Debt Ceiling Looming

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Long term patient investors constantly battle narrative versus economic reality. Most recently, debt default fears have sparked a doom and gloom media frenzy, providing endless Armageddon clickbait. While there's always a long run concern the U.S. will not be able to fulfill its debt obligations, we believe the current panic is no more than simple political theatre, a byproduct of split government in D.C. Split government, by design, is meant to slow down excess in policy making from either side of the aisle. What the founders didn't expect though, is the uniparty Washington has become in recent history.

Divided government was created as a check against partisan efforts to concentrate power. Instead, the two parties have united behind a print and spend agenda that went into effect in 1913 when the Federal Reserve was formed. While there are small differences between the Left and Right, runaway spending is bipartisan. That's why we're not overly concerned that the U.S. will default on its debt. Kevin McCarthy's main objective is to fight Democrats until small concessions are made in Republicans' favor so he can appear like a conservative champion with his supporters. President Biden's core objective is to print more money into oblivion to pay for the most absurd portions of his spending agenda. In the end, we think Republicans and Democrats will unite as always behind the same policy that leaves Americans holding the bag for the 42nd time since the 1980's.

Debt ceiling negotiations are nothing new. Since Ronald Reagan, we've raised the limit nearly four dozen times. While the short-term effects of raising the debt ceiling don't concern us, the long-term effects of the ballooning size of the Federal government is eventually going to be a problem. Today, government spending makes up over 25% of GDP, a number 8 times higher than in 1929. Debt in a vacuum isn't really the issue, the issue is how much government has grown.

In a vacuum, our $32 trillion debt load sounds terrible. But in context, U.S. annual GDP is over $26 trillion, placing us with a debt to GDP ratio of 123%. Essentially, the USA owns a $1 million house with a $1.23 million mortgage. For comparison, China's ratio is 279%, Japan's is 225%, Germany's is 60%, and India's is 92%. While we're not the worst, we're not at the 30% Ronald Reagan era-level we anymore. The question is, how much more debt can the U.S. support without a long-term collapse?

Imagine a United States family with the $1 million house and $1.23 million mortgage. Suppose that family earns $500,000 per year of after-tax income. Assuming the mortgage is being financed at current Federal Reserve interest rates of 5%, annual debt service costs are $61,500, more than manageable for the family. However, two bad scenarios can happen; first, they could lose their income and see debt service costs rise precipitously as a portion of net income. Second, their home could become valued substantially less than its current $1 million level. The same could happen in the United States. Our tax receipts could drop, something that we feel is unlikely given the government's desire to tax as much of our income as possible. On the other hand, it's possible the world spins into a massive economic depression causing the value of our assets to become devalued in the short term. We think this outcome is unlikely too…for now.

There's also a third potential outcome for our example of the U.S. family. Their income and home value could grow over time to be worth more than $1 million or even more than the $1.23 million mortgage. Over time in the U.S., this has been the case even during the worst of times. Entrepreneurs have lifted us out of near calamity by innovating new technology to make life better, reduce input costs, all while consuming less resources. If this growth continues, we won't default on our debt or run into major long run issues. However, it should be a warning to both political parties that if we don't shrink the size and scope of government, U.S. entrepreneurs will be overburdened and unable to grow us out of the mess they've created. For now, we believe the U.S. economic engine will support the debt which is why we are still optimistic and staying the course.

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