First Trust
Monday Morning OUTLOOK

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Battle of the Budget

It's hard to open up a newspaper these days and not see a scary story about the debt ceiling debate. The Biden Administration is saying that a "default" is approaching if an agreement isn't reached soon.

The US has enough revenue to pay all bondholders, but a roughly $1.5 trillion deficit this year means that if the debt ceiling isn't lifted, it won't be able to pay all its obligations, maybe even entitlement payments under Medicare, Medicaid, or Social Security.

We've been here before, and as we have seen in the past, we think an agreement will be reached and that all bond payments will be made on time. We also think it's very unlikely that any payments on entitlements will get delayed. Much more likely is that the Congress and White House will agree on some sort of framework to hold the line on increases in discretionary (non-entitlement) spending. Maybe they'll also agree to form some sort of bipartisan commission to review proposals to reform entitlements.

In other words, lots of smoke and very little fire. If an agreement is reached to limit discretionary spending, those limits are not likely to last. History is clear. In the past 90 years, non-defense government spending has grown ten times faster than GDP, and that trend is unlikely to change anytime soon. We're also guessing that if an entitlement commission is formed, that the recommendations would not come up for a vote until after the next presidential election and would likely fall short of the necessary votes.

All of this is important because the path of federal spending, largely dominated by entitlements, is unsustainable. According to the Congressional Budget Office, this year Social Security, Medicare, Medicaid, and other health-related entitlement programs will cost the federal government 10.8% of GDP. Thirty years from now these same programs will cost 14.9% of GDP.

Tax revenue is scheduled to be higher, too, due to the expiration of some of the tax cuts enacted in 2017 as well as "bracket creep" (incomes tend to rise faster than inflation, resulting in a larger share of income getting taxed at higher marginal tax rates). But the gain in revenue relative to GDP is less than one percentage point, which is well below the expected increase in spending.

You don't have to be a rocket scientist to figure out where this is heading. Simple budget accounting trends forecast a huge increase in federal debt, which means a huge increase in net interest payments by the government. In other words, the real problem isn't whether the US raises the debt ceiling right now, it is how the US will pay for all this spending over time.

At some point the US will either reform entitlement programs or raise future taxes to pay for them. Reducing entitlements would help keep more workers in the labor force and more dollars in the private-sector, which would help boost future GDP growth.

By contrast, higher future taxes would put us on the same path as many countries in Europe, with a huge size of government. This creeping Europeanization of the US would suppress future work, saving, and investment. Worse, the process would be gradual, and much harder to notice than a tidal wave of interest payments. The frog gets boiled, slowly.

While most investors are focusing on the straightforward issue of whether debt payments due this summer get fully paid, wise investors need to keep their eye on the key long-term issue. That's what we are watching. Will politicians make progress on limiting future spending? If not, the long-term growth path of the US will continue to slow.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-15 / 7:30 am	Empire State Mfg Survey – May	-3.9	**0.5**	-31.8	10.8
5-16 / 7:30 am	Retail Sales – Apr	+0.8%	**+1.1%**		-0.6%
7:30 am	Retail Sales Ex-Auto – Apr	+0.5%	**+0.6%**		-0.4%
8:15 am	Industrial Production – Apr	0.0%	**0.0%**		+0.4%
8:15 am	Capacity Utilization – Apr	79.7%	**79.8%**		79.8%
9:00 am	Business Inventories – Mar	0.0%	**0.0%**		+0.2%
5-17 / 7:30 am	Housing Starts – Apr	1.400 Mil	**1.397 Mil**		1.420 Mil
5-18 / 7:30 am	Initial Claims – May 13	252K	**255K**		264K
7:30 am	Philly Fed Survey – May	-19.8	**-19.5**		-31.3
9:00 am	Existing Home Sales – Apr	4.300 Mil	**4.230 Mil**		4.440 Mil