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**SPINOSA WEALTH**  
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*The Power Of Minds Over Money*

# The Debt Ceiling and the Road Ahead



After all the debate in recent weeks over issues related to raising the nation's debt limit, it's hard to know exactly what might happen after August 2. Borrowing represents more than 40% of the nation's expenses, and any default on the country's obligations would be unprecedented.

As a rule, panic generally doesn't help you make wise financial decisions. That's why now might be a good time to review your portfolio to see if you have more exposure to a particular asset class than you'd prefer, regardless of what happens in Washington. And as the situation evolves, here are some mileposts that bear watching:

## **Auctions of Treasury securities**

The yield on the 10-year Treasury note can serve as a barometer of anxiety levels; the higher the yield goes, the more bond prices will fall, indicating increasing anxiety in the bond markets.

Regardless of whether the debt ceiling stays the same, several significant auctions of Treasury securities are scheduled shortly after the August 2 deadline. Bids for 3- and 10-year notes and 30-year bonds will begin on August 3, and auctions will take place August 9-11. More importantly, the nonprofit Bipartisan Policy Center (BPC) estimates that payment of roughly \$90 billion on maturing Treasury securities is due on August 4.

The difficulty in producing an agreement to raise the limit has led two major credit rating agencies to announce they are officially reviewing the United States' historically impeccable credit rating. Even if the Treasury attempts to avoid defaulting on Treasury securities by prioritizing payment of its obligations, the rating agencies have warned that any such move would likely trigger a downgrade, especially if no consensus has been reached on how to tackle the deficit.

A lowered credit rating would mean the United States would have to pay more to borrow in the future, making the national debt problem even worse in the long term. That's because the greater uncertainty about the country's willingness and ability to pay its bills would likely lead both domestic and foreign investors to demand greater compensation for buying Treasuries.

## **Bonds and non-Treasury borrowing**

Higher interest rates for Treasury bonds might also result in higher interest rates on other, nongovernmental loans such as mortgages and consumer credit. Since many interest rates are based on Treasury rates, rates generally would likely be affected. And since bond prices fall when rates rise, you should keep an eye on your bond portfolio.

One indicator of investors' assessment of the risks of Treasury bonds compared to other debt is what's known as the Baa/Treasury spread, which measures the difference between the yields of corporate bonds rated Baa and 10-year Treasuries. Normally, investors demand a higher yield for corporates because of their greater risk of default. The narrower the gap between the two, the less risky investors feel corporate bonds are compared to Treasuries.

Higher rates also could mean reduced credit availability. Some observers worry that tighter credit on top of a weak housing market could hamper economic recovery. And even if there were technically no default, the mere absence of an agreement that addresses the issue before August 2 would likely raise the global anxiety level substantially.

## **Equities**

The stock market hates uncertainty, and the greater the uncertainty, the greater the potential impact on stocks. If investors become concerned about the availability of credit, they could punish companies that rely heavily on it. Fortunately, in the wake of the 2008 financial crisis, many companies took advantage of low interest rates to issue new bonds and/or refinance older debt. Also, many

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companies, fearing a sequel to 2008, have been sitting on a larger amount of cash than usual, which could help cushion the impact of tighter credit.

Markets also will be assessing the impact of either severe budgetary cutbacks or prioritization of existing government bills on the already fragile economy as a whole. If either seems to pose a serious threat to consumer spending, equities could feel the fallout.

## **Payment of government benefits, contracts, and departments**

According to the BPC, the country will have roughly \$172.4 billion coming in during the rest of August to pay \$306.7 billion of scheduled expenditures. Without an increase in the borrowing limit, the Treasury will have to rely on those revenues and prioritize which of its existing bills to pay. Here are some of the major payments scheduled for shortly after the Treasury's August 2 deadline:

Social Security payments for beneficiaries who began receiving benefits before May 1997 or who receive both benefits and Supplemental Security Income (SSI) are scheduled for August 3. Benefits for recipients with birth dates between August 1-10 are scheduled for the following Wednesday, August 10. Those with birth dates between the 11th and the 20th are scheduled for August 17, and August 24 is the date for birthdays between the 21st and the 31st.

For military service members, August 15 is the date for the scheduled mid-month installment of active duty pay, with the associated "advice of pay" notice set for August 5. And as previously noted, an estimated \$90 billion in Treasury debt payments are due August 4.

Medicare, Medicaid, Social Security benefits, defense vendor payments, interest on Treasury securities, and unemployment insurance represent some of the federal government's largest costs for the month. The BPC estimates that covering those costs completely would leave no funds for such obligations as the Departments of Education, Labor, Justice, and Energy; federal salaries and benefits; military active duty pay and veterans' affairs; the Federal Transit Administration, Federal Highway Administration, Small Business Administration, and the Environmental Protection Agency; Housing and Urban Development and federal food and nutrition services; and IRS refunds.

## **The outlook for an agreement**

Plans have been put forward to tie increases in the debt ceiling to a balanced budget constitutional amendment, to specific spending cuts, and to a combination of spending cuts and revenue increases. There also has been talk of a fail-safe plan that would give the president authority to increase the debt ceiling in stages before the 2012 election; Congress would be able to vote against those increases but would not be able to effectively prevent them.

One proposal that seems to have a chance of winning at least some bipartisan support is based on months of negotiations by the "Gang of Six" senators from both parties. The proposal is designed to cut an estimated \$3.7 trillion from the deficit over 10 years through such measures as shrinking the current six tax brackets to three, eliminating the alternative minimum tax, revising how Social Security cost-of-living increases are calculated, and reducing tax deductions for such items as mortgage interest, charitable donations, and retirement savings.

All parties have agreed it's important not to jeopardize the country's financial health. As the road to a resolution unwinds, it can be helpful to keep calm and monitor the situation.

*All investing involves risk, including the risk of loss of principal, and there can be no guarantee that any investment strategy will be successful.*

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