On The Mark

May 2023

The Retractable (Debt) Ceiling

Key Takeaways

- The government's borrowing limit is estimated to run out by early June.
- Investors should prepare for potential volatility as increased partisanship in Congress will potentially only be resolved at the final hour.
- Investors should not make impulsive portfolio decisions solely based on debt ceiling risks.

The clock is ticking on US debt ceiling negotiations. Treasury Secretary Yellen informed Congress that cash balances are estimated to run out by early June, the so-called X-date[i]. With the deadline fast approaching, markets are sending signals about investor concerns. Treasury bills with maturity dates in mid-summer are seeing higher yields.While there is no playbook on how this showdown will unfold, sadly, this is not our first rodeo either.

We have been here before

Since the enactment of the debt ceiling in 1917, Congress has voted 102 times to either raise or suspend the limit[ii]. This has taken place under both Democrat and Republican control.That's not to say things have gone smoothly in the past either.

In 2011, the debt ceiling debate went so far that the credit rating agency, Standard & Poor's, downgraded the USS credit rating to AA+ from AAA[iii]. Standard & Poor's cited the growing deficit and the prolonged debate as the reasons for the downgrade.In 2013 and 2018, debt ceiling standoffs led to government shutdowns. Each standoff, showdown, and shutdown led to short-term market disruptions for days or weeks and subsequently recovered.

Is this time different?

It feels that the political debate today is even more combative, with the potential for a stalemate ever greater than in the past. Sadly, that is not a new development in Washington. However, the one thing separating today's debt debate from those of the past is the larger-than-ever national debt. US debt at $31.4 trillion, now stands at 120% of gross domestic product as of December 2022 and is projected to increase in the future[iv]. The silver lining is that despite higher debt, the interest cost on our debt is lower than the outlays in the 1980s and 1990s[v]. Nonetheless, the potential costs ahead are higher than in years past.

What are the paths ahead?

If a deal is reached before the X date, Congress could suspend the debt ceiling for a short time to coincide with the end of the fiscal year. Alternately given the upcoming election year, the most likely scenario is a last-minute agreement to raise the debt ceiling.

If a deal is not reached and all of the Treasury's cash balances are drawn, the federal government will be forced to rely on incoming revenues to pay its bill.This would require a prioritization in payments with principal and interest payments to bondholders likely to continue while other payments like government salaries and social security benefits could be interrupted.

If a bond payment is missed or delayed, that would constitute a technical default. The chances for a technical default, while not zero, remain low given the potential implications.A default is not a winning political outcome despite the hardline posturing from both parties to date. A default would mostly likely trigger a downgrade of US debt, increase the cost of borrowing, pressure the US dollar's reserve currency status, and disrupt short-term funding in financial markets.The subsequent market fallout will likely apply significant pressure on lawmakers to find a quick resolution.

What should investors do?

Understandably, the debt ceiling drama has investors on edge. Investors should resist the urge to make impulsive portfolio decisions solely based on debt ceiling risks. Instead, they should remain focused on long-term goals and rely on diversification within their portfolio. For instance, consider precious metals like gold, currencies like the Japanese yen or, the Swiss franc, or even international equities where appropriate. However, given the potential for increased market volatility, investors should ensure they have ample liquidity to meet near-term spending needs. Finally, looking past the near-term volatility, history suggests that stock markets tend to rebound shortly following the resolution of the US debt ceiling crises.

As history is our guide, let's hope the retractable (debt) ceiling is raised while finding a longer-term solution to the escalating debt and deficit.

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20230515-5684911.1

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[i] https://home.treasury.gov/news/press-releases/jy1454
[ii] https://www.americanprogress.org/article/congress-must-raise-the-debt-ceiling/
[iii] https://www.cnbc.com/2011/08/06/sp-downgrades-us-credit-rating-to-aaplus.html
[iv]https://fred.stlouisfed.org/series/GFDEGDQ188S
[v] https://fred.stlouisfed.org/series/FYOIGDA188S

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105841 | C23-19992 | 05/2023 | EXP 05/31/2023