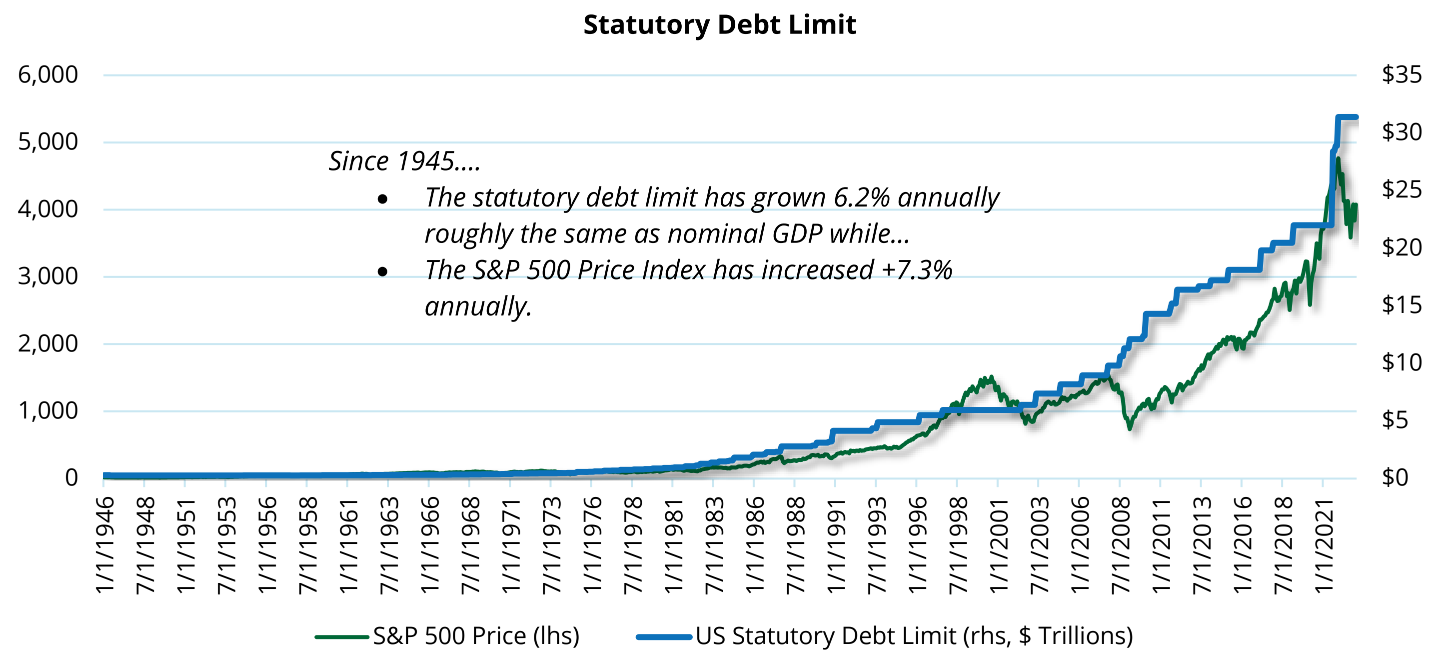
MARKET UPDATE: DEBT CEILING 2023

FEBRUARY 22, 2023

THE DEBT CEILING, WHAT IS IT?

First enacted in 1917 through the Liberty Bond Act[1], the debt limit is the amount of money the US government is permitted to borrow to meet its existing legal obligations. The limit applies to nearly all federal debt which today includes nearly $24.5 trillion held by the public (debt used to finance budgets) and almost $6.9 trillion owed to various social plans such as Social Security and Medicare.[2] Importantly, the debt limit does not grant new spending, as it simply allows the government to fund existing obligations made by past politicians. In fact, since the end of World War II, Congress has approved over 100 modifications to the debt limit—the exceptions being the immediate period following the second world war and from '98 to '01, periods when the federal government ran a budget surplus.

The debt ceiling modification process has been resolved by Presidents and Congresses regardless of which party owns control. Clearly, partisanship has increased in recent years, notably in the post Great Financial Crisis Era (2008-2009), which has led to more contentious debates around the level of US government debt. The 2011 version of the debt ceiling limit being reached was ultimately resolved, though not without investor anxiety as during that period Standard and Poor's downgraded the credit rating of the US from its treasured AAA rating. S&P went so far as to say, "The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed."[3] Twelve years later this still proves to be a good sound bite, though further US credit rating action seems unlikely this time around.



Source: Clearstead, Bloomberg LP, data as of 1/31/2023, S&P 500 Price Index

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[1] *https://crsreports.congress.gov/product/pdf/RL/RL31967*
[2] *https://www.crfb.org/papers/qa-everything-you-should-know-about-debt-ceiling*
[3] *https://money.cnn.com/2011/08/05/news/economy/downgrade_rumors/index.htm*

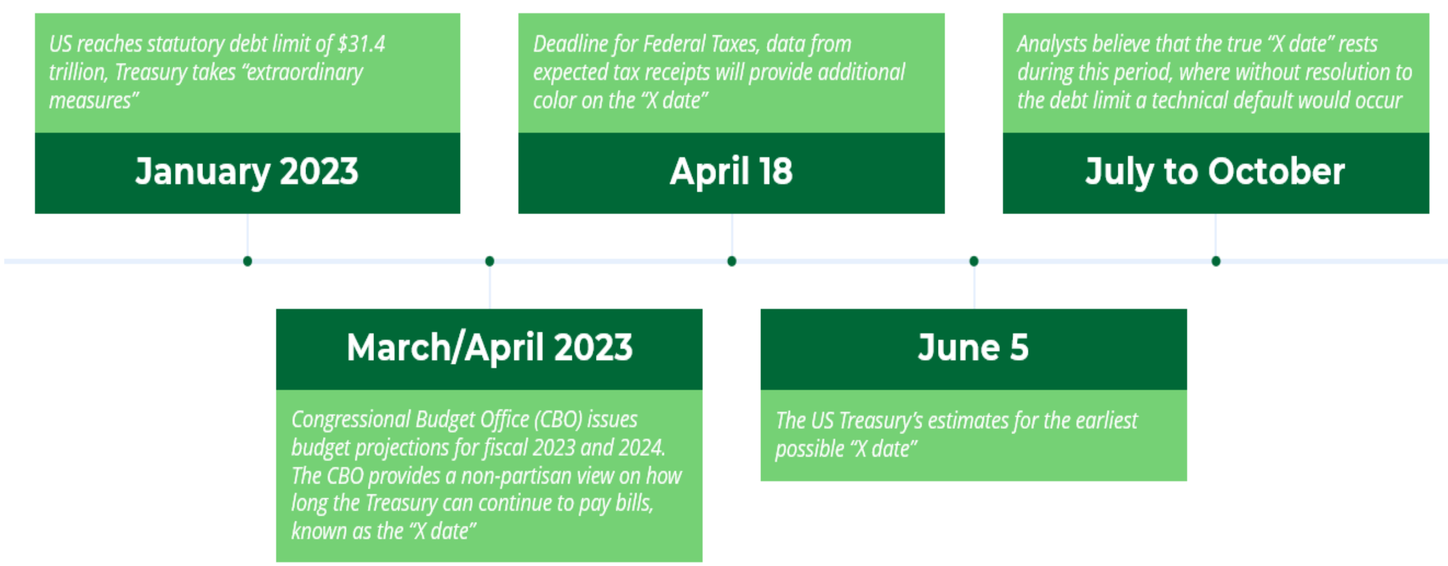
THE PROCESS

Congress has three tools when dealing with the debt limit as debt levels start to reach the statutory limit. The first is to increase the debt limit, thereby allowing additional federal borrowing. Second, Congress can simply temporarily suspend the debt limit. The third is to leave the debt limit in place which has the potential to leave the economy and capital markets in a lurch (more on this in a moment). *A fourth solution, disputed by past Presidents and legal experts, posits that under the Fourteenth Amendment the President has the authority to ignore the statutory debt limit*. Otherwise said, the first option resolves political gridlock and appeases markets, and the second "kicks the can" down the road, while the third introduces risks of technical default by the US government as political fighting and grandstanding take stage during the process to resolve the debt limit (by agreeing to either of the former two options). There are a few other ("outside-the-box type") solutions, such as the US Mint producing a trillion-dollar coin, or the issuance of no-principal US debt instruments—bonds that only pay an interest/coupon payment for a given number of years—but few expect these options to be given any real consideration by the US Treasury.

2023

That brings us to 2023, where the Federal debt reached its statutory limit of $31.385 trillion in mid-January. Without a suspension or increase of the debt limit, the US Treasury has been forced to implement "extraordinary measures" which effectively postpones the debt limit breach for a period of time. The "extraordinary measures" announced in mid-January by the US Treasury[4] includes suspension of funding the Civil Service Retirement and Disability Fund and the Postal Service Retiree Health Benefits Fund, delaying reinvestment of treasury securities held in the Government Securities investment Fund, suspension of reinvestment of Treasury securities in the Exchange Stabilization Fund, and suspension of State and Local Series Securities (Treasury securities issued to State and Local Governments). Current expectations are that the US Treasury's "extraordinary measures" are expected to delay a technical breach of the debt limit through June, though the precise timing remains a moving target.

A timeline for resolution[5]



[4] *https://home.treasury.gov/system/files/136/Description_Extraordinary_Measures-2023_01_19.pdf*
[5] *https://www.reuters.com/world/us/when-might-us-default-timeline-key-events-debt-limit-battle-2023-01-25/*

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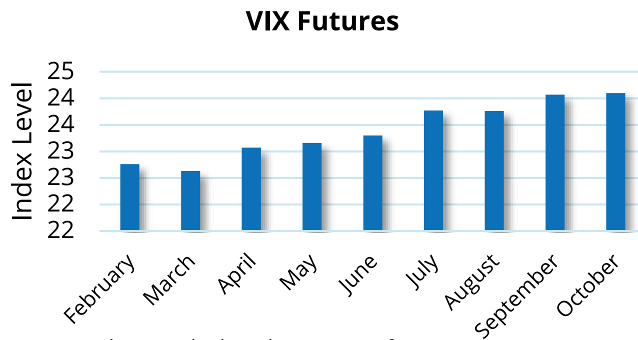
WHAT TO EXPECT



Source: Clearstead, Bloomberg LP, as of 2/21/2023

As of this writing, bipartisan efforts are underway to resolve the gridlock, though this process is yet to reach maximum political rhetoric. Our expectation is that negotiations around the budget, and deficit at large, are likely to increase into the spring and early summer months. Markets, to date, appear to be looking more towards resolution rather than conflict as the consequences of a technical default would likely lead to severe economic pain, declining asset prices, and surging bond yields—to be blunt. Meanwhile, equity market volatility futures and treasury bill yields around the June time-period appear more focused on Fed policy rather than a worst-case scenario related to the looming debt ceiling drama set to unfold. At a minimum, investors should brace for additional volatility around that time. As with the previous 22 debt ceiling actions since 1997, we expect this time to be resolved but likely not without fireworks. As always, we will provide updates as news develops.

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