TOWNELEY CAPITAL MANAGEMENT

What the Looming Debt Ceiling Deadline Means for Investors

The federal debt limit is again in the news as the country rapidly approaches a critical deadline on June 1. Investors are understandably nervous about Washington failing to reach an agreement. While it's unclear how this will play out in the coming weeks, the financial markets are mostly taking these events in stride. Below are three points to help investors maintain the right perspective around political and fiscal uncertainty.

First, it's important to understand what the debt limit is and is not. Simply put, the federal government borrows money to pay its bills by issuing Treasury securities. This borrowing is necessary because the federal government often operates with a deficit whereby spending (on defense, Social Security, emergency pandemic stimulus, and more) exceeds government revenues (primarily tax revenues). While tax revenues increase as the economy grows (even without raising tax rates), they have been outpaced by spending over time. As a result, government borrowing adds to the national debt, which hit the $31.4 trillion debt ceiling in January. Since then, the Treasury Department has employed "extraordinary measures" to ensure the country does not default on its obligations.

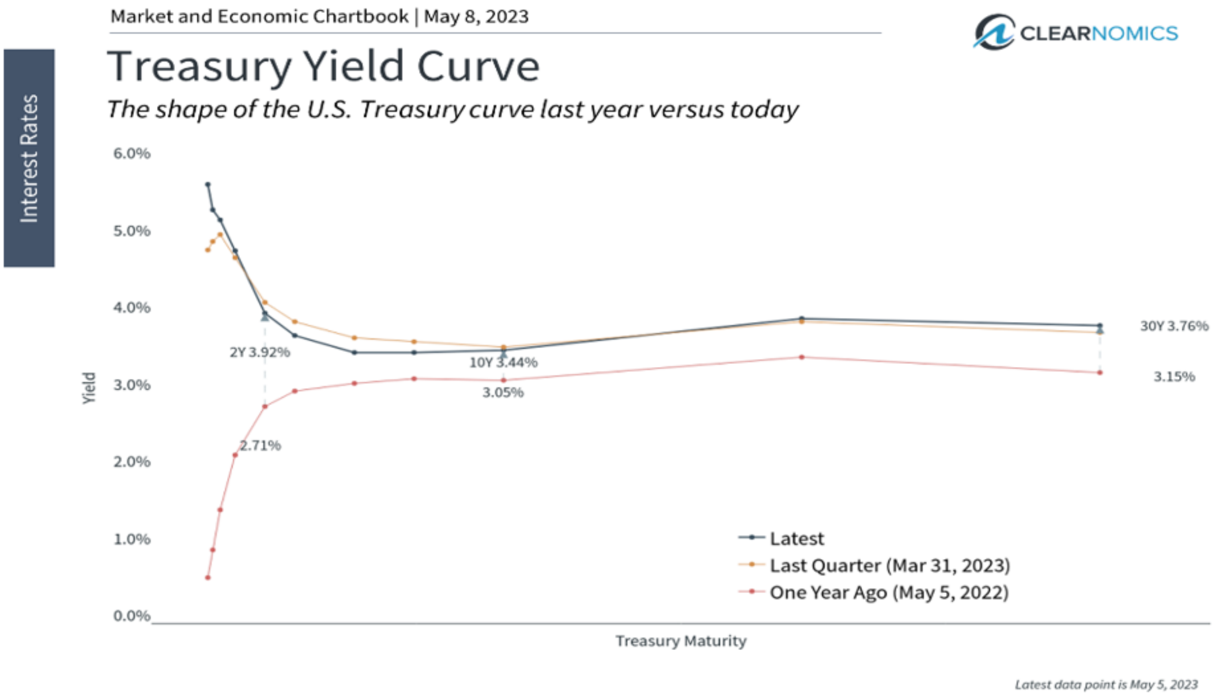
Federal borrowing reached the debt limit this past January

Sources: Clearnomics,
U.S. OMB

The debt ceiling is a mechanism that requires Congress to approve additional borrowing above these levels. Congress authorizes spending through the normal budget process that takes place each year.

Thus, the only question around the debt ceiling is whether the government can and should pay its bills, which is akin to signing the papers for a new car and then requesting an increase to your credit limit after the fact. Unfortunately, the Congressional process of approving a budget by September 30 each year doesn't consider whether the U.S. Treasury can pay its bills.

Near-term Treasury rates have jumped but longer-term rates are steady



Sources: Clearnomics, Federal Reserve
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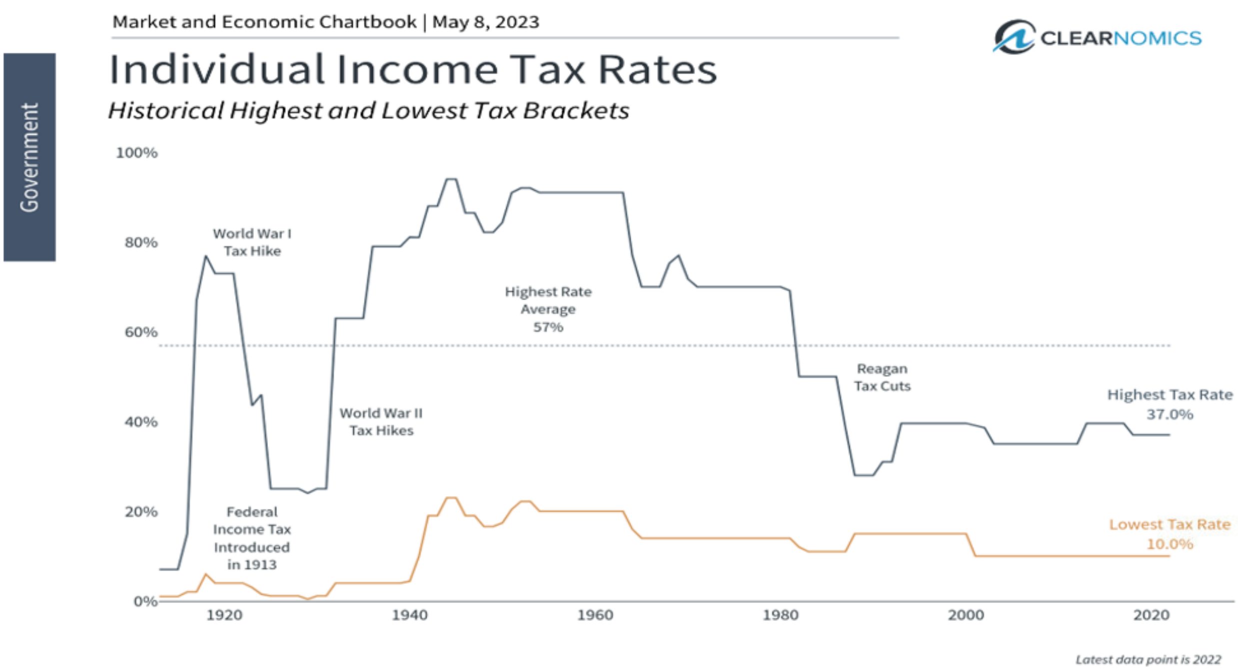
Second, the large and ever-growing national debt is a controversial, complex topic that impacts the economy and markets. Currently, Democrats, who control the White House and Senate, and Republicans, who control the House of Representatives, are in a standoff. On April 26, the House passed a debt limit bill by a narrow vote margin of 217 to 215. The House bill would increase the debt limit through March 31, 2024, or until the national debt increases by another $1.5 trillion. However, the bill limits discretionary spending and repeals renewable energy tax credits. It also increases work requirements for benefits programs. These provisions make the bill politically controversial and thus unlikely to pass the Senate and be signed into law.

As usual, there is plenty of political grandstanding around this issue, with each side trying to gain the upper hand. Similar debt ceiling standoffs have occurred over the past decade, with the limit suspended and raised in 2013, 2014, 2015, 2017, 2018, 2019, and 2021. According to the Congressional Research Service, the debt ceiling has been raised 102 times since World War II.

Fortunately, despite the headlines and investor concerns, these episodes had little long-term impact on markets. The U.S. has never defaulted on its debt. Nearly all economists and policymakers agree that doing so would lead to turmoil in the financial markets and increase borrowing costs for businesses and everyday citizens. This risk is evident in the bond market with a sharp jump in Treasury rates with maturities around the debt ceiling deadline and much lower rates after that.

The one exception to markets staying relatively calm occurred in 2011 when a similar standoff led Standard & Poor's, a credit rating agency, to downgrade the U.S. debt. As a result, the stock market fell into correction territory, with the S&P 500 declining 19%. Ironically, the prices of Treasury securities increased during the 2011 debt ceiling crisis. Even though these were the exact securities downgraded, investors still believed they were the safest in the world during heightened uncertainty. Congress eventually raised the debt ceiling and approved a new budget, allowing markets to bounce back.

Income tax rates are still low by historical standards



Sources: Clearnomics, Treasury Department, IRS

Third, debt ceiling aside, the national debt at today's level means that it has more than doubled over the past decade and, with very few exceptions, has grown nearly every year over the past century. While everyone agrees that the government should only spend what it generates in tax revenues, the unfortunate reality is that neither party has addressed the problem over the past decade. The last balanced budgets occurred during the Clinton and Nixon administrations.

This leads to the concludion that deficits are unlikely to go away. Given how heated government spending can be, investors must distinguish between their political feelings and how they manage their portfolios. In other words, investors should focus on what they can control to differentiate how things work from how they want them to be.

One factor beyond the market and economic effects is that the odds of higher tax rates may increase as the national debt worsens. Today, the highest income tax rates are slightly above their lows after the Reagan tax cuts but still far below historical peaks. High-earners in the mid-1940s paid rates as high as 94% on their marginal incomes. Even those in the lowest bracket would have paid 20% or more during the 1940s, 50s, and 60s - double today's rates. U.S. corporate tax rates were also among the highest in the world until the 2017 tax cuts. While higher tax rates are not guaranteed, engaging in a financial plan that takes advantage of relatively lower rates today can help to protect investors from future tax uncertainty.

The bottom line? The debt ceiling and federal debt must be resolved in the coming weeks. As with many political issues, investors must separate their concerns and not react with their hard-earned savings and investments. History shows that staying invested is the best approach to navigating drama in Washington.