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Debt and Chickens

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Number of times the federal debt ceiling has been raised since 1980:

- 42

Number of times the U.S. government has defaulted:

- 1

(This was a brief *technical* default on Treasury bills in 1979).[1]

Key takeaways

- The implications of failing to raise the federal debt ceiling and potentially risking default are much more significant than a partial government shutdown. This is why we believe that the federal debt ceiling will be increased before extraordinary measures expire—just as it has been increased in the past.
- Although we consider it unlikely, any political standoff or delay in raising the debt ceiling (beyond May or June) could roil equity markets until a debt-ceiling deal is concluded.
- We already have started to see yields on Treasury bills that mature near the expected debt-ceiling deadline edge slightly higher. In the event of a standoff, fixed-income markets could suffer. U.S. interest rates could rise, negatively affecting most fixed-income securities. In such a risk-off scenario, the remaining perceived flight-to-quality bond havens (such as Japan and Germany) could benefit.

Next potential showdown?

Having recently experienced a record-setting 35-day federal government shutdown, we narrowly avoided a repeat this month. We may not have long to wait before the next fiscal conflict in Washington, D.C. Last year, as part of the Bipartisan Budget Act of 2018, Congress suspended the federal debt ceiling limit until March 1, 2019. The debt ceiling is an arbitrary limit on the amount of federal debt that can be issued by the U.S. Treasury. When the debt ceiling is reached, the federal government may no longer borrow to pay bills (e.g., salaries, benefits, interest, and principal). Reaching the debt ceiling limit does not necessarily trigger an immediate crisis. The Treasury Secretary has the authority to prioritize and postpone payments to extend the debt ceiling through "extraordinary measures." This has provided a cushion ranging from weeks to months. We believe that the Treasury has the ability to manage through the hard debt ceiling spending limit until early summer.

How much Congress raises the debt ceiling limit determines the amount of time until Congress must address it in the future. By spending more than is taken in each year, the U.S. must continuously borrow more money—perpetually increasing the amount of federal debt. As we will discuss in the Fiscal policy section of this month's report, most federal government spending is outside of the annual budget process. However, unless laws are changed, Congress does not have discretion over the amount that is spent on the largest portions of the federal budget—entitlements such as Social Security and Medicare. Given that much of annual federal spending falls outside of Congress' annual budgetary discretion is, in our view, a main reason why the deficit and public debt continue to grow.

The recent change of control in the House of Representatives may increase the friction between Congress and the White House over a new debt ceiling, but we believe that the credit quality of the U.S. and global financial stability are too important to risk for domestic policy priorities. Ultimately, we expect that cooler heads will prevail and the debt ceiling will be raised before a default—even if the government does utilize extraordinary funding measures for a period of time.

[1] Marron, Donald, "Actually, the United States Has Defaulted Before", Forbes, October 8, 2013.

Car import tariff rates:

- U.S.: 2.5%
- EU: 10%
- Japan: 0%

Source: World Trade Organization, February 22, 2019.

Key takeaways

- Increased tariffs on imported autos likely would benefit the U.S. auto industry. With less competition and higher prices, U.S. manufacturers may be able to increase prices and operating margins. This could benefit the Industrials sector, on which we maintain a favorable recommendation.
- Foreign automakers could suffer a significant decline in demand from tariffs of up to 25% on U.S. auto imports. Currently slow European and Japanese economic growth could face additional downward pressure in the face of higher auto tariffs. Slower economic growth prospects should dent European and Japanese investor sentiment as well as earnings growth and equity markets. They also could be negative for U.S. firms with operations in these countries.
- Although higher auto import tariffs could possibly benefit the U.S. auto industry, higher prices faced by consumers may result in less discretionary consumer spending in other parts of the economy. This could result in lower levels of personal spending, which currently is a driving force of U.S. economic growth.

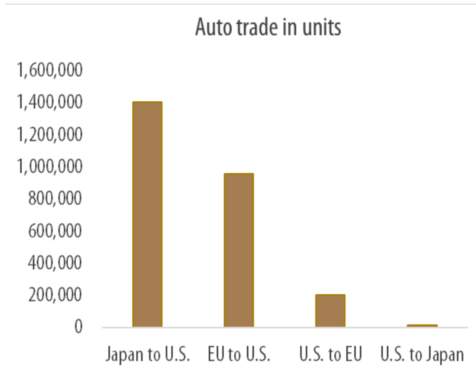
Next target—auto tariffs

With most attention directed toward China, little focus has been given to the U.S. effort to place tariffs on imported autos. Under the direction of the Trump administration, the U.S. Department of Commerce (Commerce) launched an investigation on May 23, 2018 to determine whether imports of autos and auto parts were a threat to national security. The threat was based on the concept that the U.S. auto industry is vital to the national economy and defense. However, the written code is vague on what constitutes such a threat, giving the administration discretion over how to proceed.

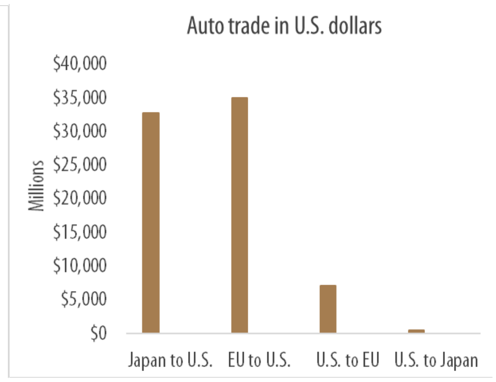
The report has been delivered to the president but not released publicly. President Trump has 90 days to decide whether to act on the recommendations contained within the report. In the past, President Trump has threatened tariffs of up to 25% on auto imports. Interestingly, imported trucks have faced a 25% tariff since 1964, when President Lyndon B. Johnson implemented the "chicken tax." This was a 25% tariff on imported light trucks and other goods. This tariff was in response to increased French and West German tariffs on U.S. chickens to protect these countries' farmers—after factory farming in the U.S. created a surplus of low-cost poultry. President Trump believes that this higher tariff has been beneficial to the U.S. truck segment, and he would like to extend it to cars. Members of Congress have spoken out against raising tariffs in this manner, and they have introduced legislation in the House and Senate to limit the president's ability to use national security as a tool in trade policy negotiations.

In general, lower tariffs benefit consumers. Having the EU lower its imported car tariffs from 10% to the U.S. rate of 2.5% would be beneficial for consumers. However, this also might force the U.S. to reduce the "chicken tax," which likely would hurt the highly profitable light truck segment. Japan has no tariff on imported autos. The barriers to foreign automakers doing business in Japan stem from setting up dealer networks, parts availability, and customer service levels (such as free maintenance and drop-off and pick-up services) that many dealers in other countries do not traditionally offer. Chart 1 reflects the current imbalance in auto trade between the U.S., the EU, and Japan.

Chart 1. Unbalanced auto trade conditions are fueling interest in tariffs



Sources: Department of Commerce, Wells Fargo Investment Institute; February 13, 2019. Chart shows exports of new passenger vehicles and light trucks in units.



Sources: Department of Commerce, Wells Fargo Investment Institute; February 13, 2019. Chart shows exports of new passenger vehicles and light trucks in U.S. dollars.

The release of this report by Commerce, prior to negotiations being concluded with China, is reversing the tactic of addressing one trade issue at a time. Initially, the administration had opened trade negotiations on many fronts and was making little progress. It then seemed to push other trade issues off the table, while focusing on China. As negotiations with the Chinese appear to be making progress, EU growth prospects continue to slow. The administration may feel that this is the time to press the EU to make a deal.

With progress being made on a positive resolution with China, we believe that the administration likely will then move forward with announcing and implementing auto tariffs. President Trump has demonstrated a pattern of announcing tariffs to get attention, implementing tariffs to bring parties together for negotiations, and then working to adjust trade terms.

The CBO's projected changes in federal revenues and spending over the next 10 years:

- **Revenues:** +61%
- **Spending:**
  - Social Security: +79%
  - Medicare: +106%

Source: January 2019 CBO Budget and Economic Outlook.

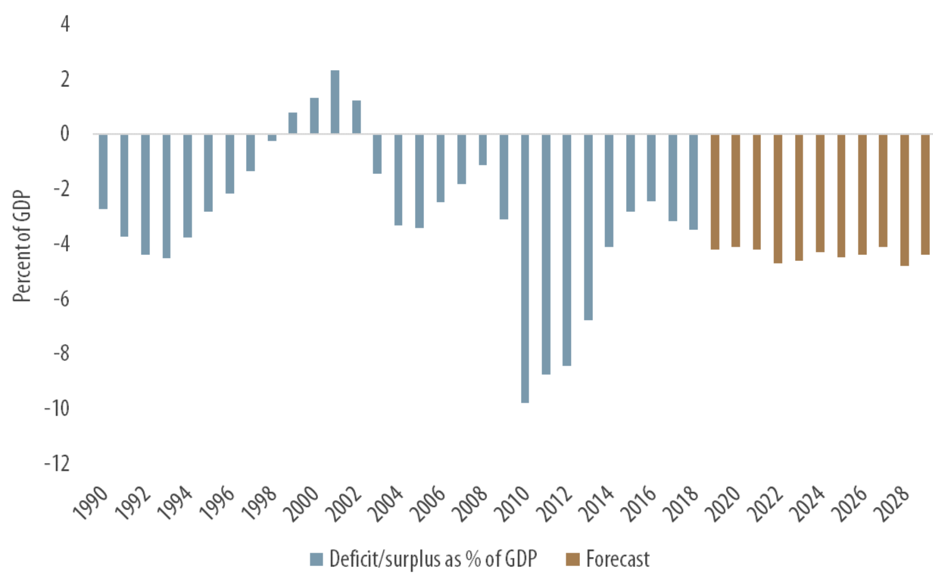
Key takeaways

- Rising federal deficits and debt reduce investment and spending on other, more productive items. They also limit the ability to respond to unforeseen future circumstances (e.g., recessions or conflicts overseas) through tax and spending policies.
- Without a reduction in federal spending, taxes likely will need to be raised. Although they are not a likely prospect before 2021, higher tax rates eventually would result in less household and business income to drive U.S. economic growth. Equity markets likely would suffer as revenue prospects decline, with sectors such as Consumer Discretionary and Industrials potentially being most adversely affected.
- High debt levels have a disinflationary effect that is likely to lead to lower inflation expectations and lower return assumptions over time. Our longer-term capital market assumptions take these factors into account.

Rising federal deficits and the resulting deterioration of America's finances

The Congressional Budget Office (CBO)[2] just released its latest assessment of the federal government's finances. The good news is that—due to higher U.S. economic growth—the federal deficit is projected to be slightly smaller than was originally forecast last year. The bad news is that it is still large. Federal revenues, mostly from corporate and personal income-tax receipts, are expected to grow, driven by continued economic growth. (The CBO's 2019 gross domestic product, or GDP, growth estimate is 2.3%, compared with Wells Fargo Investment Institute's 2.5% GDP growth forecast.) This has caused federal revenues to rise faster than initially projected. However, 2019 forecasts for federal spending (+7.4%) continue to outpace those for revenues (+6%), resulting in continually widening deficits. Chart 2 shows the scope of these deficits as a share of the U.S. economy. Having recovered from the levels seen following the worst crisis since the Great Depression, U.S. federal deficits are forecast to be persistently higher than in the past.

Chart 2. A new level of perpetual deficits?



Sources: Office of Management and Budget, Congressional Budget Office, Wells Fargo Investment Institute; February 15, 2019. Deficit forecasts are from the Office of Management and Budget. Forecasts are from the January 2019 CBO Budget and Economic Outlook, which are subject to change. Chart shows annual data from 1990 through 2029.

[2] All data used in this section is from the "The Budget and Economic Outlook: 2019 to 2029", Congressional Budget Office, January 2019.

The largest contributors to the increased federal spending and deficits are higher spending on benefit programs and interest costs. These are mandatory spending items, outside of the annual congressional appropriations process. A key reason for the spending increase is the aging U.S. population. The number of people who are 65 or older is currently 16% of the U.S. population, double what it was 50 years ago. This percentage will continue to increase as Baby Boomers age and life expectancy improves. In 2018, spending on programs related to those over age 65 consumed approximately 40% of all federal spending not related to paying interest on debt. This is currently 7.5% of the entire U.S. economy, and it is projected to rise to 9.8% by 2029. It is not a surprise that Baby Boomers would age and increase benefit programs' cost, yet the federal government has done little to address this issue.

This increased federal spending had resulted in U.S. public debt rising to $15.8 trillion at the end of the government's 2018 fiscal year (ended on September 30). As this debt continues to rise, interest costs are expected to increase—consuming a larger share of federal revenues over time. If interest rates were to meaningfully increase, the accompanying federal interest cost could become an even bigger drag on U.S. government budgets in the future.

The federal government has several options to address rising deficits and debt levels. Spending may be cut—but, with the bulk of spending being mandatory, any changes would likely impact politically sensitive social programs. Taxes also could be raised. However, having just cut taxes in 2017, tax hikes also may be politically unpopular. Some combination of both may be the best answer. Ultimately, the U.S. deficit and debt issues are a longer-term story for investors. Yet, they should not be ignored entirely. In particular, while we do not expect higher tax rates for at least the next two years, our long-term investment return assumptions anticipate higher U.S. tax rates.

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