GEMMER ASSET MANAGEMENT LLC
LOCAL PARTNER GLOBAL INVESTING

A Q&A on the U.S. Debt Ceiling

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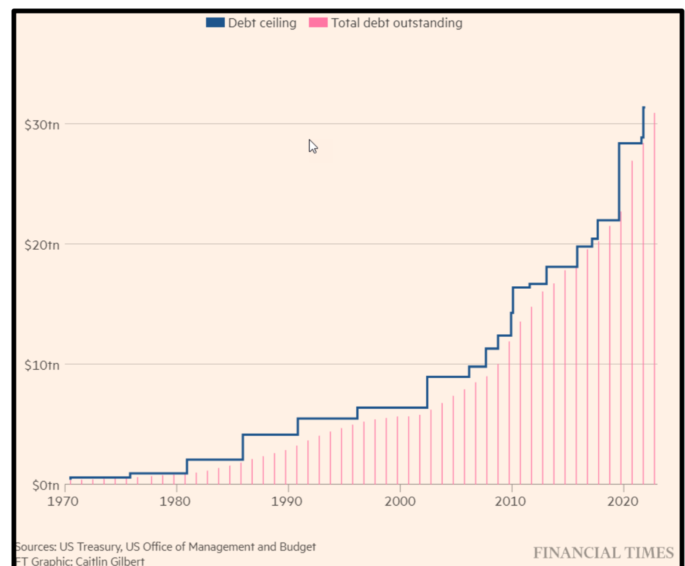
Introduction

Regardless of whether you follow politics or not, or which side of the political divide you fall on, most would agree that political risk globally is worrisome from an investment standpoint. Whether it's relations with China or the situation in Eastern Europe, there is much to ponder. In the U.S., the most immediate issue, and the one that we are hearing more and more concern about, is the pending battle over raising the debt ceiling. This issue has come into stark focus after all the chaos surrounding the election of a new House speaker. After a record setting 15 votes, Kevin McCarthy won the gavel. But what did he concede to get there, and what does it mean for House policy later this year? We won't pretend we know the answers, but we think it is worthwhile to highlight some of the characteristics of the debt ceiling issue and speculate a bit on how things might play out with an eye towards what it means for investors.

Q&A

What is the debt ceiling?

In 1917 Congress set a limit on how much federal debt can be outstanding at any one time. This allowed the Treasury to issue whatever they wanted to up to this limit. Prior to 1917 Congress had to vote on every debt issuance. Not very efficient. Since 1917 Congress has voted 100 times to increase the ceiling, 28 times since 1993 alone. Sometimes it is increased with little fanfare. At other times one party or the other will use it as an excuse to score some political points. There were major fights in 1995, 2011, and 2013 that led to extended government shutdowns.



It's worth remembering that Congress is responsible for enacting spending under separate legislation from the debt ceiling. The debt just facilitates this spending. And as you can see from the chart to the right, the existence of a ceiling has done nothing to limit the growth in total debt. Only the U.S. and Denmark have debt ceilings.

What is the worry?

Well, we are near the ceiling last approved in 2021. While we are likely to hit the $31.4 trillion limit soon, because the Treasury can utilize 'extraordinary measures,' most analysts think we cap out this summer or early in the fall. After that the Treasury cannot issue any new debt to cover current authorized government spending. In the past this has meant a government shutdown. Vendors aren't paid, non-essential workers are furloughed, and projects grind to a halt. The last shutdown was in late 2018 and early 2019.

The other major worry, and probably the bigger concern as far as the market goes, is that the Treasury will no longer pay principal and interest payments on government debt. This is the default scenario that headlines typically focus on. And for good reason – it would be bad. Investors would lose confidence in Treasury bonds, interest rates would increase, stocks would fall, and the odds of a recession would go up significantly.

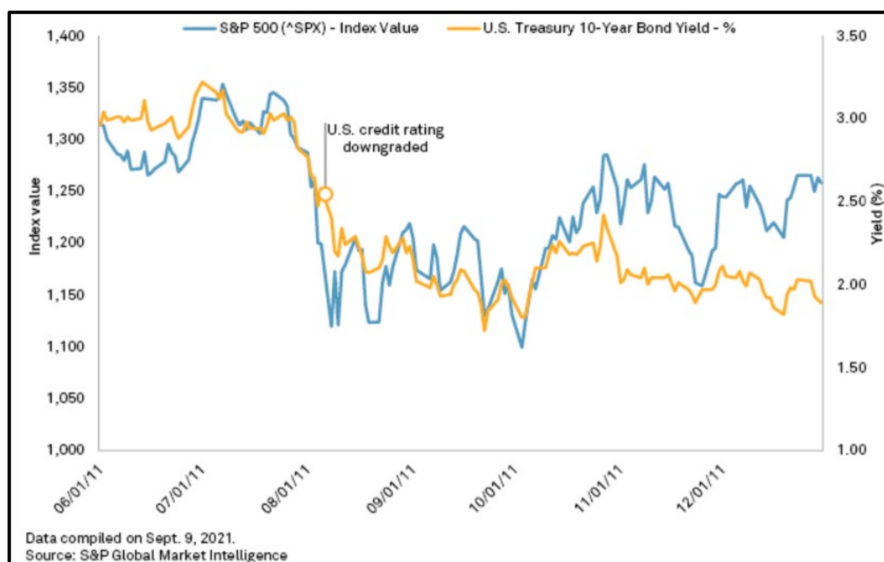
Is default really likely?

No. There are a couple reasons for this. First, the debt ceiling limit applies to increased borrowing. If a bond comes due, it can simply be repaid by issuing a new bond while staying under the ceiling. This would mean principal payments would be made regardless. Furthermore, government receipts provide plenty of cash flow to make interest payments. Currently about 10% of total tax revenue goes towards interest payments so there's plenty of wiggle room, albeit at a cost of reduced on-going spending.

The second reason is that outright default might actually be unconstitutional. The 14th Amendment's Public Debt Clause seems to say the government must pay its debts. It states: *"The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."* Subsequent governments have stated this means interest must be prioritized above all other payments—muting default risk. If nothing else, it probably means that any administration will take whatever steps are necessary to service existing debt obligations.

But what about 2011?

This was the last time the debt ceiling issue triggered some market turmoil. The government was shut down, negotiations were at loggerheads, and the U.S. credit rating was downgraded. The S&P lost roughly -7% in one day and fell -19% high-to-low (blue line to the right). Interest rates actually fell despite the downgrade as investors bought bonds as a safe haven. Investors rightly bet that outright default was very unlikely. But of course, the ceiling was ultimately increased and stocks rallied, hitting new highs within four months of the crisis.



Investors naturally remember the pain of 2011, but what's lost in the mists of memories is that Europe was in the process of melting down at the same time we were arguing over the debt issue. The downgrade may have played a part in the equity market sell-off, but Europe was certainly a factor. It may have been the main driving force, actually, but it's hard to know. We also forget that what we learned in 2011 was really something we already knew – that blowing up the economy isn't good for anyone's re-election prospects. The pressure on Congress was intense in 2011 to do a deal after the market volatility and the real-life pain of delayed paychecks and furloughs. Congress might be dysfunctional, but they have one thing in common – almost everyone wants to be re-elected.

What's different this time?

Nothing has changed about the debt ceiling itself, the dynamics, or the legal structure. What is attracting close attention, though, is that a newly empowered group in Congress is demanding deep spending cuts in exchange for raising the borrowing limit. They have also probably wrangled a number of concessions from Speaker McCarthy, which could make their negotiating position stronger. But that has yet to be seen.

What's likely to happen in the coming months?

It's hard to know of course. But we should think of the debt ceiling not so much as a light switch (on or off), but more like the tide coming in. Pressures on Treasury spending are likely to grow over the next three-to-four months, and spending halts and furloughs quite possibly will be phased in. Could we see a government shutdown again? Almost certainly. The political situation seems as intractable as it was in 2011. But outright debt default – not making principal or interest payments on Treasury bonds – isn't going to happen. The market may worry about it periodically, but as noted earlier, such an option may be simply illegal. But regardless, expect the administration to pull every accounting string in the world to make debt payments.

Could markets sell-off?

Yes, anything is possible. But there are a couple factors that makes us think any correction would be more muted than the one we saw in 2011. First, we don't have the backdrop of a possible Eurozone breakdown taking place. There was a real worry in 2011 that the crisis in European was a repeat of the 2008 financial crisis. After all, it was still very fresh in our minds. And the debt downgrade just added to the worry. Today Europe is actually surprising us in a good way. The energy crunch in the region due to Russia's invasion of Ukraine isn't materializing due to warm weather, and European growth is on the upturn. Throw in the fact that China is reopening after a long COVID shutdown, and the underlying global growth backdrop is much different from that in 2011.

Secondly, a government shutdown would mean a much less hawkish Fed. This would matter. After all, markets struggled in 2022 over fears of rising inflation and tighter central bank policy. A prolonged government shutdown would be clearly negative for growth and deflationary – something the Fed would react quickly to.

No one can rule out a prolonged standoff, but we think a deal will be completed. We might have a few weeks of uncertainty and market volatility, but it's hard to see who wins from a protracted fight. After all, the 2024 presidential campaign is going to be in full swing soon, and who is willing to sacrifice a chance at the White House?

What are the implications for long-term investors?

Few if any. We don't mean to be glib, but if you are investing with an eye towards 2030 and not 10am two weeks from now, the debt ceiling debate doesn't mean much for your allocation. We always half joke that even if we knew what the future held, predicting how the markets react to the news is another thing all together. Markets can often go up on perceived bad news and down on good. This one could turn out similarly. No one really knows. But if you are a long-term investor you don't need to bet one way or the other. We suspect that this too shall pass. Even though 2011 was traumatic, it did little to throw the economy off course for any length of time. This time could be different, sure. But we doubt it.

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