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Global Investment Strategy and
Global Securities Research teams

Q&A on the latest debt ceiling standoff

Key takeaways

- The U.S. Treasury has said that the federal government officially has reached the debt ceiling and that measures to preserve cash should run out in July or August.
- We cannot say that Congress certainly will avoid default this year, but episodes in recent decades show Congress routinely used short-term extensions before they reached a longer-term deal. We do not expect cuts to Social Security, Medicare, Medicaid, or veterans' benefits.

What it may mean for investors

- We would avoid abrupt portfolio reallocations based on speculation about the debt ceiling, and we reiterate our defensive, quality-based overall approach for short- and long-term investors.

On January 19, Treasury Secretary Janet Yellen announced that the federal government officially had reached the debt ceiling and has initiated measures to stretch its cash to pay the government's bills. Recently, the economy's slowdown has dented the flow of tax receipts and brought forward the issue, while divided leadership in Congress deepens the issue's partisan divide. We anticipate growing concern and the potential for financial market volatility while the debate heats up. This report addresses the questions we've heard most often from investors and describes our market guidance on the issue.

1. What is the debt ceiling, and why does the federal government have one?

The U.S. debt ceiling represents the maximum amount the government can borrow to cover existing financial obligations.[1] Once the debt level reaches the threshold, the Treasury may not issue new debt until Congress raises the ceiling. Originally intended to simplify the issuance of bonds to fund World Wars I and II, debt ceiling legislation later has evolved to cap borrowing and limit federal spending. Rancorous congressional debates have arisen, as legislators leverage the issue to push their budgetary priorities.

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1. Prior to 1917, Congress authorized each issuance of debt, including interest rates and bond maturities. After April 1917, Congress gave the Treasury flexibility by not restricting the purpose for borrowing. "The Debt Limit Through the Years," Bipartisan Policy Center, Jan. 20, 2023.

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2. How many times has the government reached its debt ceiling in history, and does the federal government run out of money when the ceiling is reached?

Congress historically has always intervened to raise, temporarily extend or even suspend, or amend the definition of the limit. Lawmakers have raised the debt ceiling 100 times since the end of World War II and 78 times since 1960.[2] Failing to do so could result in a government shutdown, eventually leading to an unprecedented U.S. default that would likely have negative and far-reaching implications across global financial markets.

When the ceiling is hit, the government can temporarily pay its bills with available cash, or it can implement extraordinary measures to generate more temporary funding. These measures typically alter investments or withhold contributions to government-run pension funds for federal employees, in order to pay other obligations in full and on time, until cash runs out on the so-called X-date. The X-date is necessarily imprecise, especially this time, because tax revenues are rolling over with the economy and the past year's decline in equity prices.

3. How does Congress typically reach agreement to raise the ceiling?

Congress frequently has taken measures to avoid default while negotiating the terms of deficit reduction. In 1990, for example, legislators temporarily raised the debt ceiling six times, before making a long-term debt ceiling increase accompanied by deficit reduction. Eleventh-hour compromises have become increasingly commonplace as Congress has become more polarized in recent decades. Down-to-the-wire agreements were most notable in 1995-1996, 2013, 2021, and especially 2011.

4. Have there been times when a congressional deal on the debt ceiling came close to the X-date?

Political standoffs are common, including recently in 1995-96, 2013, and 2021. The worst occurred in the summer of 2011, when Congress reached agreement just before the government was set to default in early August. The 2011 debate had a short-term but material effect on stock and bond market volatility, which spiked around the time of the agreement and a Standard & Poor's downgrade of Treasury credit (to AA+ from AAA).

The financial market outcome in 2011 was a brief period of risk-off trading, rather than a wholesale exodus from the U.S. markets. The S&P 500 Index fell, long-term U.S. Treasury securities gained, and the dollar held steady. The equity correction from July 21, 2011 to October 3, 2011 took the S&P 500 Index lower by 18%, but the index rebounded by 30% by October 3, 2012.

Economic growth stumbled briefly in the month after the 2011 debt crisis, responding as much to high inflation earlier in the year as to debt-related turbulence in the summer. The economy then returned to a stronger, but still-modest pace during the balance of the year.

The deep partisan and intra-party divisions suggest gridlock over the coming weeks around this highly charged, highly visible issue. Looking ahead, we want to keep in mind that proposals the political parties may label as unworkable today may help set the boundaries for an eventually workable plan. It's worth remembering that the 2011 compromise agreement involved substantial spending cuts, and spending contingencies have been key parts of every debt-ceiling agreement since. Moderates in both parties could reach a compromise, similar to the approach used to pass the big infrastructure bill in the last Congress, which also was divided.

2. See "Q&A: Everything You Should Know About the Debt Ceiling," Committee for a Responsible Federal Budget, Jan. 18, 2023; and "Debt Limit," U.S. Department of the Treasury, Jan. 20, 2023.

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5. Does reaching the debt ceiling change the Federal Reserve's policy approach to raising interest rates and shrinking its balance sheet?

The Federal Reserve (Fed) is responsible for maintaining price stability and achieving maximum employment, so political brinksmanship is unlikely to hinder the Fed's continued use of its tools (such as policy interest rate hikes or allowing the balance sheet to shrink) to achieve those objectives.

We believe the Fed may pause raising rates by June but most likely will continue allowing maturing bonds to roll-off its balance sheet. As the Fed's balance sheet shrinks, the reduction in market liquidity could reinforce any market volatility arising from any delayed debt ceiling deal from Congress.

6. Is it possible to know yet how equity markets broadly, and the sectors and sub-industries of the S&P 500, are likely to be affected by whatever deal Congress finally strikes?

A protracted debt ceiling debate likely will create volatility for equities, particularly the Health Care and Industrials sectors, which are closely tied to government spending.

Industrials: The Defense sub-industry derives most of its revenues from the federal government and its various agencies. The recently passed 2023 defense budget boosts defense spending by 8% over the 2022 level, with supplemental funding for Ukraine. Additionally, the Department of Defense has noted a desire to restock depleted stores in certain areas, modernize numerous programs, and true-up for prior inflation.

The main reason that Defense equities have underperformed the S&P 500 Index recently is investor concern that Congress may settle on a debt ceiling increase that sequesters discretionary spending. After the 2011 sequestration, defense spending did not exceed fiscal-year 2011 levels until fiscal year 2019. We do not currently expect this outcome given the perceived needs that drove the 2023 budget increase. Nevertheless, we favor approaching this sub-industry with caution until this latest dispute is resolved.

At present, we are maintaining our neutral view on the Industrials sector and our favorable view on the Defense sub-industry. Although volatility is possible around the debt ceiling debate, valuations have compressed, and we expect a potential buying opportunity in Defense companies if and when Congress reaches a debt ceiling deal. Looking beyond the near-term potential debt ceiling volatility, we anticipate the Industrials sector to benefit after a relatively short and moderate recession and to benefit longer-term from spending allocated by the recently enacted Inflation Reduction Act.

Health Care: The Health Care sector, and the Managed Care sub-industry specifically, depend in numerous ways on federal funding, health insurance policy, and other regulations. During the 2011 debt ceiling negotiations, a bipartisan commission recommended changes to federal health care policy. It is unclear at this time what specific changes could be proposed, but the U.S. health care system has grown significantly since 2011, especially since the coronavirus pandemic. We expect the Managed Care sub-industry to maintain strong earnings stability and to benefit from an aging population. We believe strong and consistent organic growth is also likely from the Life Sciences and Medical Devices sub-industries, as the health system adopts advanced medical technologies.

Large-capitalization Pharmaceuticals could be an area to monitor, as this sub-industry relies heavily on federal spending. However, the industry was recently the target of new tax measures in the Inflation Reduction Act, which may reduce incremental risk in the current debt ceiling negotiations. We retain our neutral outlook on Pharmaceuticals.

No concrete policy proposals appear to have majority support in Congress yet, and any final deal may or may not include the proposals appearing most prominently in the media today. We do not favor changing any of the above outlook ratings. Neither do we favor reallocating among equity sectors based on the current media headlines. We do not believe that the threat of near-term volatility changes the likelihood of longer-term factors.

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7. What could a protracted debate imply for U.S. Treasury yields over the coming months? What is our guidance?

We also favor maintaining recommended fixed-income allocations at this time. Considering that historically a debt ceiling agreement has emerged from Congress, delays are likely to create the greatest volatility among fixed-income securities due on or around the X-date. However, even short-term concerns about the debt ceiling have tended to support quality, long-term fixed-income securities. In our view, long-dated investment-grade bonds, including U.S. Treasuries, should be among the best performing sectors.

Summary implications

We cannot rule out a political miscalculation, but we believe neither party wants to be responsible for a default. What's more, in the historical episodes of debt ceiling increases, short-term extensions have been routine until Congress can strike a longer-term deal. An eventual agreement seems likely, in our view, as in the previous 78 times since 1960. Neither do we expect cuts to Social Security, Medicare, Medicaid, or veterans' benefits.

Still, media reports this winter may lead with stories about the two parties testing the political extremes. The longer the partisan arguments run into spring, the greater the potential for the period of debate to produce price weakness in equities (especially in the Industrials and Health Care sectors) and in fixed-income assets that mature during or around July and August. Higher-quality fixed income and equities have tended to be among the better performers during such intervals of uncertainty. Of course, past performance is not a guarantee of future results. Our guidance already emphasizes a cautious, quality-based overall approach for short- and long-term investors. Therefore, we prefer to avoid abrupt portfolio reallocations based on speculation about the debt ceiling.

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Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. Investments in **fixed-income securities** are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity. **U.S. government securities** are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Definitions

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