Navigating the Debt Ceiling Debate

What Are the Implications for Your Investment Portfolio?

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With the debt ceiling looming, we have received many questions about the impact this debate may have on financial markets. Below please find a few thoughts.

Anything that calls into question the good faith and credit of the U.S. government would be undeniably bad given the central role that Treasury debt and the U.S. dollar play in global financial markets. An actual default or a significant and prolonged reduction in other government payments to avoid a default would likely trigger a recession and potentially a financial crisis, negatively impacting large swaths of the economy.

Thankfully, we have never come very close to an actual default. Politicians know that shutdowns are unpopular, and a default would be much worse. Historically, they have made deals to avoid the worst while still winning some concessions they can tout back home.

Fights over the debt ceiling have typically had a limited impact on markets. Even in July 2011, which was probably the most serious debt ceiling crisis to date, the 10-year yield fell about 40 basis points, the VIX rose from 16 to 25, and stocks had a peak-to-trough loss of less than 5%—all notable but within the range of typical market drawdowns.[1]

This Time May Indeed Be Different

Congress is mired in partisan gridlock, and both sides may be more inclined to play brinksmanship than in years past. We see two potential outcomes:

1) The elevated financial market volatility in the wake of the regional bank crisis could make politicians unwilling to test the resilience of the financial markets. If so, they will seek a resolution to the debt ceiling in Congress before the end of the summer.
2) On the other hand, some politicians may view the Treasury, the Fed and FDIC's reactions to the regional bank crisis as governmental overreach and will use the debt ceiling as a device to force the discussion of the longer-term trajectory of federal debt.

What is the Debt Ceiling?

The debt limit represents the maximum amount of money that the U.S. government is authorized to borrow to fulfill its legal obligations. On January 19, Treasury Secretary Janet Yellen confirmed that the U.S. reached this limit. To continue operating, the Treasury has implemented extraordinary measures that provide some breathing room until early June. However, Secretary Yellen cautions that this timeline is uncertain. Failure to raise or suspend the debt limit could result in a funding crisis for the Treasury, which would have ripple effects across the financial markets.

The current debate on raising the debt limit is not related to new spending but rather about paying for past decisions that policymakers have already approved. Essentially, Congress is discussing whether to allow the government to borrow money to cover the spending that it has already authorized. Unfortunately, when Congress approves new spending and taxes, it does not automatically approve borrowing to cover any shortfalls. An analogy would be a person charging vacation expenses to their credit card and then debating whether to pay off the credit card bill when it comes due.

[1] More significant turmoil took place after the debt deal was signed in August 2011, but that was driven by the sovereign debt crisis in Europe, not the U.S.

What Options Does the Federal Government Have?

If a compromise cannot be reached, the Biden administration and Treasury Department have a few options they could enact unilaterally to avoid a default. These include:

14th Amendment – The fourth section of the 14th Amendment states that “the validity of the public debt of the United States … shall not be questioned.” Many argue that this clause makes the debt ceiling unconstitutional and provides Biden with protection, if he ignores the ceiling, should the question ever be brought to court.

Platinum Coin – The Platinum Coin is a concept that emerged during the U.S. debt-ceiling crisis of 2011 as a way to bypass Congress to raise the country’s borrowing limit, by minting very high-value platinum coins. To avert default, the Treasury could mint a trillion-dollar coin and deposit it with the Federal Reserve. The idea is that the Fed could then credit the Treasury’s cash balance by that same amount—giving it the ability to make payments on federal obligations. While there are many skeptics to this approach, including Secretary of the Treasury Janet Yellen, it is one avenue the Treasury Department could explore should the impasse persist.

Premium Bonds – The law sets a limit on the Treasury’s overall debt level, but it gives the Treasury broad discretion on how to structure it. For example, the Treasury could issue “premium” bonds that pay much higher fixed interest rates than the existing debt. Investors would pay high prices—in other words, a premium—for them, which the Treasury could use to retire a larger amount of existing debt carrying lower prices.

While none of these options have been used in the past or ruled on by the courts, the government could implement them should Congress prove to be intransigent.

What Will Happen in the Event of a Default?

In the event of an impasse leading to default or a major reduction in government payments, we will likely experience a recession and very volatile markets in the short term. The Fed would likely ease the Federal Funds rate and, with a Presidential election next year, politicians would be forced to work towards a deal. As such, we do not expect this to go on for long.

How Should We Position Your Portfolios in Light of the Looming Debt Crisis?

Given the inherent unpredictability of whether Congress will reach a resolution and the consequences of such an action, we do not recommend significant changes to the portfolios at this time. We build our portfolios to be resilient across a range of economic, geopolitical and market outcomes. While volatility is likely to increase as the deadline approaches, we believe being overweight quality and the U.S. relative to International Developed Markets will help insulate portfolios. These segments of the economy should perform better during bouts of volatility than sectors that connect more closely to the economic cycle.

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