INVESTMENT INSIGHTS

Analysis, Insights, and a Different Perspective — June 2023

KEY POINTS

- The U.S. typically has a budget deficit by spending more than it earns, leading to an ongoing increase in debt.
- The government often borrows to cover expenses within a limit set by Congress, known as the "debt ceiling."
- Despite concerns over U.S. debt default, the chances remain low due to manageable debt interest rates and political desire to avoid default.

NAVIGATING THE DEBT CEILING

As negotiations continue to the last hour, the U.S. debt ceiling is a key issue worrying many investors today. In this issue, we examine the financial dynamics of the United States, examining its recurrent budget deficit and the debt ceiling.

DEFICIT AND SURPLUS

When the U.S. federal government brings in more money than it spends, it is called a budget surplus. As you can see in the graph on page 2, in the 1990s and early 2000s, a rare combination of tax increases and spending cuts led to a rare surplus for a few years. When the U.S. federal government spends more money than it receives, it is referred to as a budget deficit. The graph on page 2 illustrates that the U.S. is commonly in a budget deficit and usually spends more money than it earns. This is especially true during weak economic times. For example, during the Great Recession in 2008-2009, the budget deficit escalated because of increased stimulus spending and reduced tax revenue. Both were also greatly inflated by the impact of the COVID-19 pandemic, which resulted in substantial government spending to help support the economy and individuals.

Relative to GDP, the U.S. ran a 15% deficit in 2020 and a 12% deficit in 2021. Last year, the U.S. had a 5% deficit relative to GDP, lower than the previous two years but still higher than the average of the five years before COVID-19. The government spent $1.4 trillion more than it earned; the total outlay (or spending) on things like Social Security, defense, and health care, was $6.3 trillion, whereas the revenue collected from taxes was only $4.9 trillion.[1] The federal government has already spent $925 billion over what it brought in for fiscal year 2023, putting the U.S. in a deficit for the year.[2]

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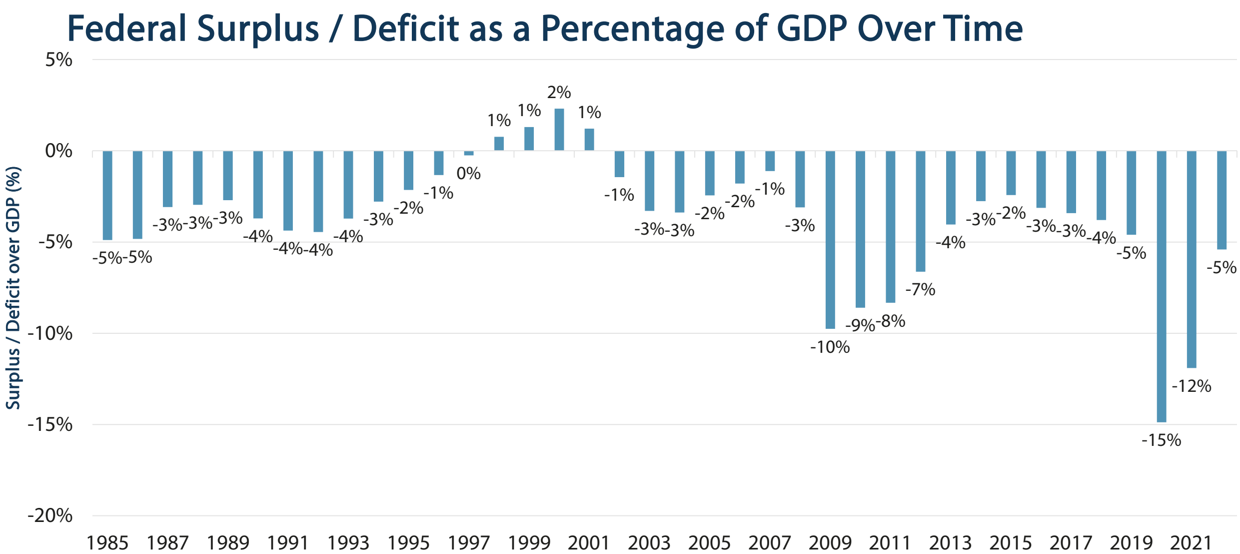
1 U.S. Treasury Fiscal Data
2 U.S. Treasury Fiscal Data

ECONOMIC IMPACT OF A BALANCED BUDGET WITH U.S. DEFICIT SPENDING

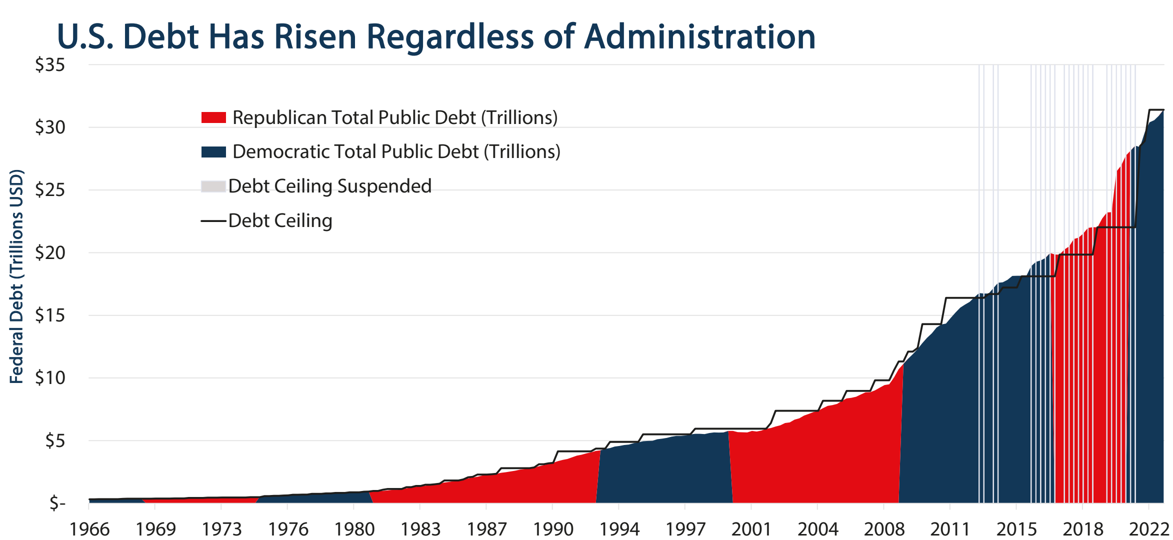


Source: U.S. Office of Management and Budget and Federal Reserve Bank of St. Louis, Federal Surplus or Deficit [-] as Percent of Gross Domestic Product

DEBT CEILING

The U.S. government typically issues debt to make up for this general shortfall, allowing the government to meet its financial obligations despite insufficient income. The U.S. Treasury Department is tasked with managing the finances and has been given the authority to issue debt up to the borrowing cap. This borrowing cap is the “debt ceiling,” or the maximum amount the government can borrow. Earlier this year, the U.S. hit its debt limit, and the Treasury is using what it calls “extraordinary measures” to keep the federal government operating. The Treasury is using its cash reserves or relying on incoming tax revenues, as it can no longer issue new debt.

These measures, however, are temporary and, according to the Treasury, are expected to be exhausted in early June. The date at which these short-term measures run out is called the “x-date,” or the date at which the U.S. cannot meet its financial obligations and thus defaults on its debt. The debt ceiling, however, is not fixed and can be changed based on approval from Congress. As you can see in the graph below, regardless of the political party in power, the budget deficits have led Congress to either increase or suspend the debt ceiling. Since World War II, this has occurred more than 100 times.[3] More recently, over the past 20 years, the debt limit has increased by approximately 400%.[4]



Source: Federal Reserve Economic Data, White House Archives, U.S. Department of the Treasury, National Archives

3 Federal Reserve Economic Data
4 NPR

POLITICS

The leadership of the two parties is currently negotiating on this topic. Republicans want certain spending cuts before they are willing to vote for a debt ceiling increase. Some of these demands are easily agreeable, while others are not. Their overall goal is to cut nonessential government spending on programs that are not mandated, and they hope the threat of default can allow negotiation on these demands.[5] The Democrats, on the other hand, believe the best solution to the problem would be increasing the debt ceiling without any underlying conditions. They believe they can focus on the spending and budget problems once the debt ceiling is raised.[6] The Senate Democrats offered a bill to raise the debt ceiling until December 2024.[7] Given their differences, both sides may likely have to compromise to strike a deal.

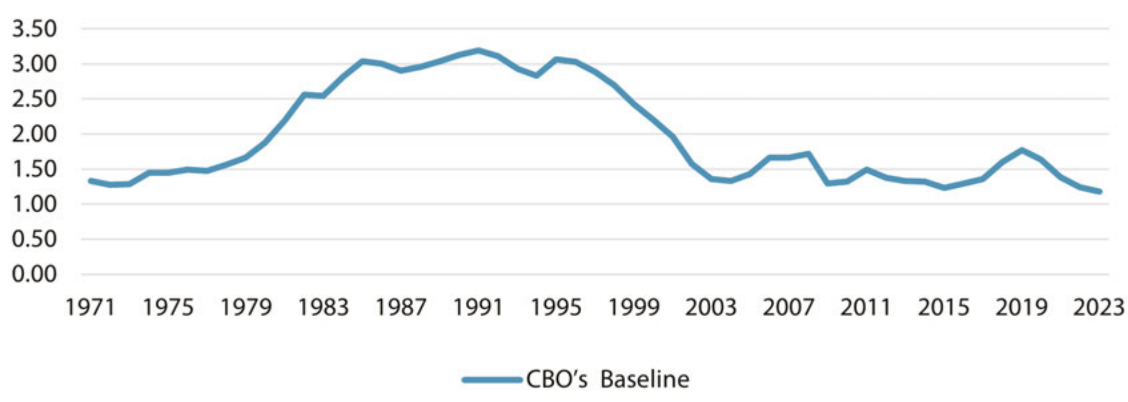
WHAT IT MEANS FOR YOUR INVESTMENTS

Given the importance of the U.S. economy and financial markets, many investors are worried about the possibility of the U.S. defaulting on its debt. For example, some parts of the short-term Treasury market have recently been distorted, with investors opting to avoid debt maturing near the x-date. Overall, the odds of a U.S. default remain low for several reasons.

First is that the U.S. does not have a problem sustaining medium-term debt. As you can see in the graph below, despite the government's growing debt, the money spent on debt interest compared to the country's total economic output has been higher in the past. Even though there's more debt, the U.S. can still manage to pay it off. This is mainly because the country's economy has also been growing. Politics and long-term debt sustainability aside, the U.S. can issue more debt, which seems sensible given the consequences of a default. Indeed, a U.S. default would be the first time in history an economic power has defaulted on its debt even though it has no immediate debt sustainability issues.

Second, both political parties have suggested that, while their political position is important to them, they would not want the U.S. to default on its debt.[8] In fact, early reports on May 26, 2023, suggest that the political parties have made some progress on their negotiation, and official details will likely be announced soon.[9]

NET INTEREST OUTLAYS (PERCENTAGE OF GROSS DOMESTIC PRODUCT)



Source: Congressional Budget Office

The debt ceiling has the potential to impact markets in the short term; however, historically speaking, these events often become footnotes in history. Instead of focusing on these short-term uncontrollable events, investors may be better served by concentrating on their financial goals and maintaining a long-term perspective.

5 CNBC
6 CBS
7 The Guardian
8 New York Times
9 NPR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