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Monthly Market Commentary
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This month's market commentary comes on the tails of many client questions about the debt ceiling and potential default. If there was ever a topic that is complex, likely to be stirred up by the media, involves politics, and has tremendous global ramifications, this is it. I wanted to get ahead of this by providing education, a frank and honest analysis, and how I think this may play out.

Commentary Summary

- The government has payment obligations ranging from Social Security to the military. These obligations are paid from tax revenue and borrowing. Soon, the government won't have enough money from tax revenue and has reached its "credit limit", so it may not be able to pay these, and other bills.
- The US Treasury market is the largest and most liquid market on earth and serves as the reserve currency for global trade and transactions. The US has never defaulted on payments to US Treasury bond holders which is why this is so scary. If the US cannot repay US Treasury bond holders, the ramifications are global and potentially unpleasant.
- This is challenging in my view because it must be solved in Washington which has never been more polarized.

Part 1: The US government, like people and companies has bills to pay.

The government has a lot of bills from Social Security and Medicare payments to military paychecks, and contractor payments. It pays these bills from income tax revenue and borrowing money. The government's bills add up to more than what it receives from tax revenue, so it borrows via US Treasury bonds. Nearly all of our clients own US Treasuries and therefore are lending money to the US Government.

- The "debt limit" is important because, by law, the government can't borrow indefinitely. Congress assigns a "credit limit" like credit card companies and banks do for individuals and businesses. The government actually hit the borrowing limit on January 19, 2023, but the US Treasury implemented "extraordinary measures" to continue paying the government's bills. The extraordinary measures are a band-aid, and the government is likely going to run out of cash to pay bills as soon as June 1.
- This could potentially impact everyone. If you hold US Treasuries, interest payments or repayment of principal may be delayed. If you receive Social Security checks, these may be delayed. If you're a doctor's office, Medicare payments for services may be delayed. If you work in the US Military, paychecks may be delayed. If you're a contractor, payments for services or expenses may be delayed. That would encompass a LOT of upset people in the near term. In terms of investments, the most significant impact is to US Treasuries which could negatively impact global financial markets, currencies, valuations, and be multi-generational.

Part 2: The US Treasury Market is critically important to global markets.

The US Treasury market is gigantic: $23.9 TRILLION.[1] For context the New York Stock Exchange (NYSE) is $22.3 trillion.[2] US Treasuries are critical because they're considered risk free and are used to help price and value everything from car loans to mortgages, companies, stocks, and bonds literally worldwide. The US government has never defaulted on US Treasury interest payments or principal repayments. As if you aren't convinced that the guarantee is ironclad (until now), most banks and trading firms don't have software to account for a default on US Treasuries.

If the government were to default on US Treasuries, a few obvious things could likely to occur.

1) Higher costs of borrowing for everyone. Use credit card debt as an example. If you miss a payment, the interest goes up because you're perceived as a riskier borrower, so your debt gets more expensive. The US government is no different. If the government fails to pay US Treasuries on time, the perceived risk by global markets goes up, so interest rates on future Treasuries issued goes up too. Since US Treasuries are considered the risk-free rate for planet earth, then higher interest rates could translate to higher borrowing costs.

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2) The burden of this cost would likely be shifted to Americans. The cost is both direct and indirect. Individuals and corporations would likely pay higher taxes to increase revenue for the government to pay for higher interest rates, there could be fewer social services and forced spending cuts in other areas.

There are less obvious ramifications that are not as well understood but potentially more unpleasant.

1) The government would likely have to lay off workers and cut spending. This would impact unemployment and economic growth.
2) The US housing market would likely be adversely impacted. Institutions with an implicit or explicit US Government backstop could face a significant hit, namely Fannie May, Freddie Mac, and Federal Home Loan Bank. Their credit ratings could be cut, and interest rates on mortgages could increase, placing further stress on the housing market and housing affordability.
3) I'm reading that the US dollar could drop, but this is too simple, in my view. The dollar could drop because investors sell US Treasuries in favor of international equities and other government's bonds (Germany, Japan). In a strange contradiction, a potential default could lead to a flight to quality/safety, pushing US Treasury yields lower as investors rush to purchase the very securities that are in the focus of the default!
4) Credit rating agencies like Standard & Poors and Moody's could decide to downgrade US debt, causing damage not only to US Treasuries but to the global financial markets which depend on Treasuries as the risk-free rate. This happened in 2011 when S&P downgraded US credit 1 notch below the coveted AAA perch.
5) Heidi Crebo-Rediker from the Council on Foreign Relations provided what I felt were an objective and sober reality.[3]
    a. This could compromise the US on the international stage because the US could lose some credibility. The US projects power through our economy and the dollar as the central reserve currency. This credibility underpins sanctions, statecraft, market stability, and commerce.
    b. We don't have a threat to the US dollar except what could be from our own undoing.
    c. This could play into the hands of our foes by handing talking points to our adversaries who seek to compete with or damage our reputation. A default could damage the US ability to lead the global economy and forge global alliances. In light of geopolitical conflict when US global leadership is both very important and being tested, Ms. Crebo-Rediker said it best, "*the timing is bad*".

Part 3: How will this play out? It's political and therefore difficult to predict

I think this will play out as follows:

1) This is partly about politics. Washington will play a showdown game of chicken until somebody swerves and a head-on collision is avoided. I don't think this will go down to the 11th hour on May 30th. I think this will go down to 11 hours, 59 minutes, 58 seconds.
2) Unfortunately, the markets may be used as a bargaining chip. A sell-off of ~15% is not unlikely, in my view and the pain caused to investors could be used by both sides to show the stress that negotiations are creating in markets.
3) The debt ceiling may be temporarily raised for 2 – 3 months to buy time.
4) At the risk of looking like an optimistic fool, I think Congress and the White House will use this time to compromise on debt ceiling increase with a cut in spending.

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This is the outline for my thesis:

1) Republicans want spending cuts to reduce the pace of spending growth. Democrats want to raise the debt ceiling without conditions, while accusing the Republicans of hostage-taking. House Speaker McCarthy doesn't have a lot of room to budge on the Republican side because of the influence of the Conservative Caucus.
2) It's not in anyone's interests politically to cave/compromise early. Both parties want to show that they negotiated until the very last minute. The US political system is designed for this to prevent any one party, any one branch from getting too much power. This is why it is often difficult to move anything forward, but this could create fireworks.
3) Both parties will need to align budget negotiations with debt ceiling negotiations so that everyone saves face.
4) The potential stock market pressure is important because it creates anxiety. Both parties will use this as leverage to force the other party's hand. Speaker McCarthy will need a market sell-off to go to his conservative holdouts for concessions in the negotiations.

At risk of exposing personal views, I think politicians are self-interested and want to keep their jobs. I'm betting that this self-interest will ultimately get a deal done. Politicians have personal investments that will feel the same pain as everyone else. They also depend on donations and support from wealthy individuals, investors, global leaders, and corporations who won't enjoy this ride and who won't hesitate to contact politicians directly or through lobbyists and superPACs to get a deal done and avoid default at all costs.

Part 3 Appendix: If the debt ceiling is raised temporarily until September, how might this play out in between?

Treasury Secretary Janet Yellen's job won't be easy.

- What will Janet Yellen and the US Treasury do when they get approval to extend borrowing?
  At what pace, and what kinds of bonds will be issued? When the US Treasury cash balance in the general account is very low (they don't have a lot of cash to pay bills, which is the default question) which could put the US at a disadvantage when issuing US Treasuries in the near term.
- Compounding the problem is the Federal Reserve rate hikes and monetary tightening. The US Treasury will issue $650 – 750 billion of debt during a credit crunch while the Federal Reserve is trying to stave off inflation. I have some concerns about liquidity implications on the back end of this.

Republicans want spending cuts.

- How and what will cuts to federal spending look like, because those cuts matter to forward-looking expectations of growth. Are there rollbacks to Inflation Reduction Act? Infrastructure spending? Other related opportunities? Those have been a support to economic growth, and if they need to be removed form forecast, that could dampen economic growth.

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Closing comments

In my view, the US has so much to lose if this goes badly. US Treasuries are considered the safest investments and serve as building blocks for the worlds' financial system. Quoting JP Morgan Asset Management, a default "*could leave some lasting scars, including a permanent increase in the cost of funding U.S. federal debt*". This is so difficult to predict because it involves politics during an especially divisive time. Focusing on what we can control, I made the decision to focus on safety and conservative investing. As I mentioned, the last time this happened in 2011, the markets sold off ~15%. For clients in discretionary PIM accounts, I may adjust our strategies by raising 10% in cash and invest in a money market mutual fund earning ~4.5% (annualized). If a sell-off does occur, I can spend this cash on stocks at lower prices. If a sell-off doesn't occur, the cash should earn 4.5% annualized, and we repurchase stocks, happy that the US government eventually did the right thing, it didn't default on debts, and US Treasuries remain the risk-free standard for global financial markets.

I remind clients that there will always be a catastrophe du jour. It's simply part of investing. The best outcomes continue to come from having a plan, sticking to a plan, and never making investment decisions based on emotions.

Questions and comments are welcome.

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Sources & Disclosures

[1] United States Treasury
[2] New York Stock Exchange, www.nyse.com, Intercontinental Exchange
[3] Heidi Crebo-Rediker, Council on Foreign Relations. Bloomberg Surveillance
The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.
US Treasury bonds are guaranteed by the full faith and credit of the U.S. Government for the timely payment of interest and principal if held to maturity.
FNMA pass-through securities/FHLMC Participation Certificates/FHLMC Gold Participation Certificates are fully guaranteed as to the timely payment of principal and interest by FNMA/FHLMC. These securities are not backed by the full faith and credit of the U.S. Government. The market value of these securities prior to redemption is not guaranteed and may fluctuate.
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