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First Trust

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Monday Morning Outlook

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Debt Limit Brinksmanship

As we said last week, the federal budget is a mess. It's on an unsustainable course. It's hard to see how tax hikes can fix it. Spending is running above 23% of GDP and tax revenues (no matter what tax rates) hardly ever rise above 20% of GDP. This leaves spending cuts as a key part of the fix.

We had hoped that President Obama would "triangulate" on fiscal issues to help get re-elected, for example, by pushing for reform of Social Security similar to what his own Deficit Commission proposed. However, for whatever reason, the president has decided to let those bipartisan proposals, many of them worthwhile, die on the vine.

The budget submitted to Congress by the White House made no significant proposals to fix Social Security or Medicare and pushes almost all of the "budget cuts" in discretionary (non-entitlement) spending until after the election in 2012. As a result, enormous deficits are on tap for at least the next couple of years.

In response, some lawmakers and opinion leaders are urging Congress to "hide the credit card." They want to use the debt limit of $14.3 trillion, which the US will hit in May or June, as a bargaining chip. In exchange for raising the debt limit, these leaders want major reductions in federal spending, reforms for entitlement programs, and an overhaul of the federal tax code. And they want it now!

Given the mess that the budget is in, we understand what motivates these leaders and we support these motives. However, our advice is to remember that a smart negotiator never takes a "hostage" he isn't willing to "kill." If you aren't willing to live with the consequences of the other side calling your bluff, then you better think long and hard about the demands you're making.

The first thing to recognize is that the debt subject to limit doesn't just depend on budget deficits. For example, it includes amounts the government owes itself in the form of Trust Funds. As a result, over the next several years, even if the budget were balanced in a cash flow sense, the debt limit would have to go up about $300 billion per year because we are borrowing from other programs. In other words, not raising the debt limit would require the government to suddenly lurch from record-setting deficits to large, on-going budget surpluses.

The cuts required to do this would be draconian. Given federal revenues of about $2.2 trillion, total spending would need to fall to $2 trillion in order to avoid raising the debt ceiling. That's a massive decline of 43% in actual spending. Yes, that's right, we borrow 43% of what we spend.

But, the US can't just cut everything by 43%. For example, we need to pay 100% of the interest on the debt. To do this, we would have to cut all other spending by 45%, not just 43%.

Then there's the issue of whether the government keeps paying Social Security. As much as we'd like to improve the program for those not already in retirement or very close to it, it's hard to see any agenda surviving a cut to benefits that current retirees already expect. But if we pay interest and all Social Security payments, then the rest of the budget would have to be cut by 58%. If we add Defense and Veterans Benefits to our list, total cuts for all other programs would need to be 85%. Yes – 85%! – including Medicare, Medicaid, highway projects, Congressional pay, the White House budget, the State Department…everything but interest, Social Security, defense and veterans benefits. We find it highly unlikely that any political movement, no matter how noble, would survive such a radical and sudden upheaval of so many peoples' lives.

Don't get us wrong. The budget is a total mess. The equivalent of a financial root canal is necessary. We fully support newly elected lawmakers who want to maximize the political leverage created by the debt limit issue to move in this direction. In fact, we'd like to see only short-term increases so the issue can be revisited time and time again, to hold the spenders' feet to the political fire. But ripping all the teeth out at once is not the answer.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-22 / 9:00 am	Consumer Confidence - Feb	65.0	**65.6**		60.6
2-23 / 9:00 am	Existing Home Sales - Jan	5.200 Mil	**5.300 Mil**		5.280 Mil
2-24 / 7:30 am	Durable Goods - Jan	+3.0%	**+4.1%**		-2.3%
7:30 am	Durable Goods (Ex-Trans) - Jan	+0.5%	**0.0%**		+0.8%
7:30 am	Initial Claims - Feb 19	405K	**411K**		410K
9:00 am	New Home Sales - Jan	0.303 Mil	**0.323 Mil**		0.329 Mil
2-25 / 7:30 am	Q4 GDP Second Report	+3.3%	**+3.3%**		+3.2%
7:30 am	Q4 GDP Chain Price Index	+0.3%	**+0.3%**		+0.3%
8:55 am	U. Mich. Consumer Sentiment	75.4	**75.1**		75.1