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# Monthly market update

Debt ceiling | April 2023

Dan Golosovker, James Liu (Clearnomics)

## Takeaways

- The U.S. hit its debt limit in January when the national debt reached \$31.4 trillion. The Treasury Department has been employing “extraordinary measures” since then.
- The federal government faces a rapidly approaching deadline to raise the debt ceiling before June 1. The President and congressional leaders are meeting to find a compromise.
- Markets have generally taken previous debt ceiling crises in stride. However, the U.S. debt downgrade and market correction of 2011 was a direct result of fiscal problems.

## Market update

This update is provided in partnership with Clearnomics, a market insights platform for asset and wealth managers. Our goal is to help you stay abreast of ever-changing markets by putting current conditions into the context of economic and market history. Every monthly update will address key issues clients are asking about and share real-time insights you can use to improve the management of risks in your fund. The updates will also provide practical historical stress-testing scenarios to help you explore potential outcomes for portfolios in the current environment.

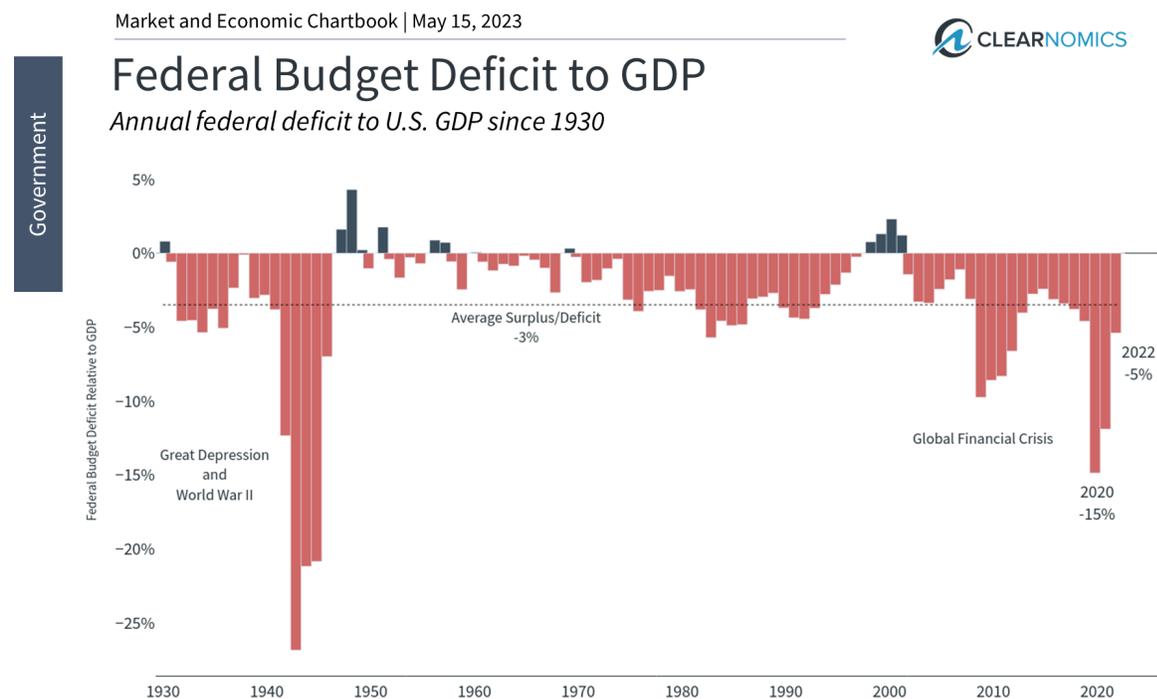
The federal debt limit is once again in the news as the country rapidly approaches a critical deadline on June 1. Investors are understandably nervous about Washington failing to reach an agreement, a possibility that both sides have agreed would be a self-inflicted catastrophe. While it's unclear how this will play out in the coming weeks, the fortunate news is that financial markets are mostly taking these events in stride. How can investors maintain the right perspective around political and fiscal uncertainty?



First, it's important to understand what the debt limit is and is not. In simple terms, the federal government borrows money to pay its bills by issuing Treasury securities. This is necessary because the federal government often operates with a deficit, whereby spending exceeds government revenues. This borrowing adds to the national debt, which hit the \$31.4 trillion debt ceiling in January. Since then, the Treasury Department has been employing what it calls "extraordinary measures" – accounting maneuvers that provide Congress time to keep paying government debts to ensure that the country does not default on its obligations.

### Exhibit 1

The federal budget deficit requires Congress to raise the debt ceiling



Sources: Clearnomics, U.S. Office of Management and Budget

The debt ceiling is a mechanism that requires Congress to approve additional borrowing above these levels. What makes this discussion confusing is that the debt ceiling is not about government spending, per se. That spending has already been authorized through the normal budget process that takes place each year.



Thus, the only question around the debt ceiling is whether the government can and should pay its bills. This is akin to signing the papers for a new car then afterwards requesting an increase to your credit limit. For most of us, the decision to buy something cannot be separated from whether we will pay for it, even if it's with debt. Unfortunately, the Congressional process for approving a budget by September 30 each year is separate from whether the Treasury can raise enough funds to pay the bills.

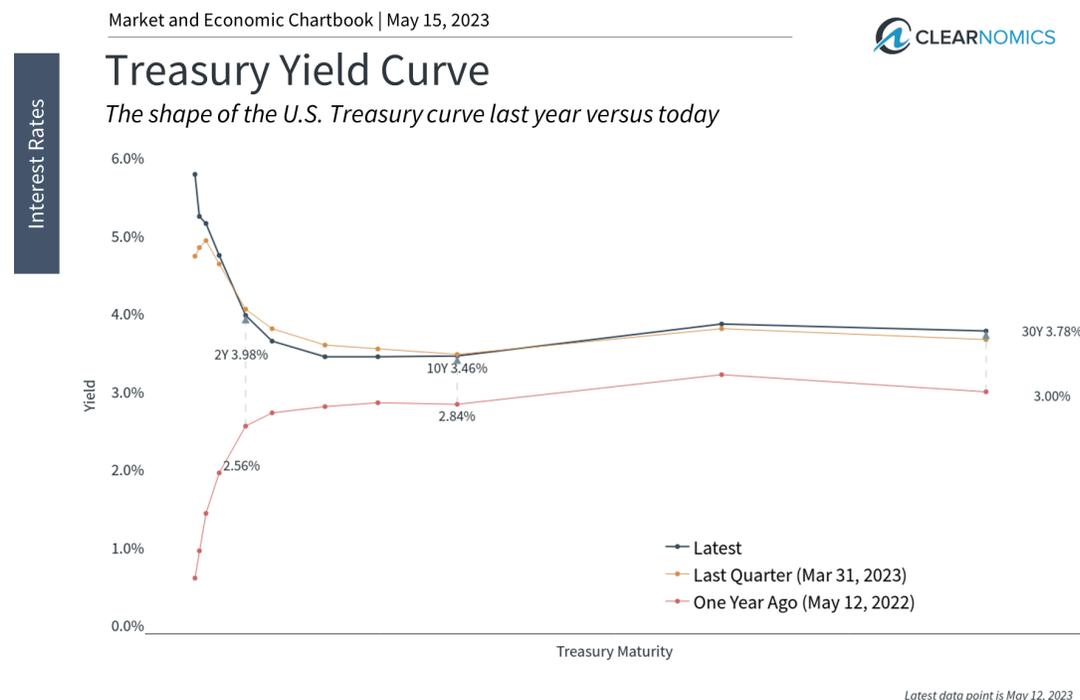
Second, the large and ever-growing national debt is a controversial topic that impacts the economy and markets in complex ways. At the moment, Democrats, who control the White House and Senate, and Republicans, who control the House of Representatives, are in a standoff. On April 26, the House passed a debt limit bill by a narrow vote margin of 217 to 215. This would increase the debt limit through March 31, 2024 or until the national debt increases by another \$1.5 trillion. However, it also includes provisions such as discretionary spending limits, the repeal of renewable energy tax credits, increased work requirements for benefits programs, and others. This makes it politically fraught and thus unlikely to pass the Senate and be signed into law.

Similar debt ceiling standoffs have occurred over the past decade with the limit suspended and raised in 2013, 2014, 2015, 2017, 2018, 2019 and 2021. According to the Congressional Research Service, the debt ceiling has been raised 102 times since World War II.



**Exhibit 2**

Treasuries maturing around the debt ceiling deadline have experienced a spike in yields



Sources: Clearnomics, Federal Reserve

Fortunately, despite the headlines and investor concerns, these historical episodes have had little long-term impact on markets. It’s still the case that the U.S. has never defaulted on its debt. Nearly all economists and policymakers agree that even a technical default would lead to turmoil in the financial markets and increase borrowing costs for businesses and everyday citizens. This risk is evident in the bond market, with a sharp jump in Treasury rates with maturities around the debt ceiling deadline, and much lower rates thereafter. At nearly 5.6%, the one-month Treasury yield is far above the fed funds rate.

The one exception to markets staying relatively calm occurred in 2011, when a similar standoff led Standard & Poor's, a credit rating agency, to downgrade U.S. debt. The stock market fell into correction territory with the S&P 500 declining 19%. Ironically, the prices on Treasury securities increased during the 2011 debt ceiling crisis because even though these were the exact securities being downgraded, investors still believed they were the safest in the world at a time of



heightened uncertainty. The debt ceiling was eventually raised and a new budget was approved, allowing markets to bounce back.

So, given how heated the topic of government spending can be, it's important for investors to distinguish between their political feelings and how they manage their portfolios. Despite the impending deadline, history shows that staying invested is the best approach to navigating drama in Washington.



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