Spring 2023

The debt ceiling debate, which will take up lots of news space in the coming months, is going to be filled with nasty rhetoric, tension, and brinksmanship. So, let's ease in, by going back to times when it didn't exist, and was a mere formality. And debt, by and large, was viewed much differently.

Back in the 20th century, it wasn't uncommon for folks to invite close friends and family over to their homes, serve food and drinks, and have everybody gather around while they burned the mortgage. (Kind of a second "housewarming," if you will.) The debt, of course, was satisfied, and the parties were meant to celebrate the homeowner's release from what usually amounted to their biggest financial burden. While more prevalent in the early 1900s, when larger down payments and short-term home loans prevailed, the ritual nonetheless kept momentum throughout the century, and was a centerpiece of episodes of the iconic shows "Mash" (Colonel Potter's home in Hannibal, MO) and "All in the Family" (Archie's in Queens).

While mortgage-burning parties haven't gone extinct, they're much rarer these days, for a couple reasons. First, with 30-year loans, refinancing, excessive leveraging (interest-only loans), and mobility, far fewer people ever pay off a mortgage. And, as a matter of decorum, in some circles, the bashes are considered gauche, bragging about one's lot in life.

While the idea of a mortgage-burning party might sound fun (recommended ideas include a backyard fire pit to roast hotdogs, s'mores, and the mortgage) and the idea of not sending out a huge chunk of cash each month might sound even better, paying off one's mortgage might not make the most financial sense.

It comes down to two main factors—cost (interest rate) and expected return if that capital is invested (growth of money). If a mortgage is over a year old, the interest rate is likely around 3%. If an investment is paying 5%, holding off on paying the mortgage is the prudent move. Say hard work or good fortune has you holding $200,000 in cash, and your mortgage stands at $100,000. Paying off the debt and investing the remaining $100,000 would earn you $5000. That's a net capital of $105,000 at the end of the year. If you were to invest the full $200,000, the net capital at year's end would amount to $107,000 ($200,000 earning 5%, less the $100,000 debt and $3000 interest payment.) As long as growth is greater than cost, having debt is a sound decision.

The same principle holds true with companies. When OCM considers buying a company's stock or debt, we first consider the appropriate debt level for their industry. Then what is the company's cash generation versus interest expenses. A good measure of this is their EBIT/Total Interest Expense ration, earnings before interest and taxes are deducted. The company has to be generating enough actual cash to cover servicing their debt, ideally seven or eight times more than is needed to simply cover interest expenses. This allows room for companies to weather a slowdown in sales and earnings when the unexpected hits. (There's been no shortage of late—pandemic, natural disasters, war in Ukraine…) And, of course, we also consider when the company's debt must be repaid and their ability to borrow even more money if needed.

We also look at the company's future projects and earnings expended from the growth and expansion. If the company can generate more cash than it costs to issue debt (interest on borrowing), then, like the mortgage example, they will net more money than had they not taken on the debt. Short-lived is the career of the CEO of a fast-growing company who announces to the board, "No returns this year, but we paid off the debt!"

Remember the old business adage, if you're not growing, you're shrinking.

(Fun fact…we're not interested in a company that doesn't have debt. Without it, another company or corporate raider can buy the company and issue debt from it to help pay for the purchase. The old "leverage buyouts" were based on this—buy a company, issue a bunch of debt—usually an unsustainable amount—and take cash out to line pockets.)

The same principles apply for the US government—a high level of debt is fine, so long as it's able to service the debt, grow the economy, and be prepared for the unexpected. For example, if the economy grows at 2% with the Fed's target of 2% inflation (that's 4% growth nominally), tax revenues, assuming the status quo, would grow by 4%, giving the government money to pay budget outlays. The government collected $4.9 trillion in 2022, so that would increase revenues to $5.1 trillion next year.

The current US debt is $31 trillion and has been growing for years. (With the bank bailouts of 2008 and pandemic recovery spending, the "unexpected," contributed mightily.) What's alarming, at least for now, is the debt is about 120% of GDP. That may seem like a big problem, but what will become clear, over and over, in the coming months, is that's debatable.

If an individual finds themselves unable to service debt, there are few solutions. Maybe they sell a car or other asset. Temporary, at best. Finding a higher paying job is not only difficult but takes time. Unlike us, unless you're on the wrong side of the law, the government can print money. They also, with the swipe of a pen, can raise taxes, or sell treasury bills, notes, and bonds. They can never be, as the saying goes, cash poor. These solutions, however and of course, can come with repercussions. Higher taxes can reduce productivity and growth in an economy, as less money is available to spend on either goods and services or expansion in the business sector. Too much debt can lead to loss of confidence in the government's ability to service the debt leading to higher interest costs and volatility in the financial markets. And as we have seen, printing money can lead to inflation as we have seen recently with the massive increase in money supply during the pandemic that Central Banks are fighting currently.

So, the trillion-dollar question—can the US government ever have too much debt? Yes. The real, and hopefully eternal, question is exactly how much debt is too much? Nobody knows the answer to that. But we're not there yet.

And the US economy grew by 2.9% in the fourth quarter of last year. Inflation has come down from historic highs—with prices rising at their slowest pace in nearly two years, having climbed 5% in the 12 months that ended in March. Not quite at the rate we need to get the economy humming, but it's a good sign, and could lead to the eventual lowering of interest rates that plague all who owe, including the government.

Remember, raising the debt ceiling allows the government to service debt it *already* has. Defaulting could devastate financial markets, which will likely punish 401(k)s and other investments, and downsize or capsize businesses, and take jobs. For better or worse, it has to be raised. Congress, at least the vast majority of members, know that.

A more useful debate, after the debt ceiling is raised, is how to make the government more fiscally responsible. Debt is fine, often good, so long as there's an ability to service it, and it's adding to the economy's expansion. Figure that out, or even have the conversation, and there's reason to celebrate, with or without the ceremonial burning of deeds.