U.S. Downgrade Not Surprising

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Fitch's downgrade of US Treasury debt sent a shockwave through markets last week, but in our opinion, shouldn't really surprise anyone. Print and spend fiscal and monetary policy of the past three years has finally come home to roost, pushing our debt to GDP ratio to 128%. We're not Japan yet, but we're headed that way if we don't change course quickly.

The recent downgrade isn't an immediate reason to panic out of stocks. In 2011 the U.S. was also downgraded, causing a short-term pullback. Despite the correction, stocks are up 233% since 2011. Each downgrade should serve as a warning to the Fed and politicians that runaway spending is unsustainable. Doom and gloomers say the U.S. is on the brink of collapse and we're headed over a cliff in a matter of months. While they might be right in the long run, we think they're wrong right now. If the United States were a corporation, we'd produce $26.8 trillion in annual revenue (GDP), an incredible amount of wealth. The problem lies not with wealth creation but rather government spending. Tax receipts are only $4.9 trillion while federal spending is $6.27 trillion. There's only two ways to close the gap – 1) Cut spending or 2) Increase taxes.

To some, increasing taxes is the lowest hanging fruit, including potential wealth taxes. Problem is, implementing a 10% annual wealth tax on billionaires would still only generate $448 billion per year in additional tax revenue, not to mention dealing with the fallout of such an absurd proposal. Alternatively, you could raise taxes on the middle class, defined as $145,000 in annual household income. Raising taxes by 10% on the middle class would generate an additional $870 billion in annual tax revenue. Both tax increases combined still wouldn't close the deficit gap.

Other proposals say corporations don't pay their fair share. Here's an easy example to understand corporate taxes. For example, it's been reported Amazon pays no federal income tax. If you dig a little deeper though, Amazon actually pays billions in taxes per year. With over 1 million U.S. employees, its estimated Amazon pays nearly $5 billion per year in Medicare and Social Security tax. For the first half of 2023, Amazon has also already paid $1.75 billion in income tax. It's also estimated Amazon collects $1.64 billion per year in sales tax. All in, Amazon collects over $10 billion in tax annually. Bottom line, taxing corporations more doesn't change the math for their income statements because all these taxes are passed down to consumers in the form of higher prices.

The better answer to our debt problem is to cut spending. The only way to cut spending is to shrink the size of the federal government. Entitlement programs like Social Security, Medicare, and other social programs now cost over $2.9 trillion, or 47% of annual spending. Interest payments on our debt are nearly $1 trillion per year and annual defense spending is nearly $800 billion. The only way to reign in spending is to have serious conversations about the size and scope of D.C. For example, Social Security was designed as a short-term post-depression era safety net when life expectancy was only 63. Based off an annual income of $75,000, company and employer contributions total $9,300 annually. Contributing $9,300 per year for 40 years at an 8% rate of return would grow to $2.4 million. A basic 4% withdrawal rate at age 65 would equal $96,000 per year, nearly 3 times higher than actual Social Security income. The difference, in our opinion, is government mismanagement.

While we don't think the most recent downgrade should be a cause for immediate panic, it should be a warning to all of us that government has grown far too big. Entrepreneurs can only bail us out to a certain extent, eventually spending needs to decrease.

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