

# Debt Ceiling Standoff: A Timely Reminder About Investor Fortitude

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In mid-January, the U.S. government reached its legal borrowing capacity commonly referred to as the “debt ceiling” or “debt limit.” Concurrently, the Treasury Department began to employ what it terms “extraordinary measures” to extend the date by which debt limit legislation must be enacted. The date on which extraordinary measures are no longer sufficient to fund government obligations is sometimes referred to as the “X date.”

If the debt ceiling is not suspended or raised by the “X date,” the U.S. could default on its debt. On May 1, 2023, U.S. Treasury Secretary Janet Yellen said that the X date could be as soon as June 1, 2023, earlier than many market participants had expected. If that date passes with no resolution, the Treasury could be delayed in making payments (or miss payments) to bond holders and in meeting other Treasury obligations, which could also create market dislocation.

Though the sense of urgency feels palpable in a 24/7 news cycle, this situation is not a new one. The debt ceiling was first established in 1917 so Congress could allow the government to borrow money more easily. Between the end of World War II and the present day, Congress approved an increase to the debt limit 102 times; 61 increases have occurred since the inflationary period of the early 1970s (Figure 1). The latest increase occurred in December 2021, when the debt limit was increased to ~\$31.4 trillion.

Even casual observers will recall this situation saturating the news coverage every few years, as political posturing is always at the center of what amounts to a partisan face off. Unfortunately, the debt ceiling has become a source of significant political and financial risk for the U.S. in a dynamic that is most prevalent during periods of divided government, which is also the case today.

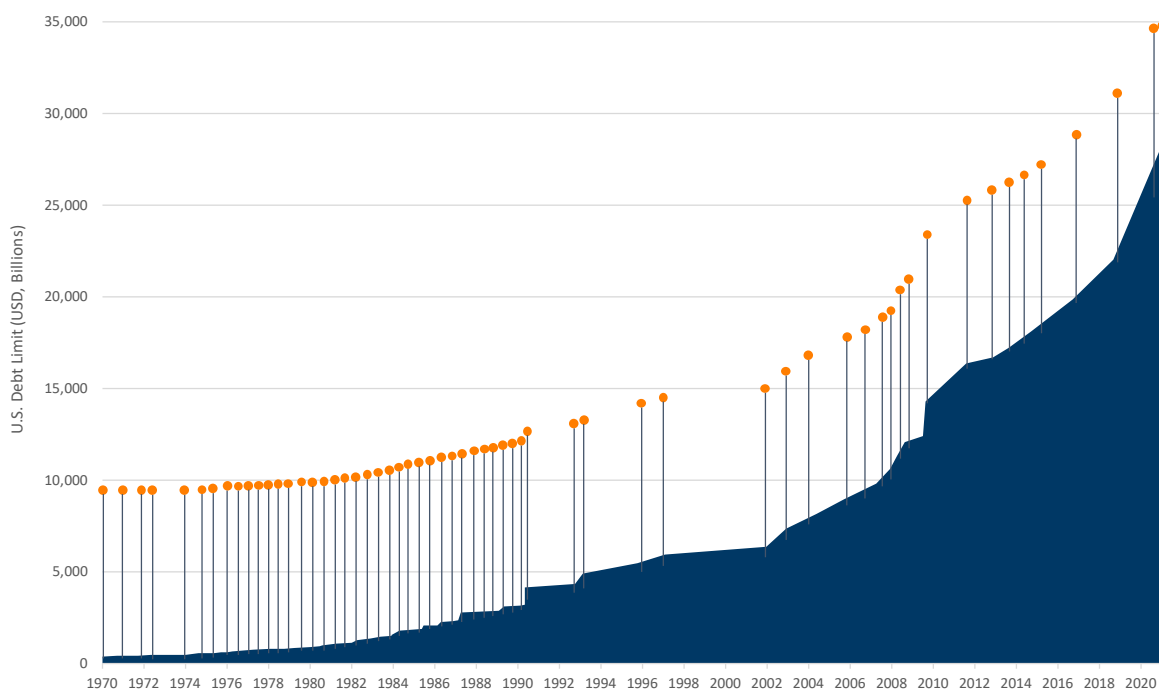
## Debt Ceiling Snapshot

- Congress suspending the debt ceiling allows the U.S. Treasury to temporarily supersede the debt limit rather than raising it by a specific dollar amount.
- Conversely, by raising the debt ceiling, Congress votes to allow an increase on the debt limit and how much the U.S. Treasury can borrow.

## Key Takeaways

- If the debt ceiling is not suspended or raised by the “X date,” the U.S. could default on its debt.
- Since the end of World War II, Congress approved an increase to the debt limit 102 times.
- The debt ceiling has become a source of significant political and financial risk for the U.S. in a dynamic that is most prevalent during periods of divided government.
- A string of fiscal showdowns between June and December could disrupt markets precisely at the worst possible time.
- Investors may want to remain anchored in their long-term strategic plans and ensure diversification.

Figure 1 – Instances the U.S. debt limit was approved by Congress and effectively raised since 1970.



Source: Congressional Research Service

## Recent History

2011 represented the first year of a newly controlled House of Representatives by the GOP, while the Senate and White House remained under the control of Democrats — a dynamic similar to its current structure. 2011 also followed a period in which many Republicans viewed federal spending as excessive — e.g., 2009 stimulus, 2010’s Affordable Care Act, TARP, etc. — not unlike 2020-2022’s COVID relief measures, infrastructure plans, Inflation Reduction Act, etc.

The 2011 debt limit was resolved in August 2011 after the Budget Control Act of 2011 was signed into law, though not before Standard & Poor’s downgraded the credit rating on U.S. debt from AAA to AA+. While this piece of legislation raised the debt limit and included spending and process reforms intended to reduce the budget deficit over the following decade, most of the reform measures were either unsuccessful or retrenched in subsequent legislation.

Post-2011, the debt limit has been lifted on several occasions — many of which transpired with relatively little fanfare. However, in the Fall of 2021 — during the middle of the COVID-19 pandemic — the Senate GOP pressured Minority Leader McConnell (R-KY) to negotiate spending reforms as the “X date” approached. Via negotiations, McConnell ultimately agreed to a process to allow Senate Democrats to lift the debt ceiling on a party-line vote, though many in his own party disagreed with this strategy. This was the last time the debt ceiling was increased, which set the stage for the current situation.

## What’s Driving the Current Impasse?

Political observers point to the convergence of several factors impacting the current debt limit stalemate, including pent-up GOP demand to reign in government spending, an increasingly divided government, and a narrow Republican majority in the House, among other issues.

President Biden and his Congressional allies have demanded a “clean” debt ceiling hike permitting the Treasury to borrow to pay for pre-approved Congressional spending. In contrast, Republicans, led by newly elected House Speaker Kevin McCarthy, have insisted that leaders from both parties negotiate a deal to lower the trajectory of federal spending to a more sustainable path. Discussions could involve tax increases and/or spending cuts to both discretionary and mandatory spending programs, such as Medicaid or food assistance.

The big difference between 2023 and the last few debt ceiling crises is that McCarthy seems to have less political flexibility than previous speakers had. Based on some of the hardline currents pulsing through the GOP, many of his colleagues seem more willing to take negotiations to the brink, if not over it, to achieve their fiscal policy objectives.

Some lawmakers have floated an idea of “debt prioritization” whereby the Federal government would establish a hierarchy that prioritizes payments while ensuring bondholders are repaid to avoid defaulting on U.S. debt. However, this process has never been tested and it is unclear whether the Treasury can implement such an approach in a timely manner and without markets reacting negatively or inviting litigation.

While it is still too early to tell how or when current debt ceiling negotiations will be resolved, there are a few plausible outcomes in our view.

1. President Biden and Congressional Republicans negotiate a budget agreement that puts in place limits on future spending, starts a process to consider additional fiscal reforms, and includes other proposals that could support the economy (e.g., energy permitting reforms). Note that it could take some time to get to this agreement, so a short-term increase in the debt ceiling may be necessary (see possible outcome #3 as that interim measure).
2. Democrats and moderate House Republicans use special House procedures (i.e., a discharge petition) to bring a “clean” debt ceiling raise to the House floor without Speaker McCarthy’s permission. This would be exceptionally difficult to execute and the time it would take to do so may not be available, especially given the quickly approaching X date.
3. House Republicans delay a long-term resolution by agreeing to raise the debt ceiling for a few months — likely until September or December of 2023, times when budget deadlines that often force decisions on difficult policies typically come into play.

It is worth noting that cuts to discretionary spending are an option, which would modestly reduce the U.S. growth outlook for 2024 and beyond. Discretionary spending is money formally approved by Congress and the President during the annual appropriations process, including funding national defense and the administration of government agencies. In the near term, a string of fiscal showdowns between June and December could disrupt markets precisely at the worst possible time: when corporate earnings may be close to bottoming and short-term interest rates could be peaking — a potentially damaging combination for investors looking to recover from 2022.

### **What These Developments Mean for Investors**

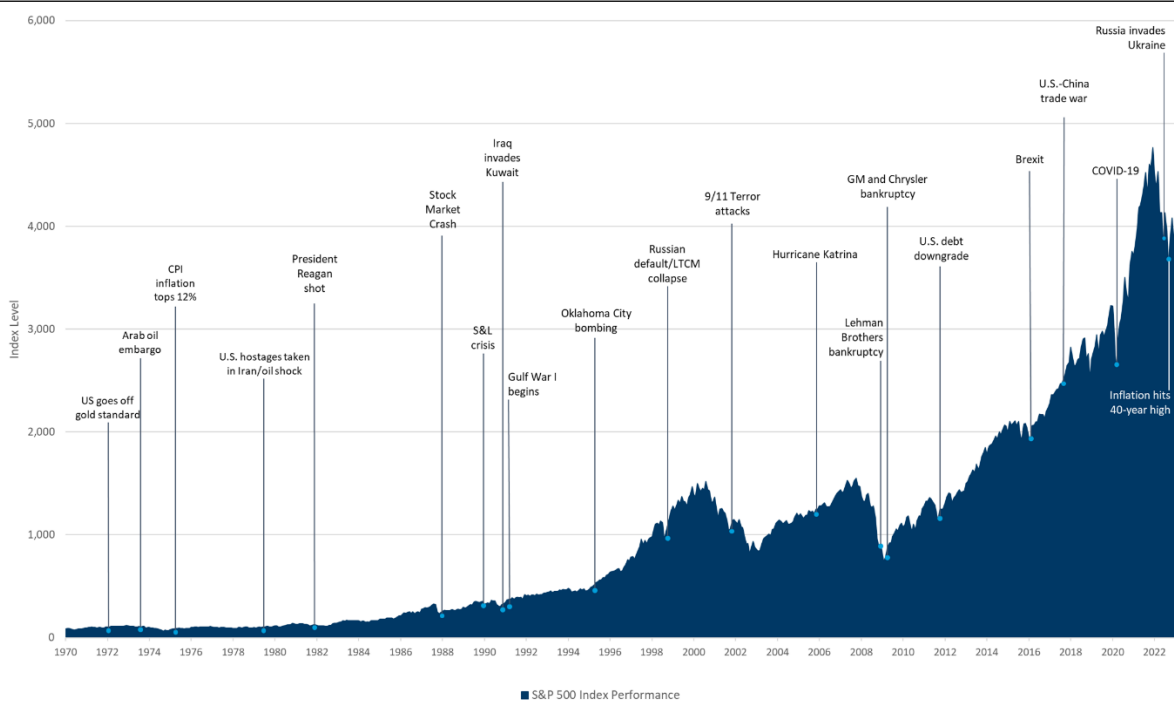
From an asset management perspective, we view the debt ceiling drama as a temporary irritation that may spark a period of volatility. However, it will not be an event that warrants a structural shift in long-term investment goals or asset allocations for two important reasons:

1. Professional investment managers understand that, barring an extremely unlikely default, volatility stemming from the debt ceiling is a temporary phenomenon, and act accordingly.

- The debt ceiling debate increases the list of items that will create uncertainty for markets, which has prompted active managers to remain defensively positioned going into the back half of the year.

For many investors, this unfolding debt ceiling flareup is a timely reminder about the importance of staying invested over the long-term. We believe looking at the market’s historical resiliency through major crises and events helps provide perspective on this type of temporary volatility. Over the last 50 years, the S&P 500 has demonstrated significant growth despite periods of high uncertainty driven by unique economic and geopolitical events – including debt limit standoffs (Figure 2). This time is likely to be no different.

Figure 2 – Historical S&P 500 performance punctuated by significant economic and geopolitical events.



Source: Morningstar Direct. Past performance of an index is not an indication or guarantee of future results. It is not possible to invest directly in an index. Exposure to an asset class represented by an index may be available through investable instruments based on that index.

Over the long-term (on an inflation-adjusted basis), staying invested in stocks and bonds is the proven and preferred course of action. Despite periods of significant volatility, over the last 40-year period<sup>1</sup>:

- S&P 500 average total return: 11% annually
- Bloomberg Aggregate Bond Index average total return: 6% annually
- Cash average total return: 3% annually (and just 1.6% annually over the last 20 years)
- Inflation average: 3% annually

## The Value of Professional Management

<sup>1</sup> Data from 1/1/1983 - 12/31/2022. Source: Morningstar Direct. Past performance of an index is not an indication or guarantee of future results. It is not possible to invest directly in an index. Exposure to an asset class represented by an index may be available through investable instruments based on that index.

Regardless of the current debt limit standoff, financial markets will continue to face a series of pressures through the remainder of 2023. Stagflation, politics, ongoing Fed rate hikes, geopolitical tensions, rebalancing labor markets, lower corporate earnings – all are plausible developments in 2023, and all may be significant drivers of market volatility.

This climate demonstrates how certain investors might benefit from professional portfolio management, which helps to dispassionately navigate market volatility. Investors who stayed the course since March 2020 – those who remained fully invested and committed to their financial plans – have benefitted. As of May 2, 2023, the S&P 500 was up 84% from its low on March 23, 2020.

While the economic environment and outlook for the remainder of 2023 are uncertain, a disciplined approach to managing investment assets is critical for cautiously mitigating risk and remaining on track to reach your long-term goals... despite the peripheral political noise.

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