Navigating the Debt Ceiling with Discipline & Diversification

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Right now, what is happening in Washington has an outsized impact on what's happening on Wall Street. The focus has been on the Fed's battle against inflation along with the ongoing turmoil in the banking sector. However, the spotlight shifted when Janet Yellen announced that a potential U.S. default may be closer than expected. Investors want to know if Congress will raise the debt ceiling and avoid a market-rattling default.

What is the Debt Ceiling? The United States debt ceiling is a statutory limit on the amount of debt the U.S. Treasury can issue to fund government expenditures. It was established to ensure that the government doesn't borrow beyond what Congress has authorized. Only Congress can authorize the borrowing of money on the credit of the United States. During World War I, Congress created the debt ceiling with the Second Liberty Bond Act of 1917. This allowed the Treasury to issue bonds and take on other debt without specific Congressional approval as long as the total debt fell under the statutory debt ceiling. In 1939, Congress instituted the first limit on total accumulated debt over all kinds of instruments. The debt ceiling, in which an aggregate limit is applied to nearly all federal debt, was established by the Public Debt Acts passed in 1939.[i]

When the debt ceiling is reached or close to being reached, the U.S. Treasury employs "extraordinary measures" to continue meeting the government's financial obligations without breaching the limit. These measures can include delaying payments, suspending investments in certain funds, and borrowing from other accounts within the government. The Treasury has already reached the current debt limit of $31.4 trillion, so it has no room to borrow further under its standard operating procedures other than to roll over maturing debt.[ii]

What happens if the U.S. were to Default? In terms of the probability of Default, markets, particularly the equity market, seem to be pricing in a resolution. Wealthcare informally polled 3rd party fixed-income managers as of May 10th, and they estimated a 90-95% probability of a resolution. One portfolio manager commented that in 2011, he gauged the probability as 1%, but due to the fractured political chasm today, the probability of Default jumped five to ten times. Elsewhere, JP Morgan's Head of U.S. Government Relation's, Elizabeth Herman, speculated there is an 85% chance a deal gets done, citing the key principals, President Biden, Senators McConnell and Schumer, and Leader McCarthy's strong and sincere desire to avoid Default.

If a default were to occur, it would be because the U.S. is temporarily unwilling, but not unable, to pay its debt. So, a default would be temporary but could have severe consequences, including a significant disruption to financial markets, a potential downgrade of the U.S. credit rating, a loss of confidence in the U.S. government's ability to manage its finances, and potentially precipitate a severe recession.

"If the U.S. missed a payment on a short-term note due in June, for example, it would spark an outcry in the markets, accompanied by extreme volatility for a day or two," Tom Hollenberg of American Funds Capital Group explains, "and then the debt ceiling impasse would likely come to an end." [iii] "When you reach a crisis, that tends to put the political gears in motion," he adds. "If that happened, I think Congress would very quickly come together and raise the debt limit, and investors would be made whole.

What's happened in the past? Here are a few key instances of past debt ceiling and budget negotiations and their market reactions:

> **2011:** The debt ceiling debate resulted in Standard & Poor's downgrading the U.S. credit rating from AAA to AA+. The uncertainty surrounding the negotiations and the potential for a default caused significant volatility in financial markets, leading to a 16% decline in the S&P 500 over a 5-week period.[iv]
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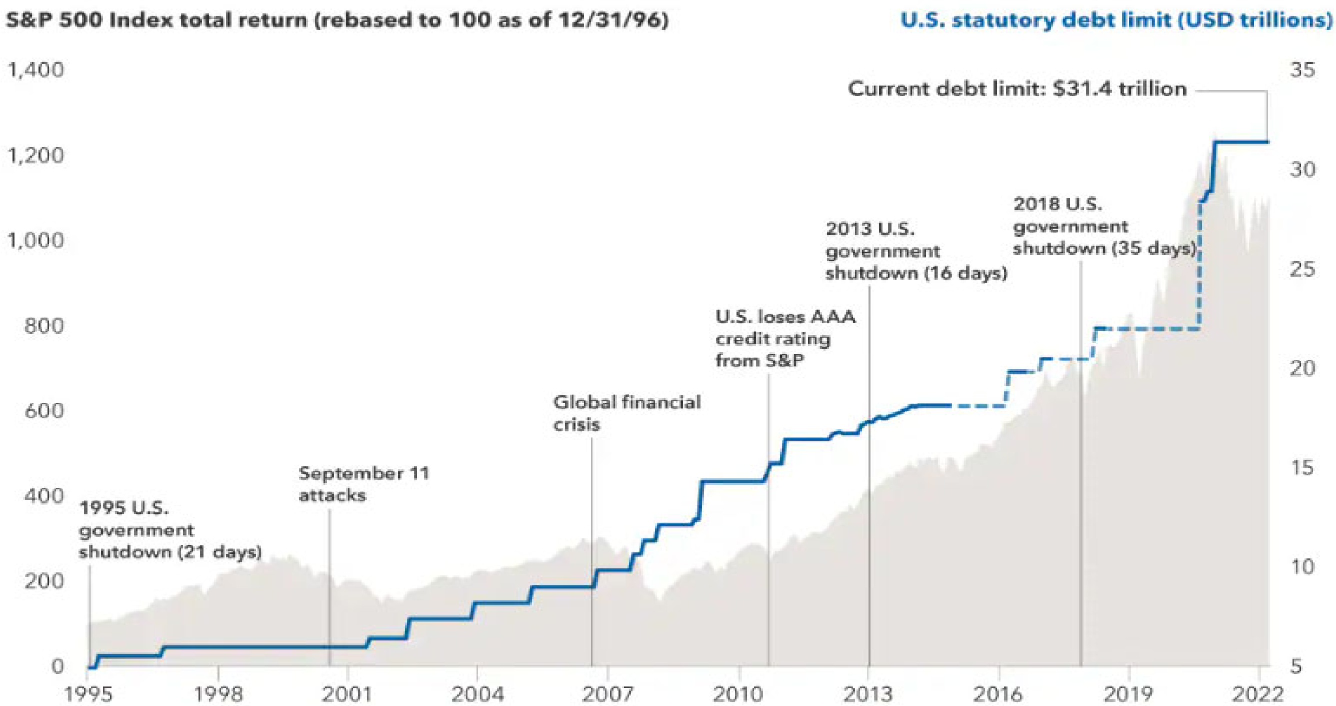
> **2013:** The debt ceiling debate coincided with the government shutdown. The negotiations caused market jitters,

but an eleventh-hour deal was reached, avoiding Default. The market reaction was relatively mild, with some volatility.

2018: The U.S. government shut down for 35 days as a result of negotiations over Government funding. Congress eventually passed a temporary solution, averting an immediate crisis. The S&P 500 rose by 10.2% during this time.[v]



As shown in the above chart, following the Global Financial Crisis in 2008, U.S. stocks embarked on one of the longest bull markets in history — a virtually uninterrupted run until the COVID-19 pandemic. This encompassed the three debt ceiling negotiations listed above. As a caveat, during this bull market, inflation was low, liquidity was high, and the debt-to-GDP ratio was much lower in contrast to today's environment featuring high inflation, quantitative tightening, and debt-to-GDP ratio above 120%.

How Should Investors React? Investors should be cautious about attempting to time their asset allocation around the debt ceiling standoff. Market volatility will likely remain elevated leading up to the deadline. It is important to remain disciplined and diversified. With history as a guide, the government has never failed to raise the debt ceiling, doing so 78 times since 1960. Markets tend to right themselves as short-term risks pass, as they did in 2011 and 2013. That said, the level of political rancor has never been deeper.

Feel free to reach out to your advisor to review your investments with a long-term view, considering your goals, risk tolerance, and the current market environment.

[I] Debt limit - Wikipedia
[II] Federal Debt and the Statutory Limit, February 2023 | Congressional Budget Office (cbo.gov)
[III] Debt ceiling showdown: Should investors worry? | Capital Group
[IV] U.S. Hits Debt Ceiling: Will It Impact Investors? | Charles Schwab
[V] Why Stocks May Soar After the Government Shutdown (investopedia.com)

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