WealthIQ: May 2023

Debt Ceiling Déjà Vu

Executive Summary: More than a decade after debt ceiling drama caused the U.S. government's credit rating to be downgraded from AAA to AA+, investors and financial markets are again at the mercy of policymakers. To end an impasse, Washington may need to acknowledge that multiple things can be true at the same time- a need to raise the debt limit and the need to reign in the federal deficit.

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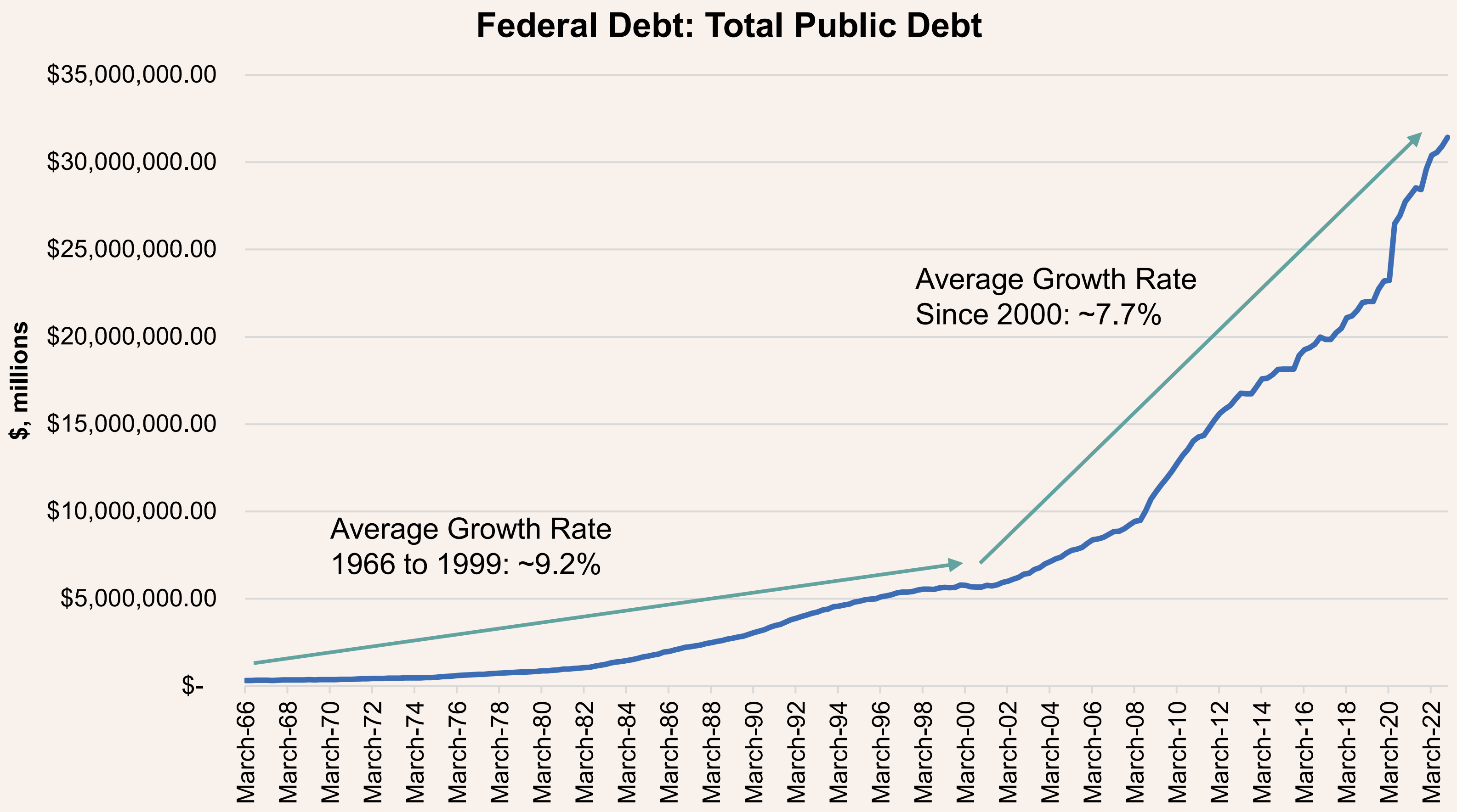
1) Let's begin by knocking some rust off should you not fully recall the 2011 debt ceiling drama. As a refresher, the debt limit does not authorize new spending. New spending is handled in a separate process through the federal budget. The debt limit focuses on financing spending already agreed to by past Congresses and U.S. Presidents. The national debt allows the U.S. to borrow to satisfy existing obligations such as social security benefits, tax refunds, and interest on treasury bonds. Post 2000, federal debt has increased substantially. The 2008 financial crisis and the COVID pandemic didn't help, and the increase in the total value of the debt displays the power of compounding.



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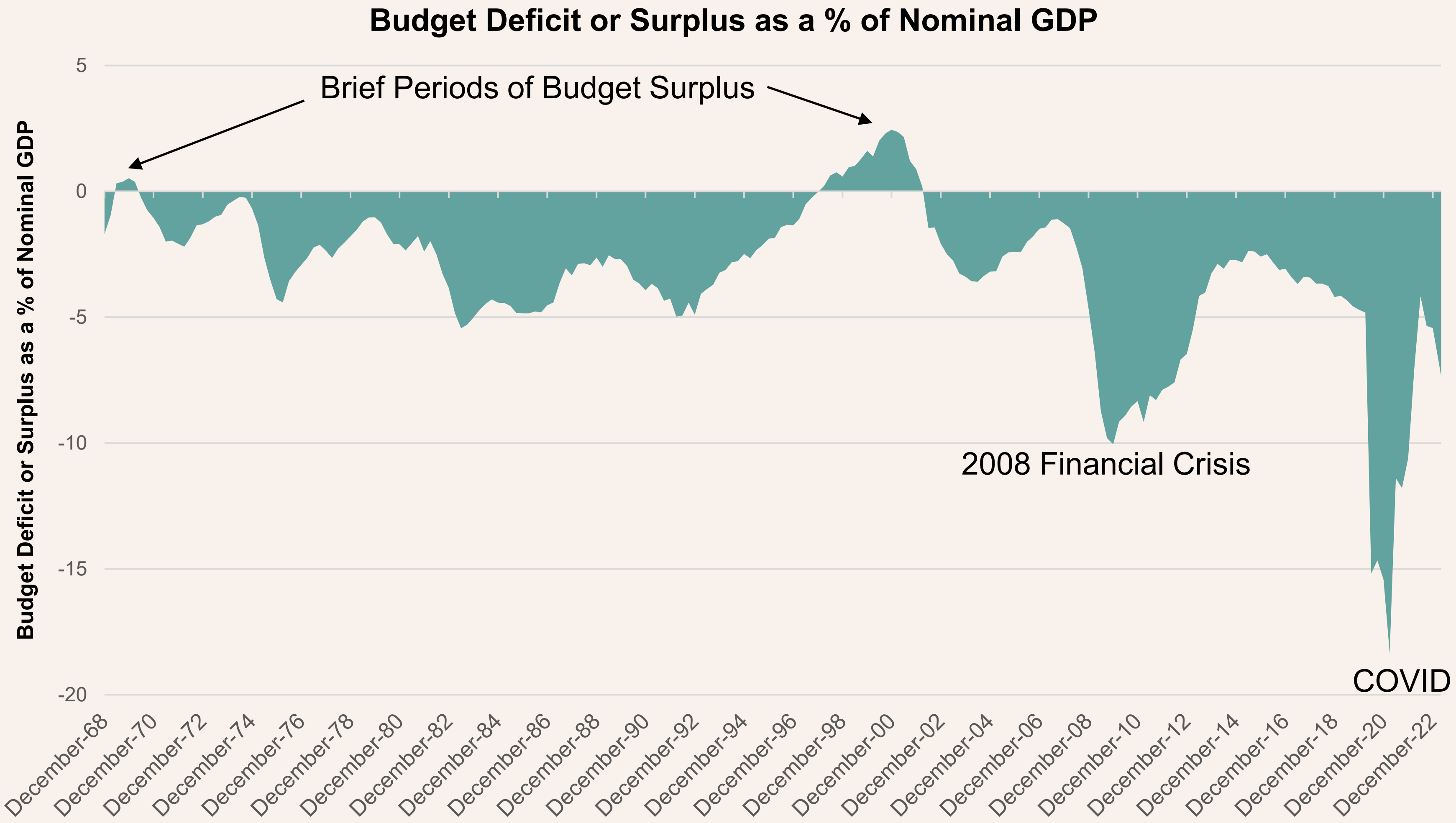
Data Source: United States Treasury; Federal Reserve Bank of St. Louis

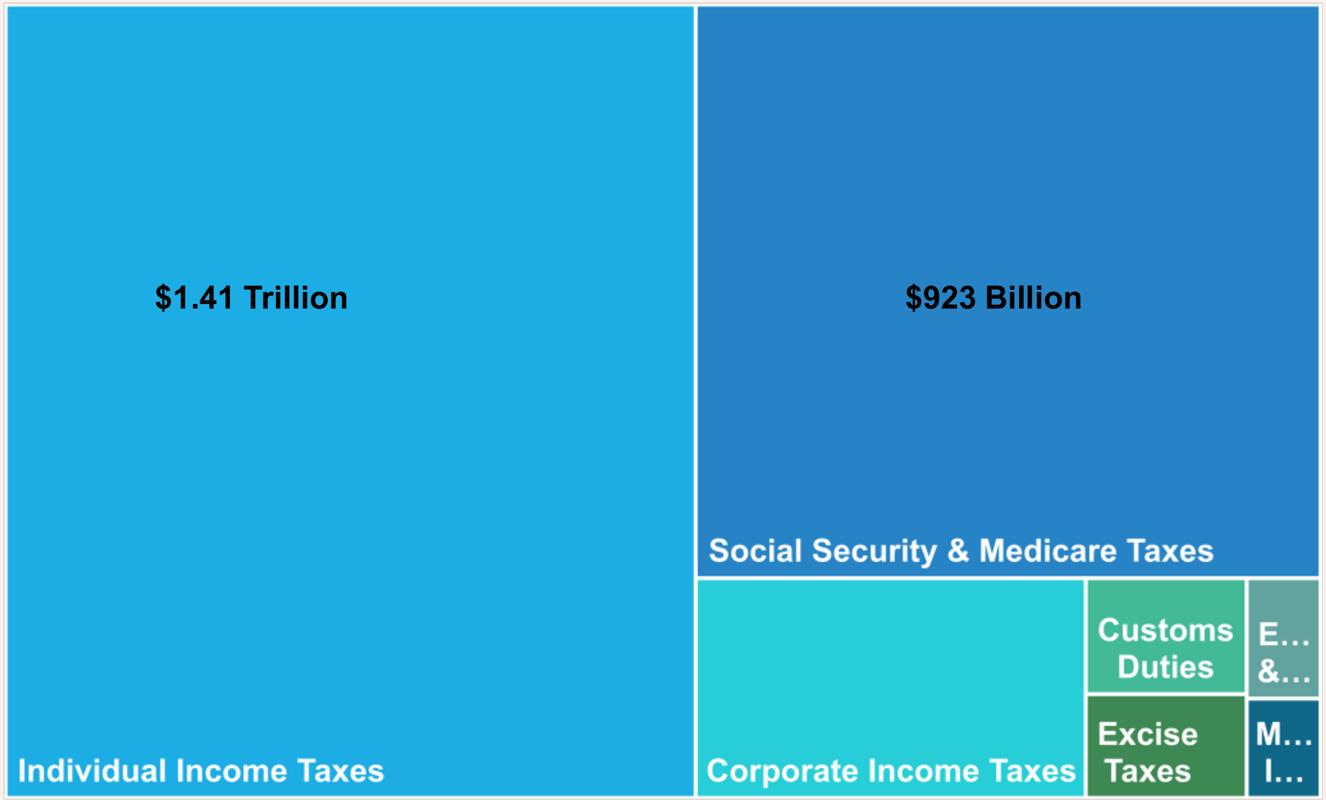
2) Over the last half century, the national debt has grown because the United States typically operates at a budget deficit (i.e., the government spends more than it brings in). Since the late 1960's, there have only been brief periods when the U.S. operated with a budget surplus (see the chart below). Negative economic events, like the 2008 Financial Crisis and COVID, typically cause the deficit to widen as tax receipts (revenue) decline and spending does not fall proportionally. Since December 1968, the average budget deficit as a percentage of nominal GDP has been about 3.3%.



Data Source: Bloomberg, L.P.; United States Treasury

3) To better understand the national debt, it's helpful to see the sources of government revenue and areas of spending. The chart below highlights government inflows. Not surprisingly, the largest source of federal revenue in 2023 has come from Individual Income Taxes of $1.4 trillion. This is followed by Social Security & Medicare Taxes at $923 billion. In total, the United States has brought in around $2.7 trillion in revenue thus far during fiscal year 2023. This is down from the $2.99 trillion in federal revenue brought in during the same period last year.

Sources of Revenue for the U.S. Government, FY 2023



Total 2023 Revenue: $2.69 trillion
Down -10% or $299 Billion from the same period last year

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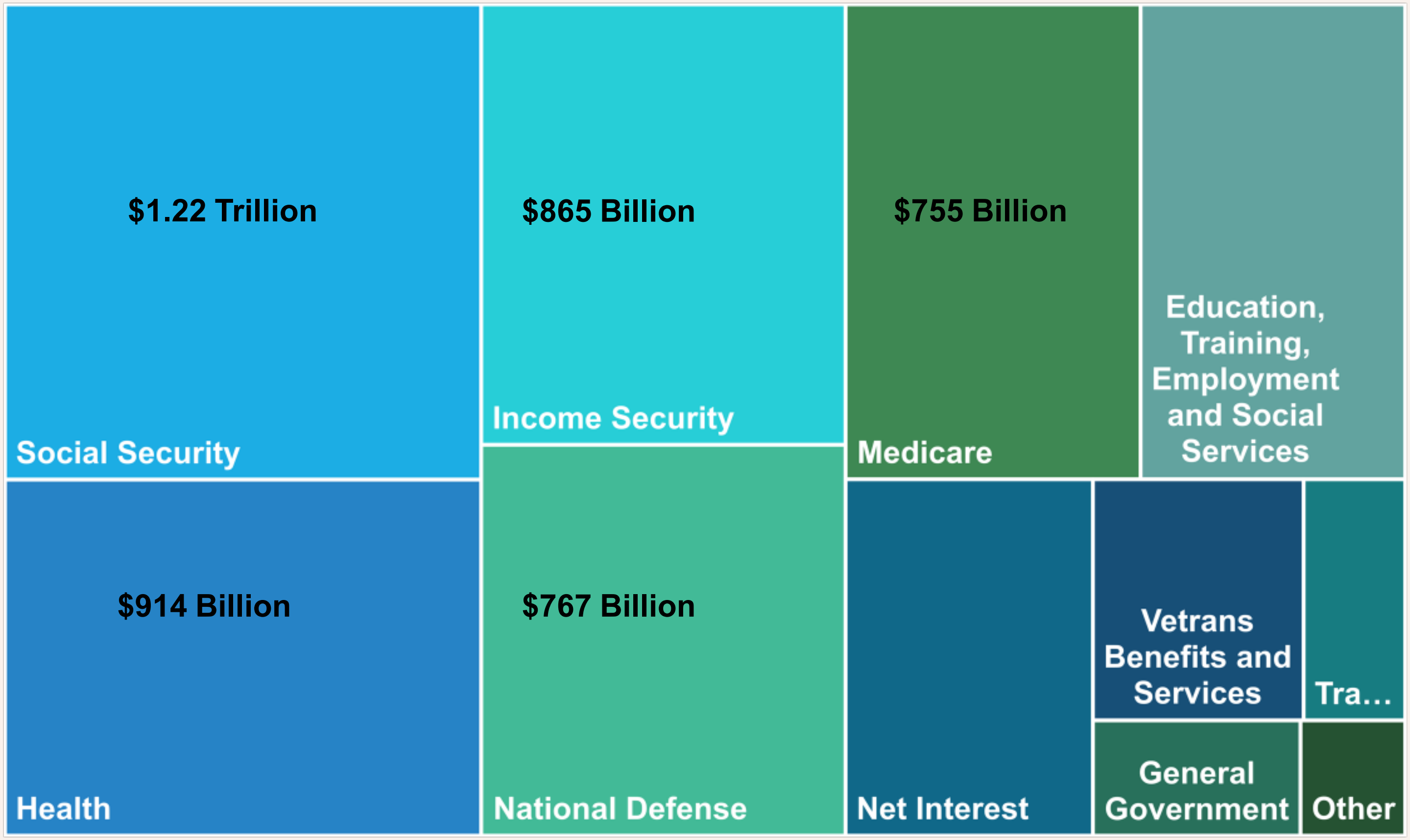
Data Source: United States Treasury

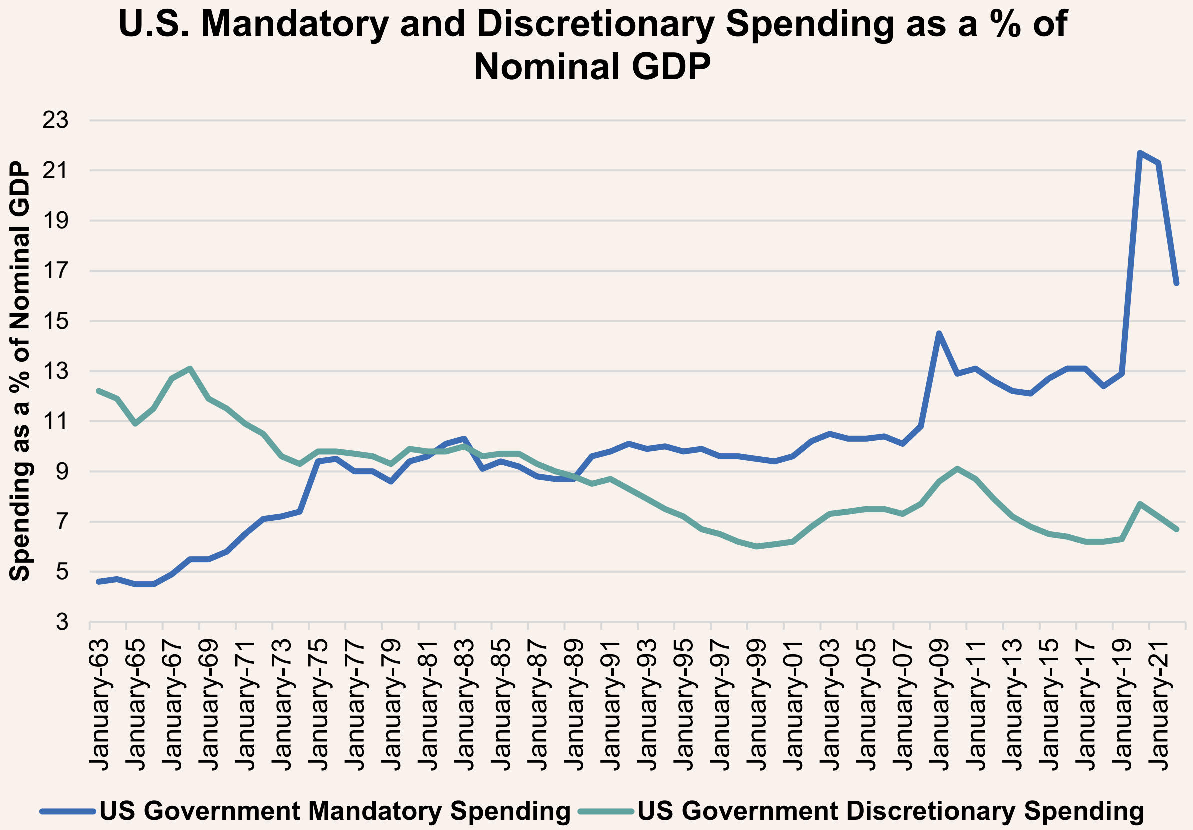
4) On the spending side, the government has spent $3.61 trillion thus far during the 2023 fiscal year. Spending has increased from $3.35 trillion for the same period last year. Below is a categorized breakdown of government spending during the 2022 fiscal year. Social Security was the largest government outlay, followed by a combination of Health (e.g. Medicaid & other services), Income Security (a mix of expenses ranging from federal employee retirement & disability to food & nutrition assistance), National Defense, and Medicare.

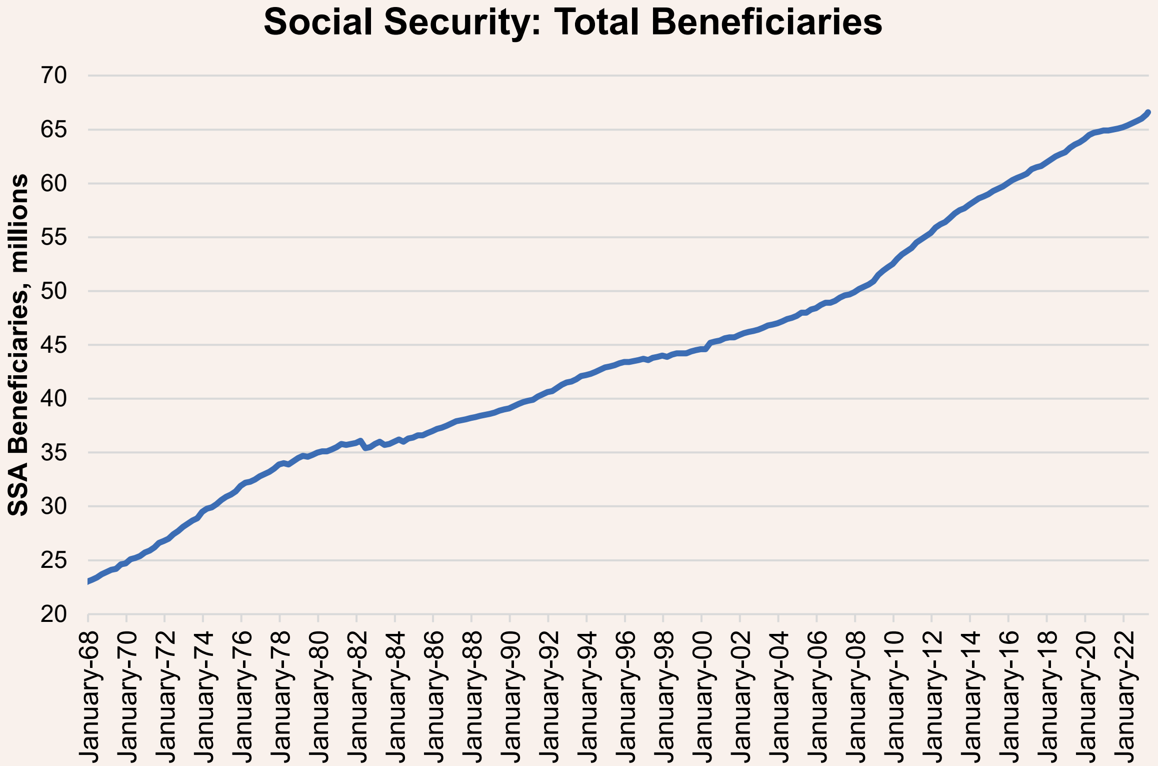
U.S Government Spending, FY 2022



Data Source: United States Treasury

5) Government spending has two core categories: mandatory and discretionary. Mandatory spending is mandated by existing laws, does not require an annual vote from congress, and includes programs such as Medicare, Social Security, and payments to state and local governments. Mandatory spending accounts for nearly two-thirds of spending. Discretionary spending is approved by Congress and the President each year and covers items like national defense and programs such as transportation, education, and social services. Over the years, mandatory spending has generally risen while discretionary spending has declined (bottom left). This makes some sense as the total number of social security beneficiaries also continues to rise (bottom right).





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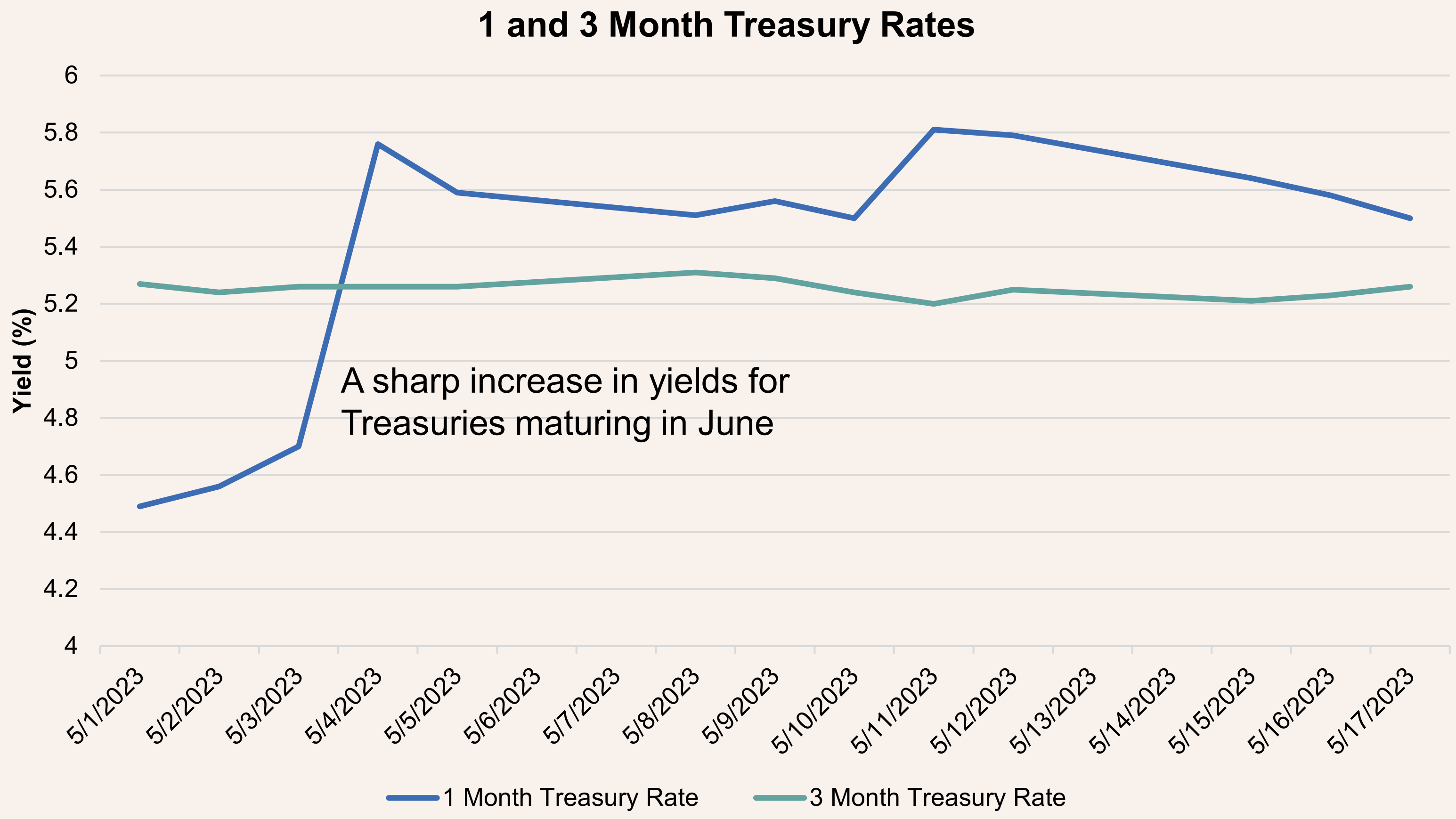
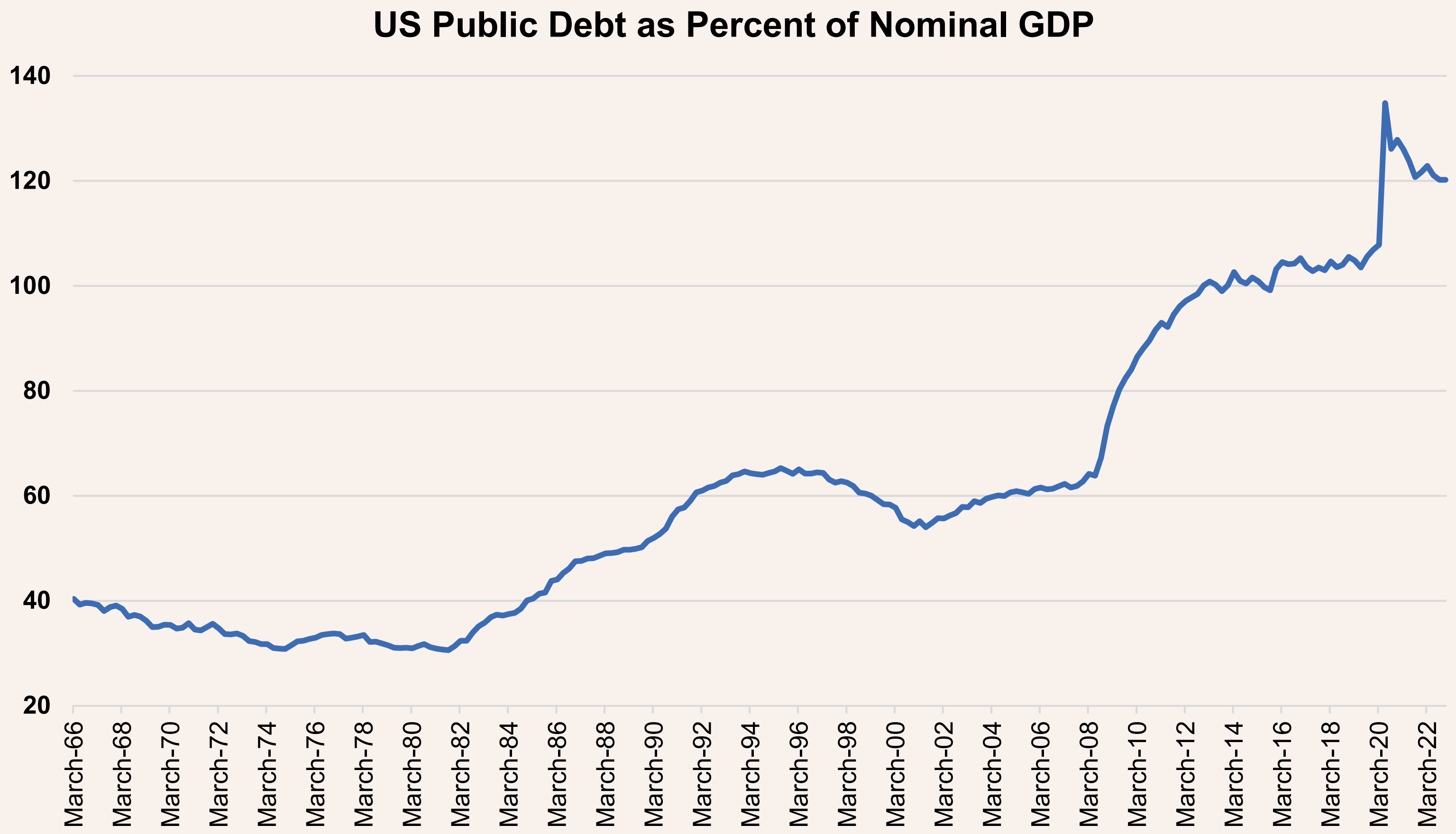
Data Source: United States Treasury; Office of Management and Budget; Bloomberg L.P.; YCharts

6) The Department of Treasury estimates that without a debt limit increase the U.S. government would be unable to satisfy all its obligations as early as June 1st. Frankly, it would be a historic failure that would likely have a cascading impact on the financial system, economy, and future generations of Americans. Fortunately, on May 17th, both House Speaker McCarthy and President Biden spoke to the importance of reaching a debt deal. During the 2011 debt ceiling drama, a deal was reached only days before a national default (or X date), with final passage ultimately occurring on the so-called X date. While policymakers may follow a similar path during these negations, financial markets have begun to price in additional risk. Most notably, the interest rate on 1-month treasury bonds is markedly higher than other short-term treasuries, potentially highlighting markets believe there is a chance negotiations could spill over into June before being resolved.



Data Source: United States Treasury; YCharts; CNBC

7) With the United States' public debt exceeding the country's economic output, we believe two things can be true at the same time- the debt ceiling needs to be raised and there needs to be hard conversations about keeping budget deficits in check. Admittedly, this is easier said than done. With most government spending allocated toward mandatory spending, this leaves policymakers with difficult decisions to make on the discretionary side of the budget. Alternatively, policymakers could make the unpopular decision to raise taxes; or pursue some combination of tax increases and discretionary spending cuts. The unfortunate reality with the federal budget is there are limited options- spend less or tax more.



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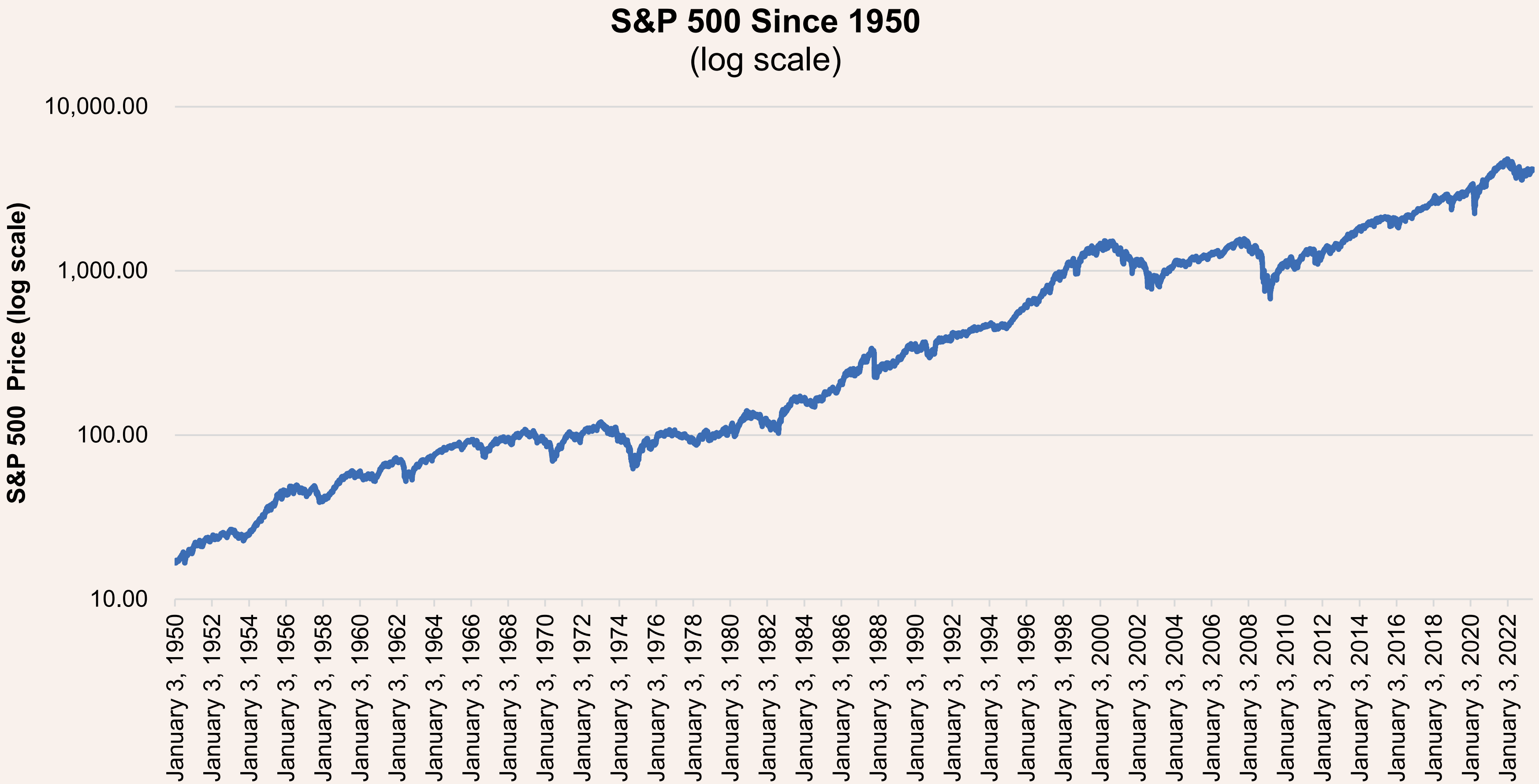
Data Source: YCharts; United States Treasury

8) There are no shortage of studies for us to reference about the importance of not overreacting to headline risk (don't worry, we won't do that after this many slides about federal debt and spending).However, we recently heard quote we like: 'everyone is a long-term investor until they have short-term losses.' We believe this succinctly reflects how even well-intentioned plans of long-term investors can be interrupted by near-term loss aversion. Perhaps one of the greatest investors of all time, Warren Buffet, has said something similar: 'Fear is the most contagious disease you can imagine.' We find looking at a long-term chart of the S&P 500 always serves as a good reminder that, historically, prior market drawdowns may have left scars, but they have yet to cause a mortal injury.



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Data Source: YCharts

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Adam Reinert, CFA, CFP®

Chief Investment Officer

George Evans II, MBA

Chief Investment Strategist

Sean Dann

Research Analyst

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