Special commentary from the Investment Advisory Group

Debt ceiling showdown coming, but U.S. debt default highly unlikely

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What Happened

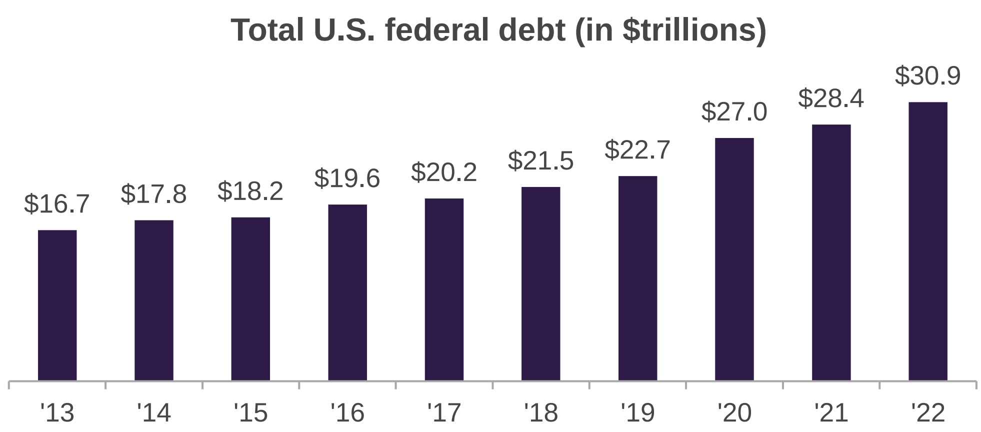
U.S. Treasury Secretary Janet Yellen warned that the United States is nearing the limit of its borrowing cap of $31.4 trillion this past week. Hitting the debt limit means the government can't borrow to help pay its bills.

The U.S. Department of Treasury (Treasury) has begun so-called "extraordinary measures," meaning it is using accounting maneuvers to continue paying the bills. For instance, the Treasury can prioritize payments while deferring others, such as suspending investments in the Civil Service Retirement Fund or the Postal Service Retiree Health Benefits Fund, etc., so that the government can continue paying its bills.

This also comes amidst the political food fight on Capitol Hill. Dragging out the election of the Speaker of the House was very messy and exposed internal divisions within the Republican Party. As a result, those political divisions raise the specter of a protracted debt ceiling fight. Ultimately, not paying the interest due on outstanding U.S. debt—which would be a default—would create a catastrophic economic fallout.

Note: A government shutdown happens when Congress doesn't pass a federal funding bill; that has already been accomplished for fiscal year 2023, which ends on September 30, 2023. A debt ceiling crisis would occur if lawmakers don't agree to lift or suspend the debt limit.

Total U.S. federal debt continues to climb.



Sources: Truist IAG, U.S. Treasury Department, Monthly Treasury Statement (MTS); as of December 31, 2022.

Our take, and Q&A

The burgeoning U.S. federal debt has long been a concern. Within the past decade, the debt has ballooned from roughly $17 trillion to almost $31 trillion today, with about $4 trillion added in response to the coronavirus pandemic, and the public debt-to-gross domestic product is now above 121%. Indeed, the level of U.S. federal debt is a concern that must be addressed over time. That said, we are not panicking nor is this a sign of impending doom.

If this sounds eerily familiar, the 2011 debt ceiling crisis caused the United States to lose its top-tier AAA credit rating from Standard & Poor's, pushing up borrowing costs in real terms and pummeling stocks.

The 2011 debt rating downgrade was spurred by political gridlock with the same configuration as now. It was the last time the Republican Party took control of the U.S. House of Representatives, which they held through 2019. Similarly, the U.S. Senate and White House were controlled by Democrats. Thus, many investors are speculating that political gridlock will once again befall the debt ceiling fight, especially since several Republican House members have already publicly demanded that any debt limit increase come with deep spending cuts. Therefore, we are bracing for a debt ceiling showdown in the coming months.

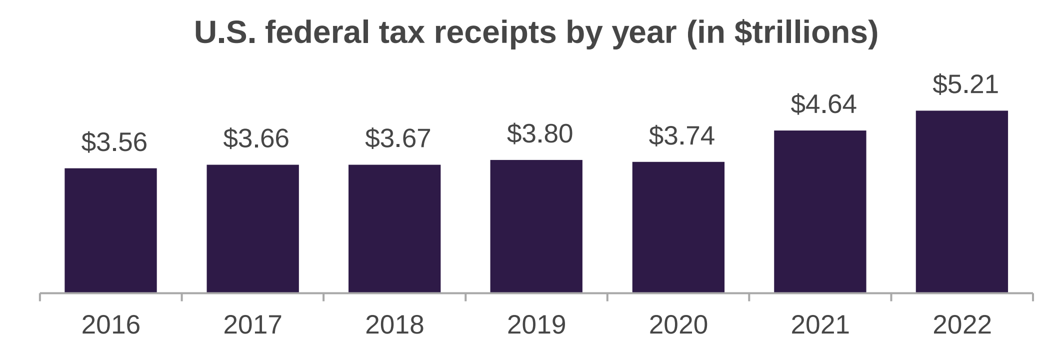
Yet, there are differences between now and 2011. The most obvious is that the Republicans hold a very slim 10-seat majority currently, 20 fewer than in 2011. The current House math makes it easier for a handful of moderates to overcome potential holdouts to get a debt ceiling deal done. Furthermore, both parties should now know that there are real consequences of political brinksmanship with the nation’s finances.

Sadly, the rhetoric on both sides will mostly get worse in the near term, which should peak following the State of the Union Address (on February 7). We anticipate neither side will get serious about crafting a solution until this summer. That leaves a lot of time and headlines between now and then, so brace yourself for more ominous talk about a U.S. debt default. Also, any credit rating downgrade discussion would negatively impact the bond market and flare up volatility due to increased uncertainty.

Is the U.S. in trouble: Could the U.S. default on its debt?

Ultimately, this is the crux of the national debt issue. In our view, the answer is emphatically no—the U.S. is not a credit risk at present. There are three key reasons underpinning our view.

First, the U.S. can afford to pay its debts and can easily service the interest. It costs $210 billion to maintain the debt, which is 15% of the total federal spending (as of 12/31/22). Clearly, the U.S. government has enough revenue to pay the debt.



Sources: Truist IAG, U.S. Treasury Department. Total receipts of the U.S. federal government, retrieved from Fiscal Data; 2022 as of December 31, 2022.

Secondly, U.S. government tax receipts are up a whopping 46% since 2016, mostly because of the wage growth that has occurred following the pandemic. When wages rise, income taxes and withholdings, including for social security and Medicare, also increase. Hence, the outsized wage growth has translated into a dramatic increase in federal tax receipts.

Moreover, the U.S. has an incredible trove of multitrillion-dollar assets that could be sold or privatized to raise funds. Obvious examples include the 650 million acres of land in the United States owned by the federal government, the mortgage portfolios within Fannie Mae and Freddie Mac, etc. Additionally, there are other hard assets (i.e., water rights, air access rights, mineral rights, etc.), not to mention soft assets like intellectual property rights, including military, cyber, and space, etc. – all of which have tremendous value but is regularly discounted to literally zero by all of those “doomsday” pundits saying that the U.S. is somehow bankrupt. Or Congress could use its taxing authority to raise revenue to make the debt-service payments. While these are not appealing options, they are levers that could be pulled if needed.

What about federal deficits?

Deficits and debt go hand-in-glove; they are related, but different. Fiscal deficits—budget shortfalls—are a primary cause of increased debt. Again, the biggest reason for the recent dramatic increase in fiscal deficits was the aforementioned pandemic response. But this isn’t just a U.S. problem. All of the key economies have pushed their fiscal deficits higher by roughly similar relative amounts. Thus, the U.S.’s fiscal deficit in relative terms has remained in-step with peers in the near term.

Moreover, these deficits are likely temporary. Some were also related to spending that was authorized but not-yet-spent by recent legislation. We anticipate that federal spending will be curbed in the coming years, either by a political deal or forced by the fiscal realities of the situation.

We are not suggesting that deficits don’t matter; however, there will be plenty of time to address the budget deficit in the coming years. Specifically, we believe that deficits need to be balanced over an entire economic cycle, but there are legitimate reasons to temporarily overshoot, such as the Great Financial Crisis and the COVID-19 pandemic.

What about rising interest rates…won’t that make the problem worse?

Yes, rising interest rates, which push up the interest expense to service the debt, are another cause for fiscal deficits. Rising rates would cause interest payments to gobble up an increasingly larger chunk of federal spending, thus crowding out other priorities.

However, the biggest reason why that situation isn’t getting dramatically worse anytime soon is that the average duration of U.S. debt has been climbing. It is now roughly 6.2 years (74 months), which is the longest it’s been since the mid-1980s. In other words, the U.S. Treasury locked in the low interest rates over the past few years by gradually extending the duration (issuing more long-term bonds than shorter term bonds). This won’t last for more than a few years but does help mitigate the near-term risk.

Bottom line

While we are bracing for a debt ceiling showdown and headline risk in the coming months, we view a U.S. debt default as highly unlikely. We believe the debt ceiling and overall debt levels are not a concern in the near term, although both topics merit attention over the longer term.

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