



# 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.<sup>1</sup> 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.<sup>2</sup>

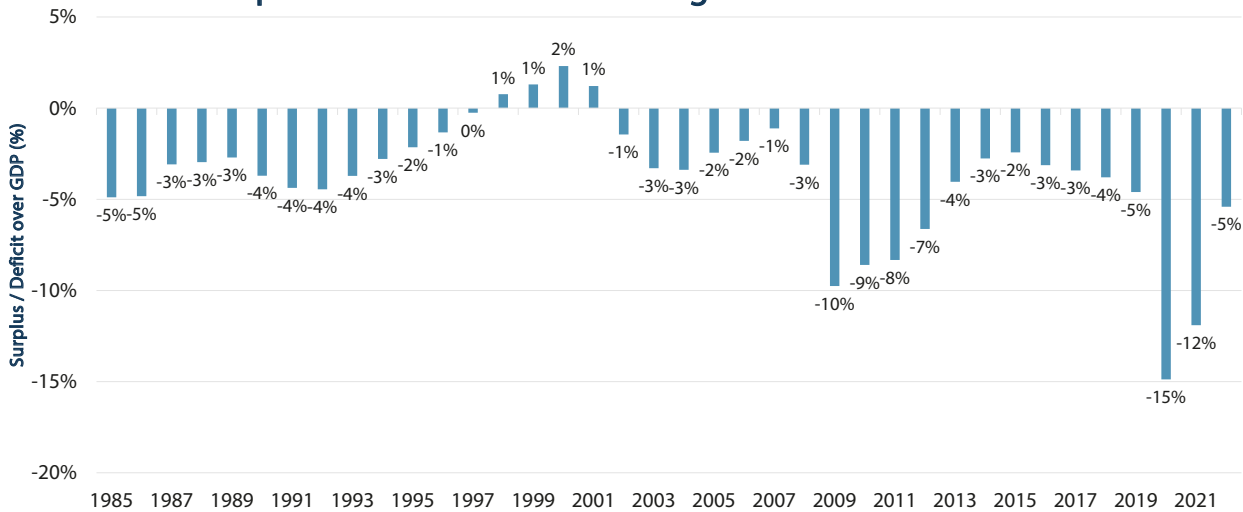
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<sup>1</sup> U.S. Treasury Fiscal Data

<sup>2</sup> U.S. Treasury Fiscal Data

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

## Federal Surplus / Deficit as a Percentage of GDP Over Time



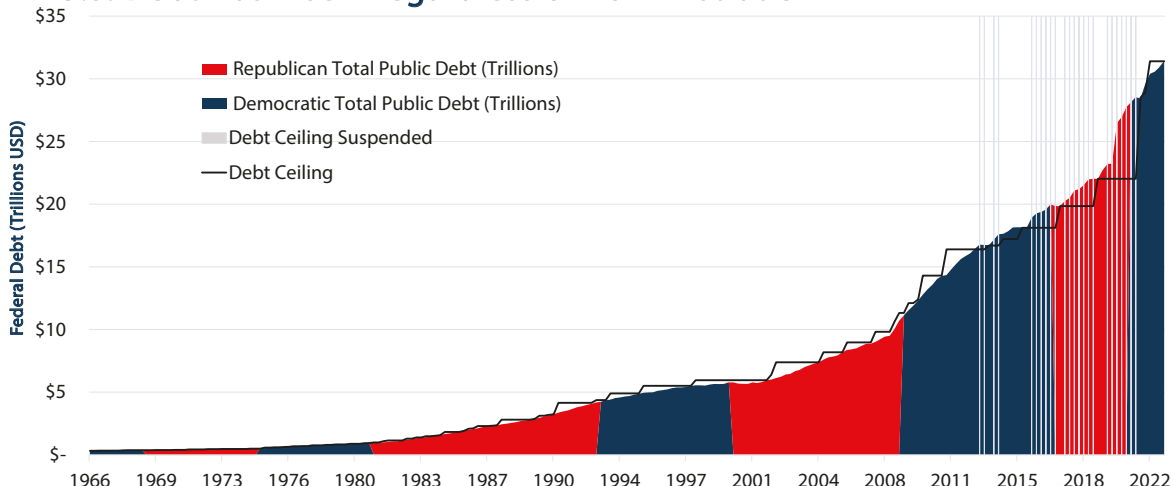
Source: U.S. Office of Management and Budget and Federal Reserve Bank of St. Louis, Federal Surplus or Deficit [-] as Percent of Gross Domestic Product

## 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.<sup>3</sup> More recently, over the past 20 years, the debt limit has increased by approximately 400%.<sup>4</sup>

## U.S. Debt Has Risen Regardless of Administration



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

<sup>3</sup> Federal Reserve Economic Data

<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> The Senate Democrats offered a bill to raise the debt ceiling until December 2024.<sup>7</sup> Given their differences, both sides may likely have to compromise to strike a deal.

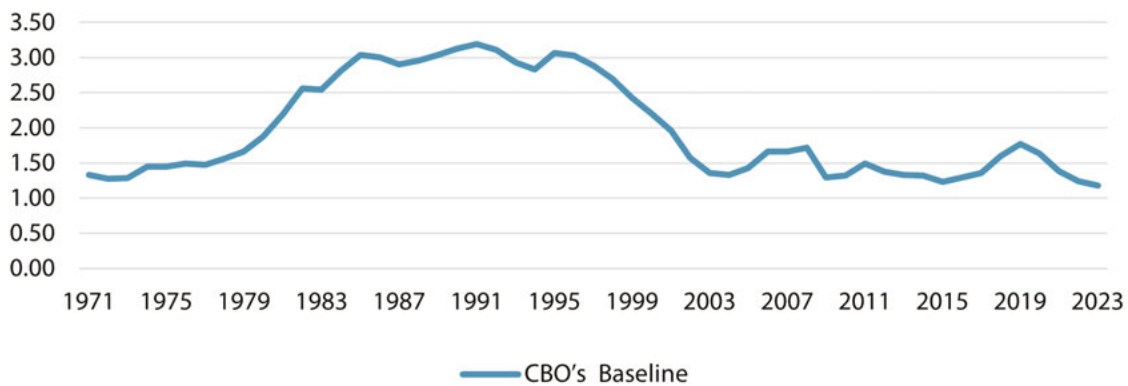
## WHAT IT MEANS FOR YOUR INVESTMENTS

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.<sup>8</sup> 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.<sup>9</sup>

### 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.

<sup>5</sup> CNBC

<sup>6</sup> CBS

<sup>7</sup> The Guardian

<sup>8</sup> New York Times

<sup>9</sup> NPR



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**Important Disclosures:** The information contained in this report is as of May 26, 2023 and was taken from sources believed to be reliable. It is intended only for personal use. To obtain additional information, contact Cornerstone Wealth Management. This report was prepared by Cornerstone Wealth Management. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Investing involves risk including the potential loss of principal. No strategy can assure success or protection against loss.

Stock investing involves risk including loss of principal. The payments of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time. IA SBBB US Lrg Cap Index is represented by the S&P 500 Composite Index (S&P 500) from 1957 to present, and the S&P 90 from 1926 to 1956. The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. S&P 90 was a value-weighted index based on 90 stocks. The Bloomberg Barclays US Aggregate Bond Index, which until August 24th 2016 was called the Barclays Capital Aggregate Bond Index, and which until November 3rd 2008 was called the "Lehman Aggregate Bond Index," is a broad base index, maintained by Bloomberg L.P. since August 24th 2016, and prior to then by Barclays which took over the index business of the now defunct Lehman Brothers, and is often used to represent investment grade bonds being traded in United States. Index funds and exchange-traded funds are available that track this bond index. Bonds are subject to credit, market, and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

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