

Unsustainable debt: Strategic asset allocation for a new era

With no simple solutions to stabilizing debt and policymakers facing complex financial-market challenges, investors may need to reconsider their approach to diversification across asset classes, geographies, and strategies.

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Research



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Key takeaways

- The rise in interest rates, coupled with persistently high fiscal deficits, is creating further upward pressure on U.S. government debt levels that are already at record peacetime highs.
- The upward adjustment in long-term Treasury bond yields puts them closer to what we would consider fair value, but if debt keeps rising over the medium term, yields may need to go higher to attract the more price-sensitive investors that now make up the vast majority of Treasury ownership.
- It's unlikely that high enough real economic growth can be achieved to single-handedly level out the debt trajectory, implying policymakers may be increasingly motivated to attempt financial repression to hold interest rates at artificially low levels (even in an environment of persistent supply-side inflation pressures).
- These dynamics imply monetary and fiscal policies may be more challenged to respond to economic or financial shocks, and potential policy swings may generate bouts of financial-market volatility; but we don't believe a catastrophic loss of confidence in the U.S. is the most likely scenario.
- Given the unprecedented backdrop, we believe prudent strategic asset allocation warrants maximum diversification: global assets denominated in non-U.S. currencies; hedges (commodities, real assets, TIPS, gold or bitcoin), and alternatives, including liquid alternatives.

Introduction

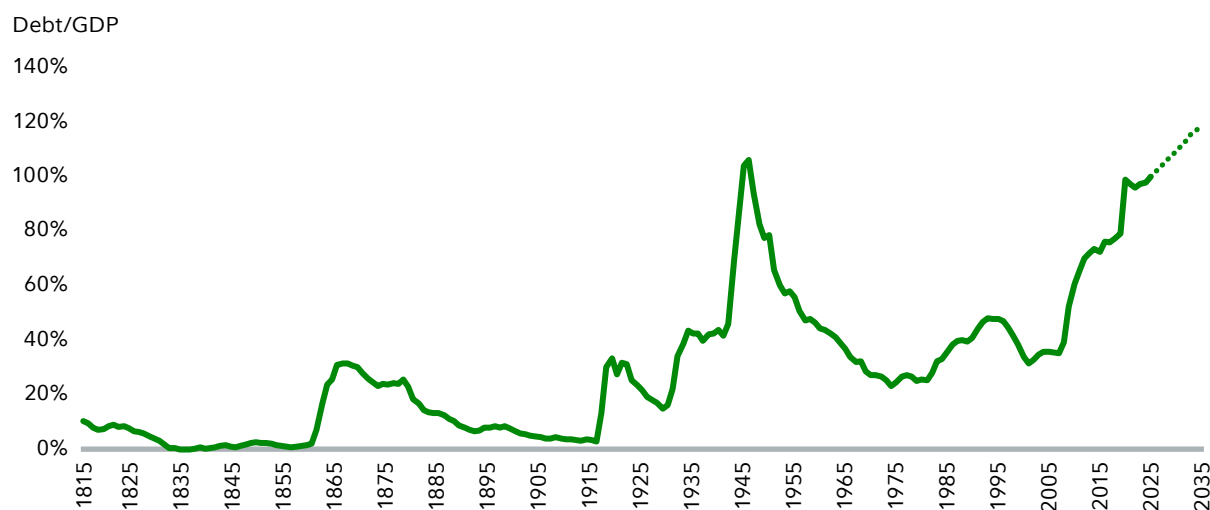
In our 2020 paper [Unsustainable Global Debt: Roadmap for Strategic Asset Allocation](#), we posited that based on historical case studies of highly indebted countries, easy fiscal and monetary policies would eventually provide the catalyst for a shift to a more inflationary regime. Higher inflation would push interest rates up, warranting greater strategic portfolio diversification, including exposure to more inflation-resistant assets.

Today, we appear to be through the first innings of this regime change, as interest rates have adjusted upward. Amid a higher for longer outlook for interest rates and inflation, public debt levels are resuming their upward ascent. The increasing burden of rising public debt service offers a challenging backdrop for fiscal and monetary policies, which will likely have a heavy influence on financial-market outcomes. In this new era, with most of the world's largest economies grappling with higher yields and severe fiscal challenges, we update our thinking on how the backdrop of unsustainable debt affects long-term, strategic asset allocation.

Fiscal outlook even worse than before

The acceleration in inflation from 2022–2023 helped contain debt/GDP levels despite still-large U.S. fiscal deficits. However, by 2025 persistently high interest rates and fiscal deficits raised the cost of debt servicing and put debt back on an upward path. The non-partisan Congressional Budget Office's 2025 baseline projections (according to current law as of this writing, and before the One Big Beautiful Bill Act approved on July 4) foresee a further rise in debt from a peacetime record of 98% of GDP in 2024 to an all-time high of 118% in 2035 (Exhibit 1). Please see the Endnotes on page 11 for more on the CBO and other government estimates that evaluate the potential impact of the reconciliation legislation.

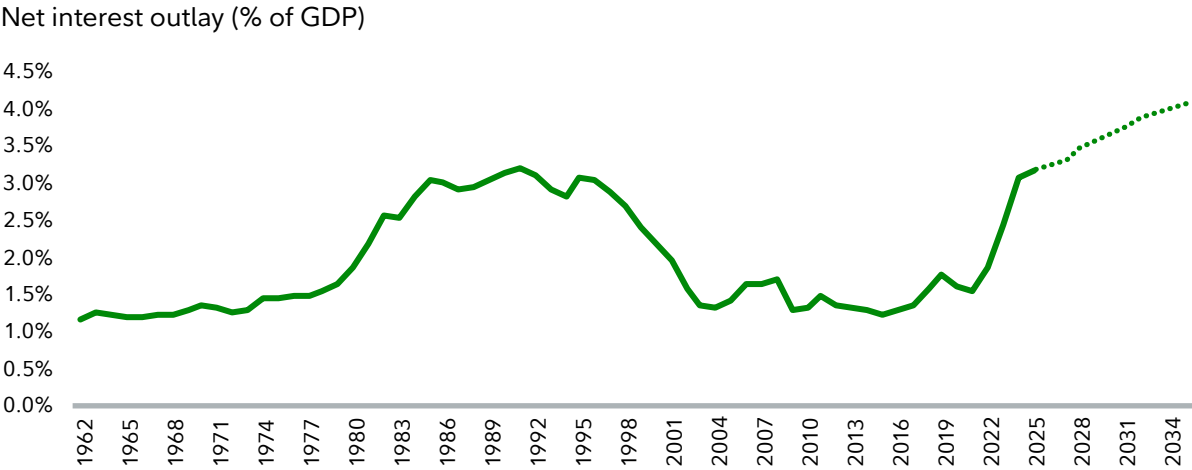
Exhibit 1: The CBO projects that U.S. government debt will rise from a peacetime record of 98% of GDP in 2024 to an all-time high of 118% in 2035.



Source: Congressional Budget Office (CBO), as of June 30, 2025. Debt/GDP is CBO baseline. Does not reflect the impact of the One Big Beautiful Bill Act. <https://www.cbo.gov/publication/61187>

Moreover, the rise in interest expense is taking on a larger share of the budget and exacerbating the political difficulties in addressing the fiscal situation. Interest payments on the debt rose to 3.1% of GDP—more than double the 1.5% level in 2021—and are projected to rise above 4% over the next decade (Exhibit 2). Interest payments accounted for 13% of government expenditures, up from just 5% in 2021 and on pace to rise to 17% by 2035.

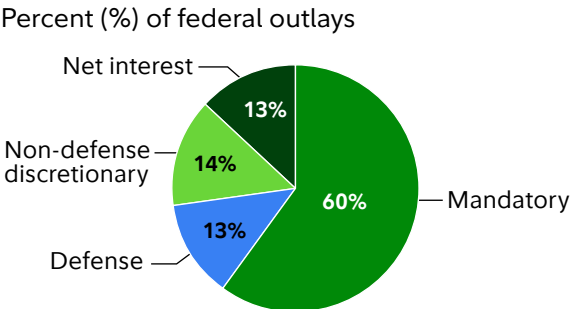
Exhibit 2: Interest payments on debt have doubled to 3.1% of GDP in just the past four years, and are projected to rise above 4% over the next decade.



Source: Congressional Budget Office (CBO). As of June 30, 2025. Does not reflect the impact of the One Big Beautiful Bill Act.

The nature of required interest payments reinforces the trend that an increasingly large portion of federal expenditures—including the more than 60% of “mandatory” spending for entitlement programs such as Medicare and Social Security—are legally obligatory (Exhibit 3). Moreover, deteriorating demographic trends put these entitlement programs on pace to deplete their trust funds over the next decade, signifying there is an implied present-value unfunded liability equal to 290% of today’s GDP. Defense spending is about 13% of outlays, leaving only about 14% of the entire expenditure budget considered non-defense “discretionary” spending. In this environment, enacting stricter fiscal policy has proven politically unattainable.

Exhibit 3: Only about 14% of the entire US spending budget is non-defense “discretionary” spending.



Source: Center for Medicare and Medicaid Services, 2025 Annual Report of the Board of Trustees.
<https://www.cms.gov/oact/tr/2025>

New legislation not likely to stabilize debt levels

The fiscal legislation would, based on preliminary CBO estimates as of this writing, further increase deficits by \$3.4T over the next decade. Fiscal deficits during this period would average about 7% of GDP, nearly double the 3.7% average over the past 50 years.¹

Due to political polarization, major changes in fiscal policy have had a tendency to happen only every four years (at best), implying the potential for a proactive policy change to address the fiscal trajectory appears unlikely before at least 2029. As a result, if interest rates stay at current levels (or go higher), the deteriorating debt backdrop is likely to lurk over financial markets in the coming years and play an influential role in investment outcomes.

Can higher growth, inflation, or financial repression make debt sustainable?

As we discussed in the last paper, there is no magic threshold level that provokes a public debt crisis. However, no country has ever increased debt/GDP indefinitely, and financial and economic risks increase as the level goes higher and servicing the debt becomes increasingly burdensome.

History shows not only that fiscal austerity is more difficult to achieve once a country is highly indebted, but also that successful debt consolidations (lowering debt/GDP) are typically not achieved through fiscal austerity alone. Instead, debt sustainability typically requires maintaining a pace of nominal GDP growth (often through higher inflation, sometimes also through higher real growth) sufficiently above the rate of interest paid on the debt.

Exhibit 4 shows CBO’s baseline economic and interest-rate assumptions that underpin its 10-year debt forecasts. Nominal growth of 3.8% (2% inflation, 1.8% real growth) is higher than the implicit interest rate of 3.5% (weighted average payments on debt), but it’s still not sufficient to keep debt/GDP from rising due to the high stock of debt and expected primary fiscal deficits.

The three alternative scenarios include three shaded values that illustrate what would mathematically be required of each individual metric to single-handedly stabilize the debt/GDP near current levels if the other two remained at the CBO baseline forecast. For instance, if the nominal growth forecast of 3.8% proved correct, interest rates would need to be held at 1.5% for the next 10 years to keep the debt/GDP stable, given the CBO’s projected path of primary (non-interest) balances.

Exhibit 4: Three possible scenarios over the next 10 years to stabilize debt/GDP—1. Rates hold at 1.5%; 2. Inflation averages 4.0%; 3. Real GDP growth averages 3.8% (with the other two metrics staying at the CBO forecasts).

		Annualized rates (2025–2035)			Shaded areas represent the rate required of that variable in order to stabilize debt/GDP over the next decade if the other two variables are held at the CBO baseline level.
	CBO baseline	Alternative scenarios			
Interest rate	3.5%	1.5%	3.5%	3.5%	
Inflation	2.0%	2.0%	4.0%	2.0%	
Real growth (GDP)	1.8%	1.8%	1.8%	3.8%	
Nominal growth (GDP)	3.8%	3.8%	5.8%	5.8%	

Source: Congressional Budget Office (CBO), Fidelity Investments (AART), as of June 30, 2025.
¹ Congressional Budget Office. "Information Concerning the Budgetary Effects of H.R. 1, as Passed by the Senate on July 1, 2025." See: [61537-hr1-Senate-passed-additional-info7-1-25.pdf](#)

Any flavor of these scenarios would require some combination of significantly different outcomes than CBO's forecasts and a major sustained divergence between interest rates and economic fundamentals. Could the estimates be wrong in a way that improves the debt outlook? Let's investigate possible alternative assumptions.

- **Tariff revenues?** U.S. tariff revenues are not included in the CBO's analysis of the tax and fiscal legislation approved in July, and if the annualized rate of collection in June 2025 were to continue for the next decade it would raise more than \$2 trillion of additional revenues and could roughly offset the increased deficits from the recent fiscal legislation.² However, even this result would simply offset the extra cost of the latest fiscal package (not stabilize debt/GDP), and this assumption does not take into account that higher tariff collection would likely weigh on GDP growth (if any of the tariff cost is absorbed by U.S. businesses or consumers).
- **Higher growth?** Our real GDP forecast is exactly the same as the CBO's at 1.8%, and we view the upside and downside risks to this forecast as roughly balanced. On the upside, AI could become a transformative technology and potentially add nearly 1% of real growth for a decade once adoption ramps up. (For more, please see "Artificial Intelligence: An X-factor in a New Investment Regime," and "A Strategic Allocator's Guide to Productivity and Profits.") On the downside, real growth would be 0.5% slower over the next couple of decades if immigration comes to a stop and would be slower yet if the immigration rate becomes net negative. Overall, U.S. real growth on a rolling 10-year basis hasn't reached 3.8% needed to stabilize debt/GDP since the late 1960s to mid-1970s, showing how difficult it would be to sustain a productivity boom in a mature economy with aging demographics.
- **Lower interest rates?** The CBO assumes an average of 4% for the 10-year Treasury yield over the next 10 years, with a projected 3.5% average interest rate on the entire stock of debt (short and long term). Higher growth or inflation expectations would presumably push up interest rates even more, unless rates could be influenced below the nominal growth fundamentals.

In summary, there appears no simple solution to prevent debt levels from rising further, and until there is a greater political impetus to reduce fiscal deficits, policymakers may be motivated to attempt forms of financial repression to expand the gap between nominal growth and interest rates.

"Financial repression" is the term commonly used to describe when policymakers actively attempt to set interest rates at artificially low levels in order to service the debt. For example, the United States successfully held 10-year Treasury yields around 2% during and in the years immediately following World War II in order to finance wartime expenditures.

With no simple solution to prevent debt levels from rising further, policymakers may be motivated to attempt forms of financial repression to expand the gap between nominal growth and interest rates.

² U.S. Treasury, Bureau of Economic Analysis, as of June 30, 2025. Other estimates, such as those from the CEA and the CRFB, do incorporate the potential impacts of the tariffs. See Endnotes on page 11 for more information.

The challenge is that government policy has to remain credible—and investors satisfied with the bond yields being earned—for this policy to be sustainable. If bondholders perceive that the government is attempting to inflate away its debt or offering insufficient yield compensation, they may become discouraged from holding government bonds. This can then result in higher interest rates, a weaker currency, and in a worst-case scenario a crisis of confidence that would devastate debt consolidation efforts. Our long-term study of highly indebted countries highlighted several examples of financial repression efforts that ended with bouts of runaway inflation, including Germany after World War I.

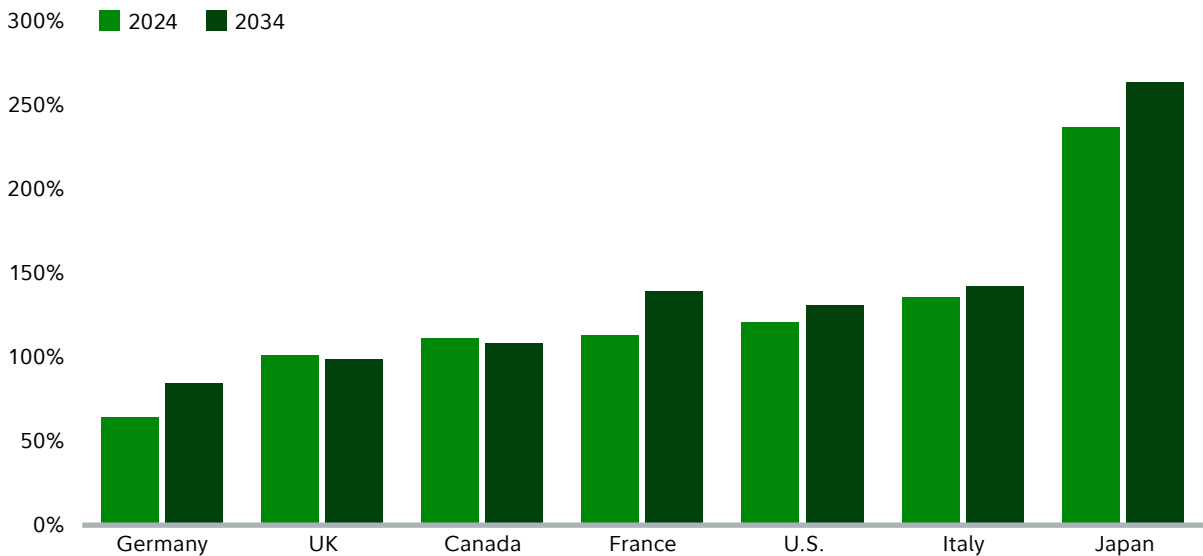
Without a silver bullet for U.S. debt consolidation on the horizon, investors will likely be more sensitive in the coming years to how fiscal policy and government debt issuance affect the environment for interest rates and the overall investment landscape.

Not just a U.S. issue

A similar debt dynamic also exists outside the U.S., as most of the world’s largest advanced economies possess high debt levels, deteriorating demographics, and severe long-term fiscal challenges. Six of the seven G7 countries have debt/GDP levels of at least 100%, and we expect most of them to continue rising over the next several years given the International Monetary Fund’s (IMF) projections of primary (non-interest) balances (Exhibit 5). Recent developments, such as the elimination of the debt “brake” in Germany to allow for greater fiscal expenditure on defense, have likely exacerbated the outlook.

Exhibit 5: Six of the seven G7 countries have debt/GDP levels of at least 100%, and we expect most to continue to rise over the next several years.

Gross government debt (% of GDP)



Source: International Monetary Fund (IMF), Fidelity Investments (AART). As of June 30, 2025.

Yields: More fairly valued, but more sensitive to fiscal outlook

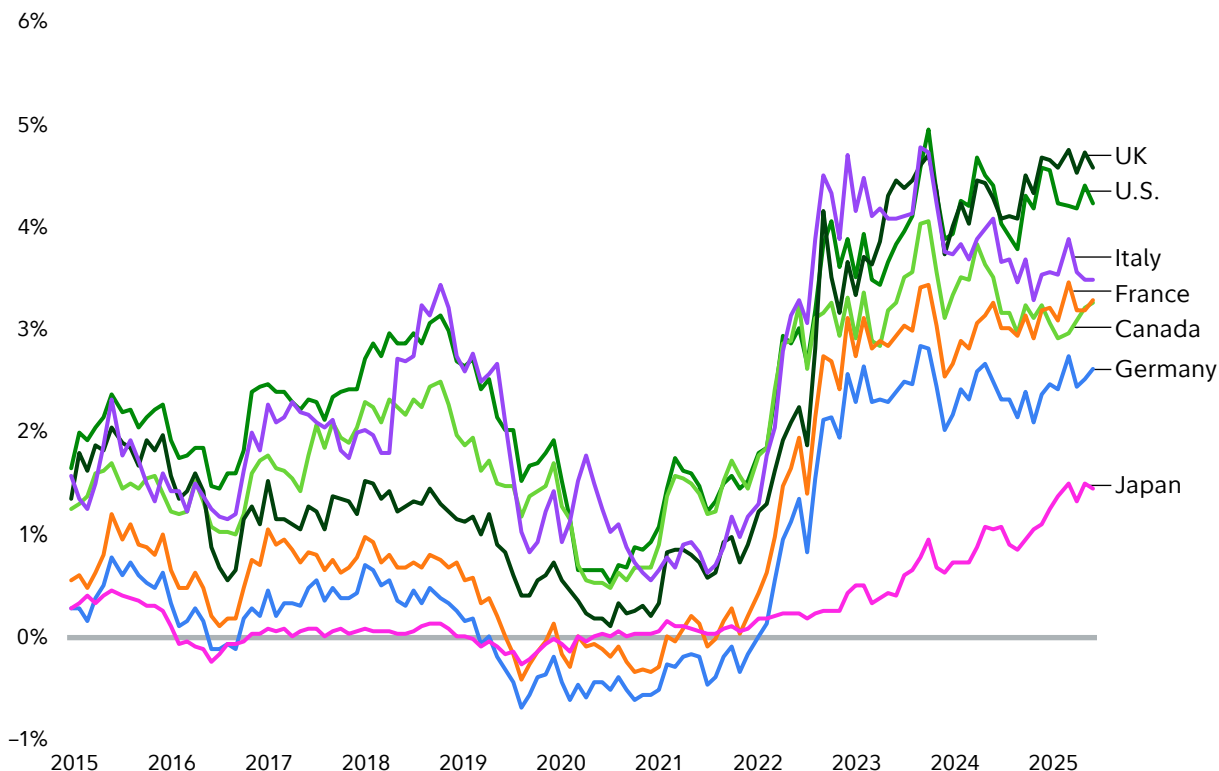
Higher public debt levels in the U.S. and other advanced economies imply there is a larger supply of government bonds that must be absorbed by investors. The “Liz Truss moment” in 2022—when the UK government’s plans for unfunded tax cuts contributed to a 200-basis point spike and 20-year high in 30-year UK government bond yields—illustrates we have re-entered an era when fiscal dynamics can influence financial markets.

The good news is long-term bond yields have already adjusted upward in the past several years (see Exhibit 6), and their yields are now closer to what we would consider fair value based on our long-term fundamental outlooks for growth and inflation. For instance, in the U.S., long-term government bond yields rose significantly beginning in 2022 and have remained at levels not seen since before the Global Financial Crisis (GFC) in 2008 (4.4% as of July 7, 2025).

Over long periods of time, we estimate 10-year Treasury yields should roughly trade at the long-term growth rate in nominal GDP, which we estimate at about 4.4%. (For more, please see “Secular Outlook for Global Growth: The Next 20 Years.”) The bond yields of several other G7 countries are also nearer our long-term estimates of their nominal GDP growth, implying that yields may already have reconnected to long-term fundamentals after a prolonged disconnect following the GFC.

Exhibit 6: Yields may have reconnected to long-term fundamentals after a prolonged disconnect following the GFC.

10-year sovereign bond yields (%)



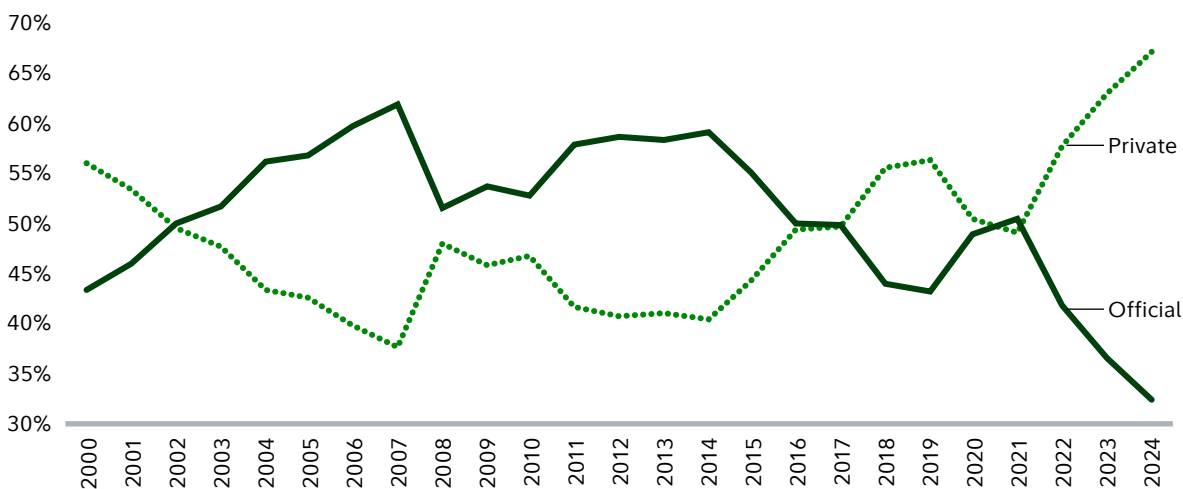
Source: International Monetary Fund (IMF), Fidelity Investments (AART). As of June 30, 2025.

However, if debt levels continue to rise as expected, it remains to be seen whether yields will need to increase even further to attract additional investment. The demand outlook is complicated by the fact that central banks are no longer major purchasers of government bonds as they were during the post-GFC decade of quantitative easing, and in fact several (including the Federal Reserve) have been reducing the government-bond holdings on their balance sheets.

As a result, private investors—both domestic and foreign—now hold two-thirds of U.S. Treasury bonds, up from a low of 38% on the eve of the GFC in 2007 (Exhibit 7). The ownership of Treasuries is now dominated by investors who tend to be more price-sensitive, and are thus more likely (than central banks) to demand higher yields if they perceive elevated fiscal risks or diminished creditworthiness.

Exhibit 7: Private investors now hold two-thirds of U.S. Treasury bonds, while central bank ownership has declined since the end of asset purchases during quantitative easing.

U.S. Treasury ownership



Source: U.S. Treasury, Federal Reserve, Fidelity Investment (AART). As of Dec. 31, 2024.

Since the mid-1980s, median U.S. 10-year Treasury yields were 30 basis points less than the U.S. nominal rate of growth, a lower borrowing cost that can probably be attributed to U.S. “exceptionalism” due to the status of the dollar as the world’s reserve currency and Treasuries as the global reserve asset. AAA-rated governments outside the U.S. centered almost exactly at their nominal rate of GDP growth, while non-U.S. developed countries that were AA-rated during this time experienced median 10-year borrowing costs 60 basis points above their nominal GDP growth. This suggests a further deterioration in the perception of U.S. fiscal risk could translate into less advantageous borrowing terms and potentially push up long-term yields above their fundamental fair-value levels, which would increase interest costs and further complicate the fiscal outlook. (Note: The U.S. is AA-rated by all three major credit rating agencies after the downgrade by Moody’s in May 2025.)

New regime: Debt backdrop creates more challenging monetary-fiscal policy dynamic

We believe the rise in yields over the past three years marked the early innings of a new regime, a break with the decade that followed the GFC. Today's regime is defined by greater supply-side inflation pressures (demographics, de-globalization, climate) that make a return to steady, low inflation and interest rates difficult.

The challenges (and connection) of fiscal and monetary policy in this environment is the defining feature of this regime for the financial markets. In the past several decades amid low inflation, the Fed could ease monetary policy aggressively to address any financial or economic problems that arose, and fiscal policy could be used as countercyclical stimulus during economic downturns. Now, however, with more persistent inflation, higher levels of interest rates, and market concerns about fiscal sustainability, policymakers likely face greater limitations. In this environment, we could see the following:

1. More difficulty addressing shocks to the system

Any disruption to steady trends—from a burst of inflation, a recession, or trade wars—may create complex financial-market challenges for policymakers that are more difficult to address. For instance, already large budget deficits could widen significantly if revenues drop during a recession, potentially limiting the space to ease fiscal policy.

2. Tendency toward fiscal dominance and financial repression

At high levels of debt and with climbing interest payment outlays by the federal government, interest-rate decisions by the central bank typically become more influenced by debt-financing considerations. This “fiscal dominance” can create a situation where fiscal policy overshadows monetary policy for the economy and financial markets, and there is a natural tendency toward financial repression to keep interest rates artificially low. Policy options include a wide variety of

measures including encouraging banks to own more Treasuries, but there are risks of unintended consequences as well as of compromising the central bank's independence and credibility.

3. Potential for market volatility due to fluctuations in policy

The combination of greater susceptibility to shocks and prospective efforts to subdue interest rates below market levels provides a more volatile backdrop for policymakers. As they confront one challenge, they may sow the seeds of the next challenge, creating the possibility of dramatic policy swings. For instance, if inflation accelerates when interest rates are being held artificially low, monetary policymakers may need to shift from financial repression to hawkishness. The presence of similar debt and policy challenges across other major economies further compounds the potential for these episodes to generate global market volatility.

Monetary/fiscal challenges: No silver bullet

- Risks may rise as debt and debt costs become more challenging
- Shocks to the system may be harder to address
- Tendency toward financial repression
- Fiscal policy could overshadow monetary policy
- Confronting one problem may sow the seeds of another one

Investment implications for strategic asset allocation

In the short term, financial-market trends may be driven by near-term fluctuations in the economy, corporate earnings, investor sentiment and behaviors, and other cyclical factors. However, we believe the medium-term debt backdrop offers the following considerations for longer-term, strategic asset allocation decisions.

- Catastrophic worst-case scenarios—for instance, a crisis of confidence in the U.S. Treasury market and dollar—are not the most likely outcomes. However, we acknowledge that we are in uncharted territory with no obvious historical parallels, which makes it harder to analyze and assign probabilities to potential outcomes.
- With fiscal concerns unlikely to disappear anytime soon, it's reasonable to expect potential rate volatility and less diversification from U.S. Treasuries than during the past few decades. Current yields suggest a solid outlook for long-term bond returns on an absolute basis, but we should probably expect higher bond-equity correlations and less price appreciation potential for bonds to offset equity downturns (at least compared to the post-GFC period).
- Maximum diversification within a strategic asset allocation is warranted, something that with perfect hindsight we know was not as necessary during the past several decades of falling rates, low inflation, and lower debt levels. This diversification may include:
 - Inflation hedges (commodities, real assets, TIPS) to guard against the historical proclivity of policymakers to attempt to use inflation as a tool of debt consolidation.
 - Global assets denominated in non-U.S. currencies, in order to hedge against the potential for dollar weakness and foreign capital flows to seek diversification away from dollar-dominated exposures.
 - Other hedges that offer exposures to a greater variety of conditions, such as alternatives (including liquid alternatives), gold or bitcoin, which may have lower correlations with traditional stocks and bonds. (For more, please see, “A Call to Action for Building Resilient Portfolios.”)
 - Funding diversification from both fixed-income and equity positions. Today's long-term valuation starting point is more favorable for U.S. bonds than U.S. equities due to fair-valuation bond yields and historically high equity PE ratios. (For more, please see, “Capital Market Assumptions: A Comprehensive Global Approach for the Next 20 Years.”) This is a notable change from our last paper—written when rates were at historically low levels—which suggested funding diversifying positions by reducing the fixed income portion of the allocation. In this new era, bonds will likely prove to be a crucial portion of long-term allocations, and increased diversification will need to be a “whole of the portfolio” exercise.

Investment implications: Greater diversification warranted

- Inflation hedges (commodities, real assets, TIPS)
- Global assets denominated in non-U.S. currencies
- Other hedges (gold, bitcoin)
- Diversify equity/fixed income positions

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Investment Thought Leadership Vice President Martine Costello Duffy provided editorial direction for this article



Endnotes

About CBO forecasts and other government debt estimates:

The CBO was established by the Congressional Budget Act of 1974 to provide objective, nonpartisan information to support the Congressional budget process and to help the Congress make effective budget and economic policy. The CBO is among a number of government agencies and organizations that provide estimates and analyses on the impact of policy to debt levels, which can differ based on the assumptions used and over what time periods. Other forecasts have been prepared by the Council of Economic Advisers (CEA), an agency within the Executive Office of the President established by Congress in the 1946 Employment Act, and the Committee for a Responsible Federal Budget, a non-profit, bipartisan organization.

For more, please see: cbo.gov; whitehouse.gov/cea; and crfb.org.

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