The debt ceiling: An update and potential implications

The federal debt limit, or debt ceiling, remains center stage for investors. Treasury Secretary Janet Yellen cites June 1 as a date by which her department may be unable to meet government obligations. Without a firm deal by what is termed the "X-date," the U.S. government may default on some of these obligations for the first time since the U.S. government first issued $2 million in bonds to pay for the Revolutionary War on June 22, 1775.[1] In addition to setting a negative historical precedent, speculation on whether the U.S. Treasury may forego paying interest or principal on government-issued debt has implications for all financial markets.

The U.S. Department of the Treasury defines the debt limit as "the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations, including Social Security and Medicare benefits, interest on the national debt, tax refunds and other payments."[2] The Treasury department adds that the debt limit does not authorize new spending commitments, but instead finances existing obligations already authorized by past Congressional and Presidential actions. Since 1960, Congress has addressed the debt limit 78 times; 49 times under Republican presidents and 29 times under Democratic presidents.[3]

In April, the House of Representatives passed a debt ceiling increase that included some federal spending reductions. The White House has said it will not support any spending cuts as part of a debt ceiling increase. The Speaker of the House and the President have been engaged in negotiations to find agreement on an increase to the debt ceiling that would satisfy both parties. Negotiators have been meeting around the clock for the past several days, with some members of Congress anticipating the emergence of an agreement this holiday weekend and votes in the House and Senate coming next week.

Treasury Secretary Yellen's most recent letter to Congress noted that "we have learned from past debt limit impasses that waiting until the last minute to suspend or increase the debt limit can cause serious harm to business and consumer confidence, raise short-term borrowing costs for taxpayers, and negatively impact the credit rating of the United States."[4] Almost on cue, a major bond ratings agency, Fitch, placed the United States "AAA" rating (its highest) on Rating Watch Negative yesterday, indicating that it may downgrade its view on U.S. government-issued bonds' creditworthiness. Fitch listed the following among drivers for this negative outlook: Debt ceiling brinksmanship, reaching the debt limit, debt default rating implications, governance challenges, weakening fiscal outturns and a high and rising public debt burden.[5]

Market implications

As investors, we evaluate a range of variables to assess capital markets' forward prospects. Those factors include corporate earnings, economic growth, consumer activity, inflation, central bank policy and asset price patterns. We use

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[1] https://home.treasury.gov/about/history/history-overview/history-of-the-treasury. May 25, 2023

[2] https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit#:~:text=The%20debt%20limit%20is%20the,tax%20refunds%2C%20and%20other%20payments. May 25, 2023

[3] Ibid

[4] https://home.treasury.gov/system/files/136/Debt-Limit-Letter-to-Congress-Members-20230522-McCarthy.pdf. May 25, 2023

[5] https://www.fitchratings.com/research/sovereigns/fitch-places-united-states-aaa-on-rating-watch-negative-24-05-2023. May 25, 2023

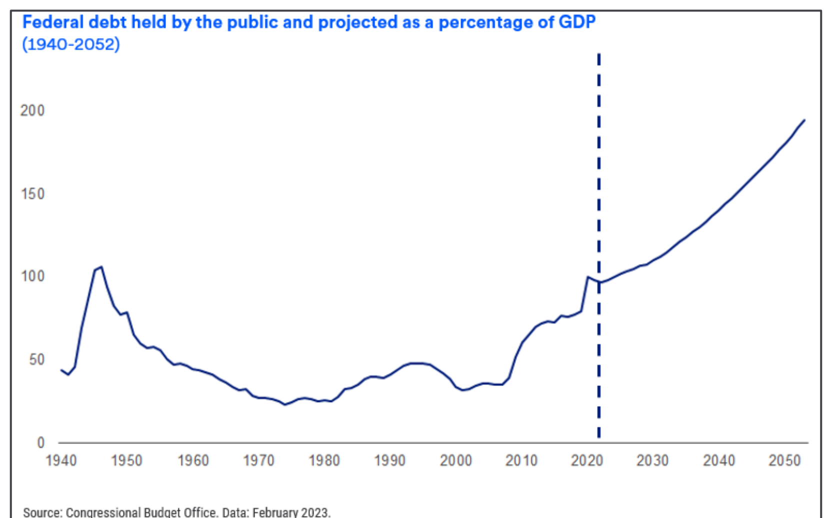
the term "edge" to describe our and other investors' ability to gauge these variables and make decisions that will help improve the odds of a favorable outcome for clients. From an investor's point of view, predicting debt ceiling outcomes is an "edgeless" phenomenon, both in terms of timing of any resolution and the long-term capital market impact. That said, if a default were to occur, we would anticipate some immediate downside risks to both stocks and bonds as investors assess broader implications. We would not expect downside risks attributable to a default alone to be enduring, but we do have concerns about a negative reaction triggering potential downside moves linked to weakening liquidity measures and potential consumer challenges we are forecasting for later this year.

While much of the financial media focuses on how the stock market may react to a default, we are most focused on bond market implications. The U.S. Treasury bond market remains the cornerstone of global finance. In addition to the U.S. dollar being the reserve currency of the world, U.S. government bonds are major holdings for foreign governments. On the latter point, foreign ownership of U.S. debt has increased from 5% of total debt outstanding in 1970 to as high as 40% in 2019.[6] Brinksmanship around the debt ceiling can challenge the "full faith and credit" underpinnings behind any government's debt issuance, particularly the United States. If bondholders and ratings agencies have concerns about either the government's mechanical capabilities or solvency to cover debt owed, the U.S. government risks prospective bondholders requiring more compensation in the form of a higher interest rate.

Our concern is a default exacerbating other near-term issues that may have more durable market implications, such as our interrelated concerns of liquidity and consumer health. Liquidity reflects the amount of capital available for consumers, businesses and governments to lend, borrow and invest. With the U.S. Federal Reserve raising interest rates and reversing its bond purchasing program, current challenges in the banking system, and the eventual debt limit reconciliation resulting in the government issuing debt and taking dollars out of markets to finance obligations, capital may not flow as freely as we get deeper into the summer. Consumers remain in relatively good health, but we are starting to see some increases in credit card borrowing and an uptick in delinquencies, which can portend more stress within households. The labor market is strong, but should the economy weaken and job availability decline while consumers are putting more purchases on credit, higher interest rates could present further challenges.

The bigger picture

In addition to these near-term concerns, we created a chart using data from the Congressional Budget Office entitled "When Will the Bill Come Due?", with estimates of federal debt as a percentage of the gross domestic product (GDP). This chart is reproduced here, showing projections out to 2052 with the dashed line representing today. As you can see, debt levels continue to grow, and if bondholders require the U.S. government to borrow at increasing rates, a self-reinforcing debt spiral may result. This is a fixable issue, but one that requires compromise and tough choices.



We have advocated for clients to have a slightly more defensive portfolio orientation in the current environment, recognizing that every client situation is unique. We will keep you posted on developments as they unfold and please do not hesitate if we can answer questions specific to your unique needs.

[6] https://sgp.fas.org/crs/misc/RS22331.pdf. May 25, 2023

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