in social spending, the energy transition, wars and increasing defence spending. The United Kingdom, for example, took on the highest level of new debt outside of the pandemic in June due to rising interest expenses and social security costs. In addition, there is likely to be another deep recession in the medium term, which is likely to lead to rising unemployment and thus also rising government debt.

The accelerated rise in government debt is a global phenomenon

Fig. 4: Accelerating government debt is a global phenomenon

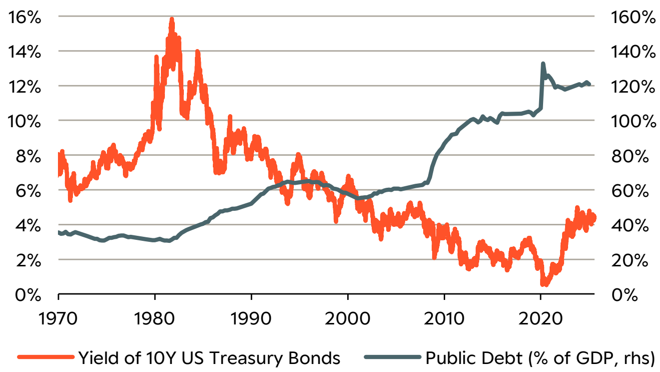
Government debt is higher and growing faster than before the pandemic, driven by the largest economies



Note: The Y-axis shows the change in debt levels relative to GDP between 2019 and 2025. The X-axis shows the change in debt growth relative to GDP by comparing the growth rate from 2014-19 with the forecast for 2024-29. Bubble size = share of global GDP in 2024. Source: IWF

Abb. 5: Rising interest costs favour further increases in debt

Rising yields and high debt are weighing on government budgets



Time period: 01/01/1970–24/07/2025

Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

A rapid shift back to more private debt and away from government debt also seems politically impossible. This would mean austerity and higher taxes, which is not a winning combination for politicians. For the electorate to accept such measures, there would first have to be a serious financial crisis, which does not seem likely at present.

Without a real crisis, a return of austerity and higher taxes seems unlikely

In addition, there are two specific reasons why the further increase in government debt seems unstoppable: the inevitable rise in interest expenses and fiscal dominance.

The rise in government debt in the 40 years leading up to the early 2020s was easily manageable thanks to steadily falling interest rates. In the 1980s, debt was relatively low at around 40% of GDP, but interest rates were high. Since then, debt has risen while interest rates have fallen for 40 years. This has changed in recent years (see Fig. 5). Interest rates are no longer falling structurally, quite the opposite. As a result, interest expenses are becoming a significant part of government spending. For example, interest costs on US government debt are expected to exceed national defense spending for the first time in 2025. This development marks a turning point in US budget policy and reflects the sharp rise in debt and significantly higher interest rates. Unless savings are made elsewhere, this will increase the deficit and debt will continue to rise. This is increasing political pressure on the central bank to lower interest rates. Since Fed Chair Powell has so far resisted this pressure, President Trump is increasingly threatening to dismiss him prematurely. Powell's term officially ends in May 2026.

Rising interest expenses are becoming a significant part of government spending and are further increasing debt

Even the US Federal Reserve is no longer able to effectively slow down the rise in total debt. If the Fed raises interest rates to limit private credit growth and combat inflation, this is likely to lead, ironically, to a faster increase in the government deficit rather than a slowdown in credit growth in the private sector. The usual instruments for managing the economy are no longer working properly: the Fed can no longer effectively slow down total lending in the system.

The central bank's interest rate policy is no longer having the desired effect – interest rate hikes are increasing government debt

This means that we are currently in an environment of fiscal dominance – fiscal policy dominates monetary policy. As a result, the usual monetary policy instruments for controlling the economy are becoming ineffective. The Fed faces a dilemma. If it lowers interest rates too much, it stimulates borrowing in the private sector and investors increasingly focus on scarce assets rather than productive investments. However, if it keeps interest rates high, this inflates the government deficit and jeopardises the government's debt sustainability. In either case, total debt continues to rise.

Fiscal dominance – fiscal policy dominates monetary policy

Only a significant increase in productivity – for example, through artificial intelligence – could make the outlook for the future more optimistic. If potential growth and thus tax revenue rise significantly, the budget deficit could decrease again. However, it is unclear whether this will happen. In the coming years, at least initially, tariffs, restrictive immigration policies and the undermining of institutions are likely to lead to a misallocation of capital, which, according to our economists' estimates, will result in a reduction of the US trend growth rate from 2% to 1.5% and exacerbate the fiscal risks facing the US.

Greater productivity could make the scenario look more optimistic, but for now, trend growth in the US is likely to fall

Consequences for financial markets and investors

Consequence 1: Short-term recession unlikely, medium-term risk of bubbles and corrections

High, rising, and procyclical fiscal spending makes a recession less likely in the near term. This supports equity and commodity markets. Government bonds, which had the upper hand during the years of disinflation in an economic downturn and especially during recessions, are the ones suffering. However, this procyclical stimulus increases the risk of bubbles forming on the financial markets and the economy overheating in the medium term, which could then lead to a deeper recession and the bursting of speculative bubbles in the medium term.

Procyclical fiscal spending supports equity and commodity markets and weighs on government bonds

Consequence 2: Structurally higher and more volatile inflation

Government debt and persistent deficits drive inflation in the long term. Continuous fiscal stimulus leads to higher (nominal) growth and thus tends to increase inflation. In addition, the situation of fiscal dominance means that, to ensure the government's debt sustainability, the central bank keeps interest rates lower in the medium term than would be appropriate in view of growth and inflation – real interest rates are kept negative or at least below potential growth by means of financial repression. This also argues for more growth and/or structurally higher inflation. Additional factors such as deglobalisation, demographic change, the energy transition, and high military spending are causing even more inflation.[1]

Rising government debt and fiscal dominance, alongside structural drivers, are likely to result in higher inflation in the medium term

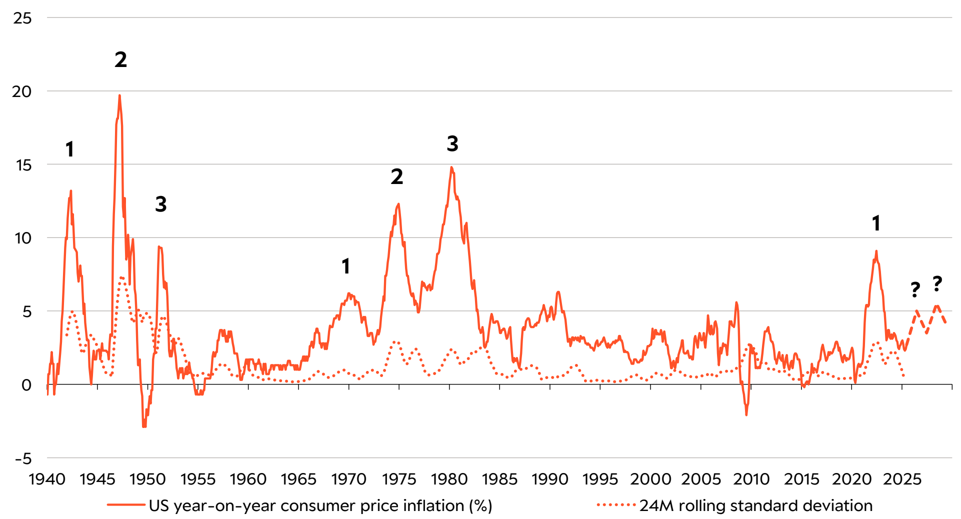
We therefore remain convinced that inflation will remain structurally higher than in the deflationary environment of the years between 2000 and 2020 and will be subject to greater fluctuations, i.e. it will come and go in waves. One reason for this are the longer-term supply bottlenecks for raw materials and the increasing shortage of labor. These are likely to cause inflation to rise again in the event of a growth recovery. The result would be stronger and faster monetary policy cycles and thus shorter, more pronounced, and more erratic economic cycles similar to the environment in the 1940s and the 1960s and 1970s (see Fig. 6).

In addition, inflation is likely to be subject to greater volatility

[1] See: Berenberg Markets Focus "What comes after the inflation hump? Implications for investors," November 3, 2022

Fig. 6: One inflation spike rarely comes alone! Inflation and inflation volatility are likely to remain high

Without a slump in the labour market and with increased raw material capacities, renewed real growth is likely to fuel inflation again



Time period: 01/01/1940 – 30/06/2025
Source: Bloomberg, own calculations

Consequence 3: Rising bond yields and a steepening of the yield curve until central banks or the government take countermeasures

US government bonds suffer from rising supply and falling international demand

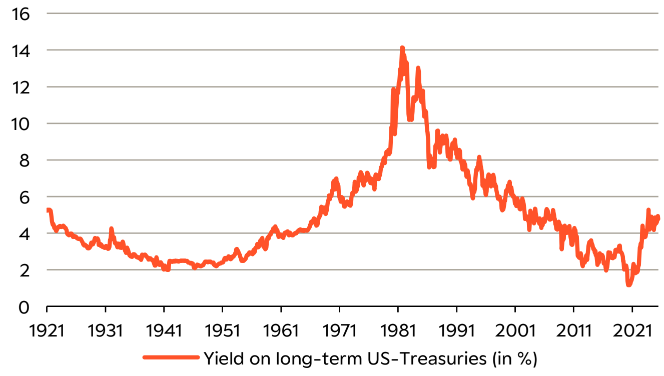
Government bonds are the ones that suffer when a recession becomes less likely, the supply of bonds increases, and rising inflation risks make protecting purchasing power more important for investors. In the coming years, the US government will likely have to find buyers for an additional USD 500 billion to USD 600 billion worth of government bonds every quarter. However, international investors are showing less and less interest in US government bonds. Emerging markets in particular are increasingly reducing the US dollar share of their currency reserves. This development is referred to as the de-dollarisation of central bank reserves. A major trigger for this was that Russia can no longer access its US dollar reserves due to Western sanctions following its attack on Ukraine. However, Donald Trump's policies have also led to a fundamental loss of confidence in the reliability of the US and the US dollar. Against this backdrop, more and more countries want to diversify their access to capital and reduce their dependency on the dollar-centric financial system.

Regulatory changes in the US are intended to stimulate domestic demand for US government securities

The US is responding to this with regulatory changes to stimulate domestic demand for US government securities. In June/July 2025, the US banking regulator relaxed the capital requirements (Supplementary Leverage Ratio, or SLR) for large banks to enable them to hold more US government bonds on their balance sheets. In addition, under the recently passed Stablecoin Regulation (GENIUS Act) in the US, issuers of stablecoins are now required to back their digital coins 100% with US government debt securities. In the medium term, however, only higher yields and a weaker US dollar (see consequence 4) are likely to generate sufficient demand for US government bonds. In the medium to long term, we consider rising yields on long-term bonds in the US to be one of the main risks for the markets. Unless the US stops issuing new long-term bonds, the central bank starts buying US government bonds on a large scale again (quantitative easing) or controls the long end of the yield curve by other means.

Fig. 7: Long-term rate turnaround appears to be complete

With the pandemic, long-term interest rates reached their lowest level in 2020 and have been rising ever since

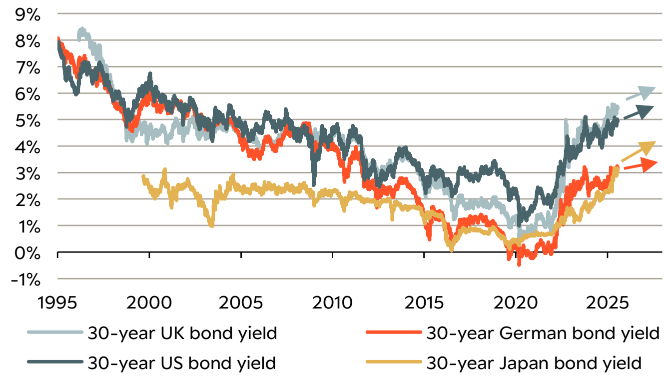


Time period: 01/01/1921 – 30/06/2025

Source: Haver Analytics, Bloomberg

Fig. 8: Yields on long-term government bonds likely to continue rising in the medium term

Yields on long-term government bonds rose significantly worldwide



Time period: 01/01/1995 – 25/07/2025

Source: Bloomberg, own calculations

At first glance, higher bond yields make bonds more attractive to investors again. However, as long as there is a risk of further increases, bonds with long maturities are not very attractive to investors. This is even more true if investors fear that the yield level does not compensate for the existing inflation risk sufficiently. If yield levels are artificially suppressed by low central bank interest rates, quantitative easing, or yield curve control, investors are less likely to generate real returns that are commensurate with inflation. Over time, investors are 'expropriated' ('financial repression') by excessively low or negative real interest rates, and the government's debt burden is reduced – similar to the situation in the 1940s.

The risk of financial repression makes government bonds less attractive to investors

Consequence 4: Devaluation of the US dollar and need for global diversification

A weaker US dollar would also make US government bonds more attractive to international investors again. For this reason, and to increase the international competitiveness of US companies, weakening the highly valued US dollar is an explicit goal of the Trump administration. Over the past 10 to 15 years, a great amount of capital has flowed into the US dollar and US dollar-denominated assets. As a result, both the valuation of the US dollar and that of US dollar-denominated assets have risen steadily. The US dollar is therefore overvalued against almost all other currencies. Figure 9 illustrates this for the Euro/US dollar currency pair. Despite the US dollar's depreciation of more than 10% against the euro since the beginning of the year, it is still overvalued by more than 20% based on purchasing power parity.

The US dollar is overvalued against almost all other currencies

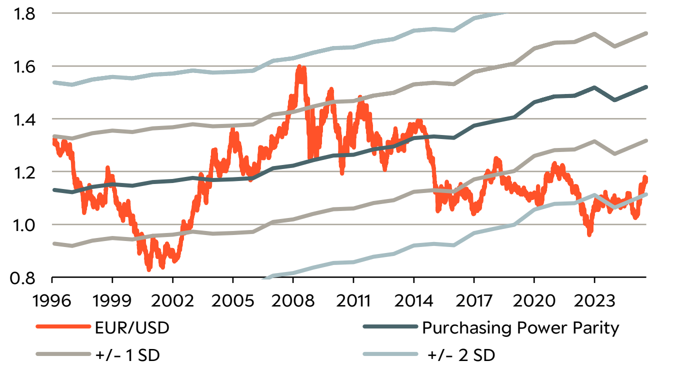
Apart from the high valuation and the US government's desire, structural factors (rising US debt, loss of confidence in US institutions, de-dollarisation of central bank reserves, emergence of alternative investment targets and opportunities) also point to a medium-term depreciation of the dollar.[2] Accordingly, the dollar has been trending weaker since the beginning of the year, even though the interest rate differential between the US and other countries has widened (see Fig. 10). Unlike in the past, the US dollar did not prove to be a safe haven during the phase of heavy selling of risky assets in early April.

In addition to the valuation, structural factors and the US government's desire also speak for a devaluation of the dollar

[2] See: Berenberg Markets Focus "The role of the US dollar in global portfolios is undergoing structural change," May 27, 2025

Fig. 9: US dollar remains overvalued

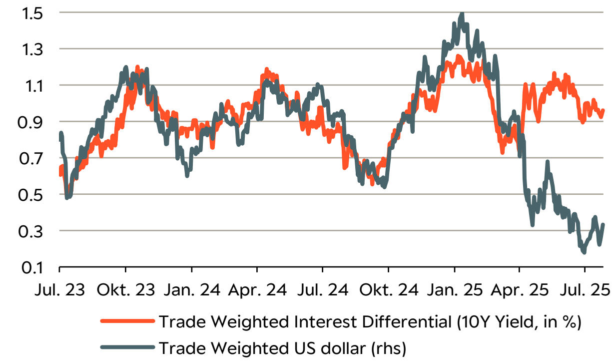
EURUSD compared to EURUSD purchasing power parity according to the OECD



Time period: 01/01/1996 – 25/07/2025
Source: OECD, Bloomberg, own calculations

Fig. 10: Relationship between interest rate differentials and the US dollar recently broken

During the most recent phase of market turmoil, the US dollar did not prove to be the classic "safe haven"



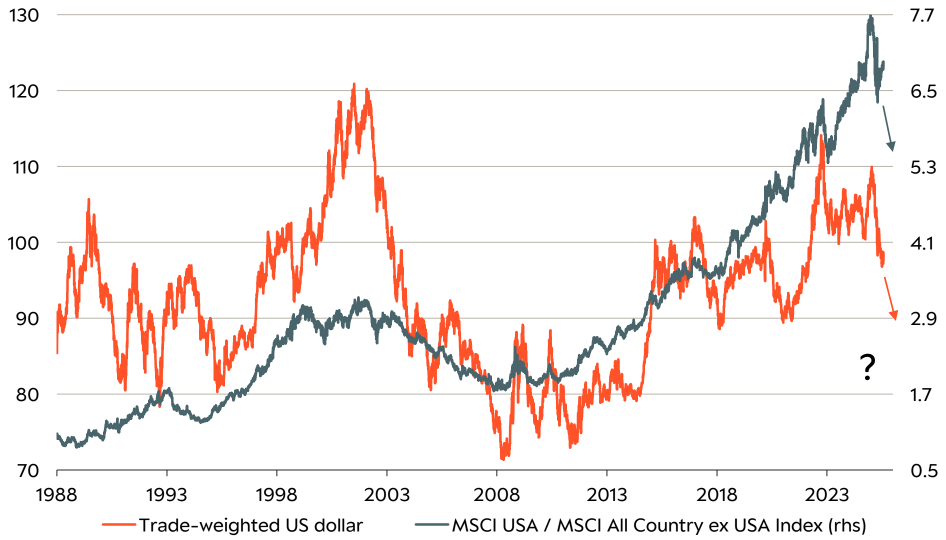
Time period: 01/07/2023 – 25/07/2025
Source: Bloomberg, own calculations

We expect the US dollar to continue to weaken in the medium term, similar to the period from 2003 to 2008, thereby normalizing the overvaluation of the US dollar and US dollar-denominated assets in the coming years. However, Figure 9 also suggests that the dollar is unlikely to stabilize near purchasing power parity after the correction of its overvaluation. It is much more likely that this trend will continue until the US dollar is significantly undervalued. Historically, the US dollar has usually been either significantly overvalued or significantly undervalued. A EUR/USD exchange rate of 1.50 is therefore not unrealistic over a five-year horizon.

The overvaluation of the US dollar and US dollar assets is likely to normalize in the coming years

Fig. 11: Dollar weakness favors stocks outside the US

Trade-weighted US dollar vs. US/world ex. US



Time period: 01/01/1998 – 25/07/2025
Source: Bloomberg, own calculations

In light of this, investors should hedge their currency risks in US dollar investments more strongly, reduce their focus on the US, and diversify their investments more globally. US equities have outperformed over the past 15 years, along with the appreciation of the US dollar (see Fig. 11). A normalisation of the valuation of the US dollar and US dollar investments is likely to lead to better relative performance of investments outside the US in the medium term. For investors who have focused heavily on US investments in

In the medium term, a better relative performance of investments outside the US is to be expected recent years, it may make sense to shift toward investments from the rest of the world. Greater geographical diversification also makes sense again because individual stock regions have shown a declining correlation since the financial market crisis.

Consequence 5: Tangible assets and scarce investments become more important

Parallel to rising debt, the US Federal Reserve has increased the money supply, known as central bank money. An arbitrarily expandable monetary base strengthens asset classes with real value whose supply is limited – i.e., real estate, gold, commodities, and stocks with pricing power or a high "real asset" component (companies that hold real assets whose value is not yet sufficiently reflected in their valuation, e.g., mining stocks…). Demand for scarce assets of the highest quality as protection against inflation and currency devaluation remains high. This is illustrated by the development of the gold price in recent years, and particularly its decoupling from the development of real interest rates in the US.

Demand for scarce, high-quality assets as protection against inflation and currency devaluation remains high

In the past, there has been a strong correlation between gold prices and real interest rates. Gold competes with US government bonds as global reserve assets. Gold is a scarce commodity whose supply grows by only about 1 to 2% annually, but it does not pay interest. Government bonds pay interest but are issued in much larger quantities. When government bond yields are high relative to inflation, they attract investors who would otherwise buy gold. When yields are not high enough relative to inflation, investors flock to gold. Since around 2022, this correlation has broken down (see Fig. 12). Despite rising interest rates, the price of gold has risen. This reflects the shift toward a fiscally dominated environment. This decoupling is relevant for all asset prices with real value characteristics, especially for scarce goods.

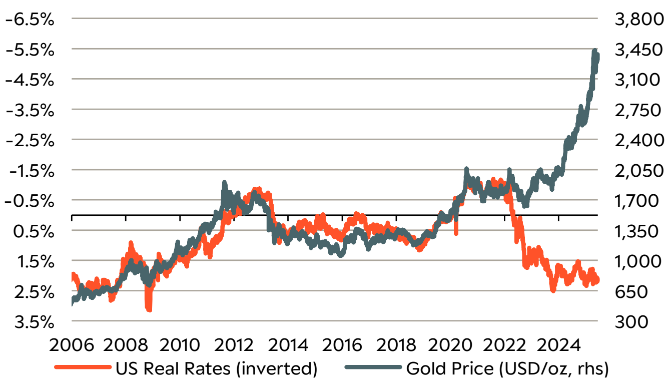
Since 2022, the correlation between gold prices and real interest rates has broken down

We have long argued that an environment of rising government debt, increasing fiscal dominance, and financial repression to ensure the government's debt sustainability argues in favour of a significant proportion of real asset investments in portfolios – at the expense of bonds. The price of gold has risen in parallel with US debt over the past few decades (Fig. 13). If both continue to move in parallel, the price of gold is likely to reach USD 6,000 per ounce in 2035. This would correspond to an annualised return of about 6.3%.

Rising government debt, increasing fiscal dominance, and financial repression argue in favour of including real assets in portfolios

Fig. 12: The price of gold rises despite high US real interest rates

Investors fear a devaluation of the US dollar – they therefore prefer gold to US government bonds, despite their seemingly attractive real interest rates

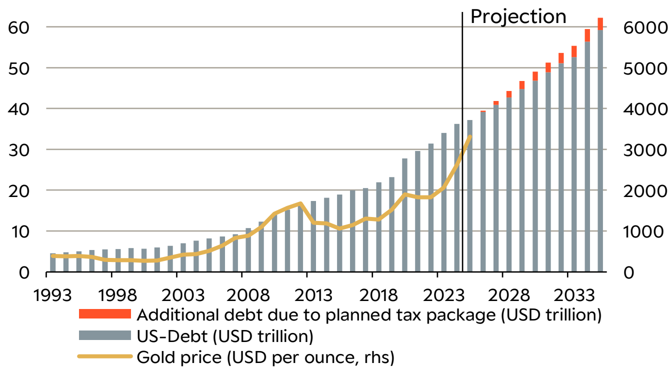


Time period: 01/01/2006 – 24/07/2025

Source: Bloomberg, own calculations

Fig. 13: Potential for gold price rises with debt levels

In view of rising government debt, not only in the US, and a depreciating US dollar, gold remains in demand as a safe haven



Time period: 01/01/1993 – 31/12/2035; As of: 25/07/2025

Source: Bloomberg, own calculations

Consequence 6: Stronger positive correlation between equities and government bonds requires broader portfolio diversification and alternative hedging strategies

In times of elevated inflation and inflation volatility, bonds no longer offer reliable hedging protection. When inflation is the dominant market theme, equities and government bonds tend to move more in tandem. If inflation surprises on the upside (downside), this typically has a negative (positive) impact on both asset classes. Historically, when core inflation reaches 3%, there has been almost exclusively a positive correlation between stocks and government bonds (see Fig. 14).[3] During periods of elevated and volatile inflation rates, bonds no longer reliably fulfil their role as a diversification against equity risks.

If inflation is the dominant issue, stocks and government bonds tend to move more in tandem

Investors should therefore look for alternatives to diversification. Multi-asset portfolios that focus purely on equities and bonds will find it more difficult to effectively reduce their volatility in this environment. There are two solutions to this problem. The first is broader portfolio diversification, which we refer to as "True Multi-Asset," with a higher proportion of real asset investments such as commodities and commodity companies. In addition, these offer a hedging effect precisely when commodity prices lead to inflation surprises and bonds and equities suffer equally from inflation surprises. This was very evident in 2021, in the summer of 2023, and in April 2024.

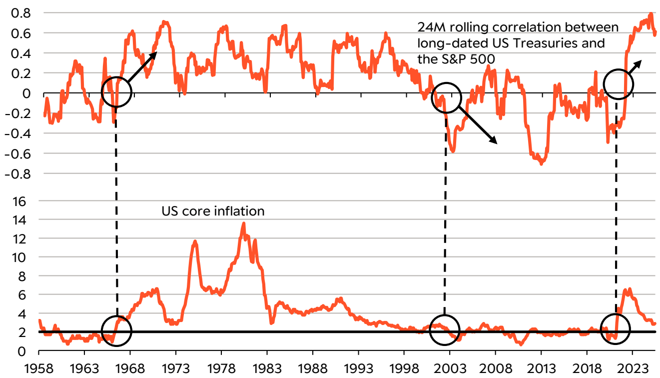
Commodities and commodity companies broaden portfolio diversification

A second solution is to use reliable option-based hedging strategies that can benefit from both falling markets and rising volatility.[4] Many other diversification approaches that appear uncorrelated in stable times show strong correlations in market crises and therefore offer no protection. Their diversification is often disappointing when it is needed most. With option-based hedging strategies, the goal must be to keep the "negative carry," which reduces portfolio returns in good times like a recurring insurance premium, as low as possible. Currently, there are only a handful of investable investment approaches on the market that can achieve this. Demand for these approaches is likely to continue to grow strongly, as option-based hedging strategies can be a sensible alternative to portfolio diversification.

Option-based hedging strategies instead of bonds without reliable diversification effects

Fig. 14: Historically, higher inflation has led to greater correlation between risk assets and government bonds

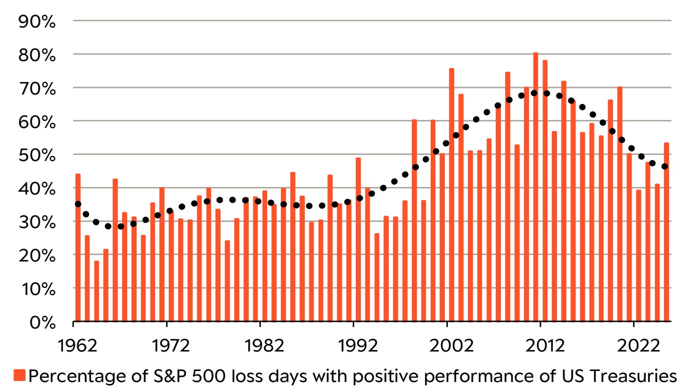
Trend in the 24-month rolling correlation between long-term US government bonds and the S&P 500 Index and trend in US core consumer price inflation



Time period: 01/01/1958 – 30/06/2025
Source: Bloomberg, own calculations

Fig. 15: Bonds also hedge equities significantly less on a daily basis than in the period from 2000 to 2020

Percentage of all S&P 500 loss days with positive performance of US government bonds



Time period: 01/01/1962 – 25/07/2025
Source: Bloomberg, own calculations

[3] See: Berenberg Markets Focus "Stronger synchronisation of equities and government bonds likely to shape the coming years," August 30, 2021
[4] See: Berenberg Insights "Changing market environment requires new ways to diversify" March 13, 2024

Conclusion

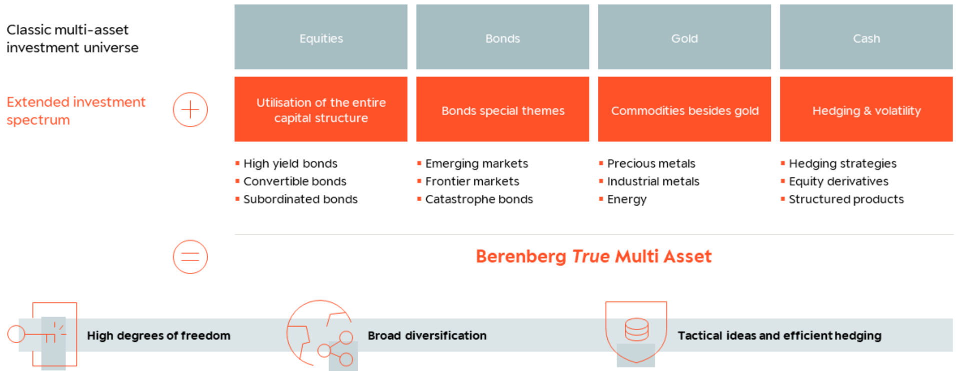
The trend toward sharply rising government debt in both the US and worldwide is unlikely to be halted in the coming years. High government spending and fiscal incentives are likely to prevent a recession in the short term. However, this procyclical stimulation increases the risk of bubbles forming on the financial markets and the economy overheating in the medium term – which could lead to a deeper and more painful recession and the bursting of bubbles on the financial market in the medium term. High government spending, structural inflation, rising bond yields, the devaluation of the US dollar, and the search for real assets and alternative hedges are likely to be the defining trends of the coming years. Investors should urgently take these into account in their strategies.

High government spending, structural inflation, rising bond yields, the devaluation of the US dollar, and the search for tangible assets and alternative hedges are likely to be the defining trends of the coming years

Against this backdrop, we at Berenberg have for years been focusing our multi-asset strategies on a significant proportion of real assets such as commodities, including those other than gold, the use of the full capital structure, and diversification across all asset classes, regions, and segments. We call this approach "True Multi-Asset".[5]

With our "True Multi-Asset" approach, we have been focusing on broader diversification and an increased proportion of real assets in the portfolio for years

Fig. 16: Berenberg *True* Multi Asset – more than just a mix of stocks, bonds, gold, and cash



Source: Berenberg

5 See: Berenberg Markets Focus "A golden age for active and true multi-asset," February 21, 2023

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