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Investment Insights

Debt Ceiling Questions and Answers (Update)

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AUTHORED BY:

Chief Investment Office

Data as of May 11, 2023

What is the debt ceiling? 1

Why is Congress debating this now? 1

As the "X-Date" approaches, what is the current state of the federal government's finances? 2

What are the policymakers' positions and legislative options to address the debt limit? 2

What happens if the debt ceiling is not increased? 3

Have policymakers used the debt ceiling to pursue deficit reduction in the past? 4

How have debt-ceiling concerns affected risk assets in the past? 4

What are the potential market implications this time? 5

How can investors prepare? 5

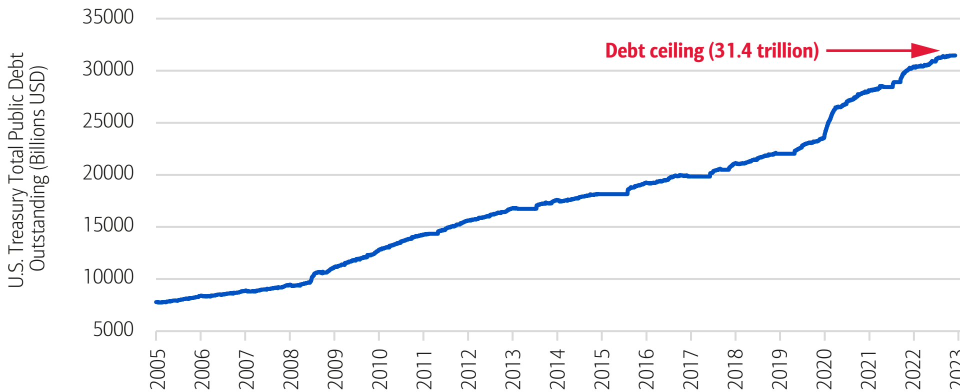
What is our view on the outcome? 5

What is the debt ceiling?

Put simply, the debt ceiling is the maximum amount of debt that the U.S. government can accrue. The federal government has a variety of bills to pay, including Social Security and Medicare benefits, military salaries, interest on the national debt and tax refunds. However, it typically runs a deficit each year, meaning it spends more money than it receives in taxes and other revenue. The Treasury borrows money to make up the shortfall by issuing debt to investors around the world, but the total amount that can be borrowed is ultimately limited by the debt ceiling. Although Congress authorizes spending, those obligations cannot be met if the Treasury does not have the ability to borrow more than the statutory limit it authorizes itself.

In the event that the debt ceiling is reached, Congress is charged with modifying it. This has happened fairly regularly throughout history, with the ceiling being raised or suspended 102 times since World War II.[1] Most recently, it was raised to $31.4 trillion in December 2021 (Exhibit 1).

Exhibit 1: The U.S. Government Has Approached The Debt Ceiling.



Source: Bloomberg. March 6, 2023.

Why is Congress debating this now?

The U.S. hit the debt ceiling of $31.4 trillion on January 19th. From here, the Treasury is expected to run down its cash balance at the Federal Reserve (Fed) and employ

[1] Congressional Research Service. November 22, 2022.

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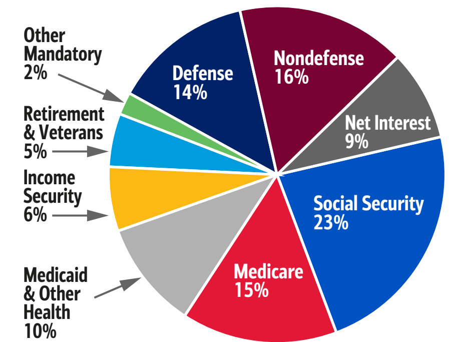
"extraordinary measures," which are a variety of accounting maneuvers that help the government avoid defaulting on existing obligations. The Treasury Department first used these measures in 1985, and they have been used six times between May 2011 and the end of 2021.[2] However, they are not long-term solutions. Recent estimates warn that extraordinary measures could be exhausted as early as June 1, also known as the "X-date." Congress is tasked with suspending (to a date certain) or raising (to a sum certain) the ceiling ahead of that date. Absent an agreement, the U.S. runs the risk of default.

As the "X-Date" approaches, what is the current state of the federal government's finances?

The budget for the current fiscal year (ending September 30, 2023) includes total discretionary spending of approximately $1.7 trillion of which $858 billion is allocated to defense. Not included in this figure is over $4 trillion of mandatory spending, which supports various entitlement and government benefit programs and pays interest on government debt. The Congressional Budget Office (CBO) projects a total deficit of $1.4 trillion for fiscal 2023.[3] However, lower-than-expected April tax receipts and increased expenses have further widened this gap between revenue and spending. Anticipating the drop in April tax revenue, a March 9 report—*Budget of the U.S. Government Fiscal year 2024*—from the White House's Office of Management and Budget (OMB), projects a fiscal 2023 deficit of $1.7 trillion (a $300 billion increase over the CBO's projection) resulting from higher mandatory spending and lower individual income tax revenue for the year.

Exhibit 2: Composition of Full Year 2024 Spending



Sources: CBO and Piper Sandler as of February 8, 2023.

With the projected annual deficit exceeding 80% of total discretionary spending, and little willingness to cut defense spending, which makes up almost half of discretionary spending, a "balanced budget" is unrealistic in the near term. Seemingly, this could only be accomplished through a combination of significant broad-based tax increases and cuts to entitlement programs. The current balance of power in Washington appears to take both of those options off the table. Instead, any constraints on spending will likely target freezing or limiting the growth of nondefense discretionary spending to slow the expansion of the deficit. This means that deficit spending is likely here to stay, and the debt ceiling will continue to be a recurring concern for years to come.

The potential debt ceiling consequences of efforts to backstop uninsured bank depositors should also not be ignored. Initially $40 billion was provided from the Treasury to the Federal Deposit Insurance Corporation (FDIC) to support banks facing large deposit outflows. These funds, if held by the FDIC or lent to banks, would be unavailable to meet other federal government liquidity needs, potentially moving forward the "X-date". While the initial $40 billion of liquidity sent to the FDIC has since been returned to the Treasury, likely eliminating the effect of that transfer, if future support is required these previously unanticipated cash outflows could exhaust the government's liquidity sooner than expected.

What are the policymakers' positions and legislative options to address the debt limit?

The initial positions articulated by each party have primarily focused on the other party's role in expanding the federal debt, implying that the other party's culpability discredits their proposed solutions. Republicans, pointing to trillions in deficit spending under the Biden administration, have indicated they will seek spending cuts as a part of any agreement that would increase the debt limit. To that end, on April 26, House Republicans passed the Limit, Save, Grow Act, which would raise the debt ceiling for about a year and provide for approximately $4.2 trillion of deficit reduction over the next 10 years. Most of this savings would come from a cap on discretionary spending at fiscal year 2022 levels, and increasing spending at a rate of 1% per year going forward. Democrats counter that

[2] Committee for a Responsible Budget. January 18, 2023.

[3] Congressional Budget Office: *The Budget and Economic Outlook: 2023 to 2033*. February 15, 2023.

similar spending increases occurred under the Trump administration, accommodated by Congressional Republicans who continually agreed to raise or suspend the debt limit at that time, and are seeking a "clean debt ceiling increase" without cuts to government spending. Additionally, the president's fiscal year 2024 budget proposal included revenue-raising proposals to reduce the deficit through higher taxes on corporations and high-earning individuals. These proposals should be viewed as political positioning and stand little chance of withstanding the other party's opposition, but they do provide a framework for negotiations between the two sides to begin.

Ultimately, to raise the debt ceiling, House Republicans, the Democrat-controlled Senate, and the White House will have to find enough common ground to draft a bill that will gain sufficient support on both sides of the aisle. In the Senate, a filibuster-proof 60-vote majority will have to support the bill. In the House, this will require a simple majority vote on a bill brought to the floor by Republican Speaker Kevin McCarthy. The expectation is that to reach the floor of the House, such a bill would include some degree of spending cuts versus the clean debt ceiling increase favored by many Democrats.

Some have cited a potential path to bypass the Speaker's power, using what is known as a "discharge petition" to pass a clean debt ceiling increase without spending cuts. This procedure can effectively force a bill to the House floor with a majority vote. However, with Democrats in the minority, a discharge petition will require some House Republican votes to pass. The process also has many technical requirements that make it both time-consuming and inflexible. Finally, even if successful in the House, the bill would also have to pass the Senate without any changes. For those reasons, relying on a discharge petition to raise the debt ceiling is a long shot.

In some instances, the debt ceiling has been suspended rather than raised. This has happened 7 times since 2013, including three times between 2017 and 2019. This is a way of delaying the contentious negotiations while still permitting the federal government to borrow and pay its obligations. Given the Republicans' desire to use their current political leverage to target government spending, a long-term suspension is unlikely; however, it is possible that Republicans will seek a short-term suspension to align the deficit reduction proposals with fiscal year 2024 spending bills later this year.[4]

What happens if the debt ceiling is not increased?

No one really knows. If the debt ceiling is not raised prior to the "X-date", the federal government could continue to pay certain obligations from cash flows, but without the ability to take on additional debt, some obligations would not be paid. The inability to pay these in full, for any amount of time, would put the U.S. in a technical default on its obligations. During past debt ceiling standoffs in 2011 and 2013, contingency plans were made to ensure that interest on federal debt would continue to be paid to avoid defaulting on such obligations in the event a resolution was not reached. Prioritization of spending is now being explored as part of the current debt ceiling debate, primarily to ensure that bondholders and Social Security recipients continue to get paid in the event the debt ceiling is not raised prior to the "X-date".

Beyond the potential effect on government bondholders and individuals who rely on federal government benefits, the effects of a default would reverberate throughout the economy. First, a potential downgrade in the credit rating for Treasurys could make borrowing more expensive for the government, which would only worsen the federal deficit. Furthermore, higher interest rates on Treasurys could have a domino effect on other interest rates, making borrowing more expensive for individuals and corporations already facing the highest interest rates seen in over a decade.

Limit, Save, Grow Act (LSGA) of 2023 (H.R. 2811)

Deficit Reduction in LSG:	Savings (billions)
Cap Fiscal Year 24 Discretionary Spending at 2022 Level and Grow at 1%	$3,195
Rescind Unobligated Pandemic Relief Funds	$30
Rescind Internal Revenue Service Funding Boost	$(120)
Repleal Inflation Reduction Act Green Tax Credits	$531
Reverse Student Debt Cancellation and Related Changes	$460
Work Requirments in Supplemental Nutrition Assistance Program and Medicaid	$120
H.R. 1 (Permitting Reform)* and REINS** Act	$3
TOTAL	$4,219

*Streamlines the process for approving energy projects under NEPA by limiting the scope of environmental reviews on energy projects and prohibiting federal agencies from considering indirect and cumulative environmental impacts. **Regulations from the Executive In Need of Scrutiny Act. Source: Committee on Ways and Means Congress.gov as of April 27, 2023.

A potential downgrade in the credit rating for Treasurys could make borrowing more expensive for the government, which would only worsen the federal deficit.

[4] Note: some have called for abolishing the concept of the debt ceiling altogether, given the frequency of the protracted Congressional debates to raise it and the negative consequences associated with a potential default. While there are certainly other means of pursuing spending cuts, it is unlikely Republicans will agree to forgo having this option going forward.

A technical default, resulting from failing to raise the debt ceiling, should be distinguished from a government shutdown, which occurs if Congress fails to pass spending bills prior to the start of the fiscal year. Without authorizing spending for the fiscal year, certain government agency employees who are deemed "nonessential" would not be paid during that period, while other employees and creditors would continue to be paid. A default, on the other hand, would be significantly more disruptive, as the government simply wouldn't have the funds to pay for services and debts that have already been authorized.

Have policymakers used the debt ceiling to pursue deficit reduction in the past?

Over the past several decades, the need to increase the debt ceiling has frequently been a catalyst for passing legislation aimed at reducing federal deficits. Historically, the enacted deficit reduction policies have taken many forms beyond cuts to discretionary spending. Notable examples include: a 1985 debt ceiling increase paired with a goal to balance the federal budget by 1991; a presidential line-item veto power over deficit-increasing legislation in 1996; and "pay as you go," (PAYGO) legislation in 1990 and 2010 requiring tax cuts and spending increases to be offset with either spending reductions or increased revenue.

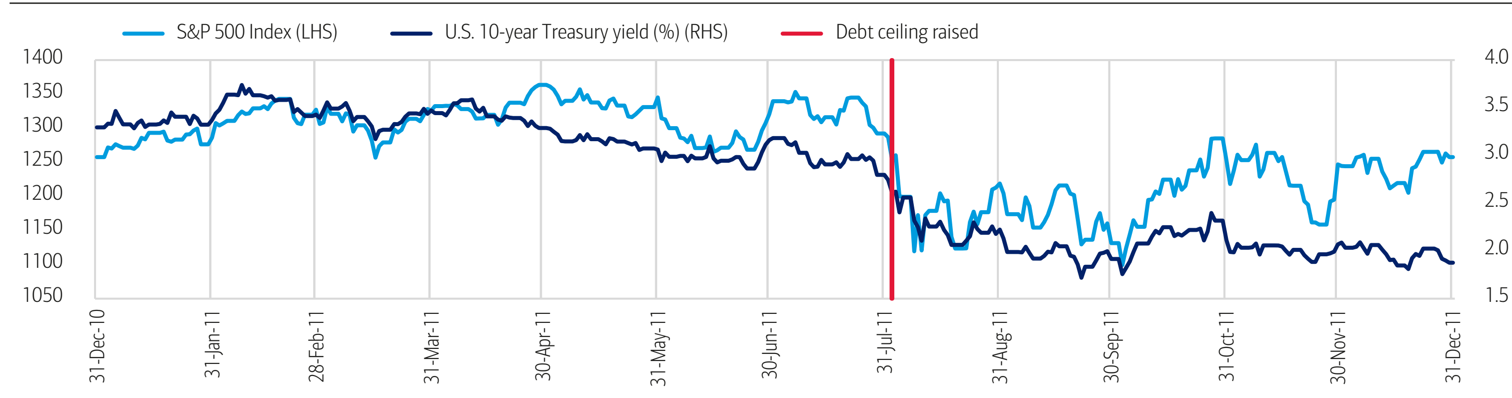
The current debt ceiling debate seems to resemble 2011 more closely. The 2011 agreement led to a $2.1 trillion increase in the debt ceiling paired with over $900 billion of deficit reduction measures, primarily consisting of limits on discretionary spending, and a requirement to pursue an additional $1.2 trillion of savings to avoid mandatory budget sequestration.

How have debt-ceiling concerns affected risk assets in the past?

2011 was the last time that the U.S. has come close to defaulting. After fraught and extended negotiations, Congress eventually resolved the crisis by passing the Budget Control Act of 2011, which became law just two days before the "X-date". Shortly after, Standard & Poor's downgraded the U.S. long-term credit rating for the first time, dropping it from AAA to AA+, even though the U.S. narrowly avoided a default.

Unsurprisingly, risk assets reacted negatively. An equity market sell-off began a few weeks ahead of the deadline and accelerated afterward, with the S&P 500 falling by 17% over the course of the debt-ceiling drama[5] (Exhibit 3). Consumer Staples and Utilities were the best-performing sectors, while Financials, Energy and Real Estate lagged.[6] Volatility spiked, the dollar waivered, and credit spreads widened. Treasurys surprisingly rallied, though this was likely driven by a "flight-to-safety" amid other macro concerns at the time (the European sovereign debt crisis). Risk assets ultimately stabilized in the months following the resolution.

Exhibit 3: Market Activity During 2011 Debt Ceiling Negotiations.



Source: Bloomberg. March 9, 2023. Performance would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Past performance is no guarantee of future results. Please refer to index definitions at the end of this report.**

[5] Bloomberg. Dates referenced: July 22, 2011 – August 8, 2011.

[6] Bloomberg. Refers to S&P 500 Global Industry Classification Standard (GICS®) Index Level 1 sectors. Dates referenced: July 22, 2011 – August 8, 2011.

What are the potential market implications this time?

If history is a guide, we would expect volatility to spike as the deadline approaches over the next several months. The longer it takes for Congress to reach an agreement, the more volatility risk assets are likely to experience. In an unlikely best-case scenario, the debt ceiling will be resolved well ahead of the deadline, causing minimal turbulence for financial assets. The worst-case scenario of a U.S. default would likely wreak havoc on global financial markets, but this outcome is also highly improbable. We will likely land somewhere in the middle—market implications will vary depending on the outcome of upcoming debt-ceiling negotiations and the timing of the ultimate resolution. However, investors should keep in mind that the looming debt ceiling drama is only one of the factors that could affect markets in the months ahead. A decelerating economy, still-elevated inflation, banking industry churn and the path of monetary policy are likely to have a much larger influence.

How can investors prepare?

While bouts of market churn can be anticipated in the lead-up to the “X-date”, investors should remember that volatility is considered a normal part of investing. Further, market pullbacks may create an opportunity for long-term investors to add high-quality investments. Investors should consider upholding a defensive posture while also remaining agile if asset prices were to weaken later in the year. In the “grind-it-out” market environment, a well-diversified portfolio of both Equities and Fixed Income strategies helps to prepare for this type of environment. Despite near-term headwinds, we ultimately believe that 2023 will likely be a foundational year in which a diversified portfolio of stocks, bonds and alternatives, for qualified investors, is resurrected.

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What is our view on the outcome?

Facing a slowing economy and an election in 2024, Congressional leadership on both sides of the aisle and the president, in particular, will want to avoid the economic fallout of going to the brink of a debt ceiling breach (or beyond). This will be the motivation to arrive at a bipartisan agreement ahead of the “X-date”. Furthermore, with recent "X-date" projections indicating a potential early June default, Republicans might have some additional leverage in this standoff. Speaker McCarthy was able to wrangle a majority of the House to pass the partisan Limit, Save and Grow Act, which would raise the debt ceiling and cut spending. While this bill has no chance of advancing in the Senate, it has put the ball in the Democrats' court to make a counter proposal, and has brought the parties to the table for initial meetings with little time to spare. Despite still being far apart on an agreement, this is an important first step to finding enough common ground for a bill that will pass the Republican House and gain the support of Senate Democrats and the president.

We are of the opinion that a deal comes together before the accelerated X-date. With the Limit, Save, Grow Act as a starting point, a bipartisan deal could include aspects of that legislation to secure modest concessions from Democrats. While Democrats will resist calls to repeal key pieces of the president's agenda, such as green energy tax credits and student loan relief, other provisions might be part of a compromise bill. This could include: (1) rescinding unobligated Covid relief funds, (2) passing an energy permitting reform bill, (3) reducing and capping discretionary spending for the next year or two and (4) an extension of the debt ceiling until after the 2024 elections. If the parties are close to a deal or can agree in principle on the level of spending cuts, a short-term extension of the debt ceiling could be an interim step to provide more time to complete a deal and flesh out the details; possibly aligning a final debt ceiling agreement with a budget deal for fiscal year 2024. This could provide support for Democrats claiming to have received a clean debt ceiling extension and negotiated on only budget related items. This could also provide support for Republicans claiming to have cut federal spending in turn for a ceiling extension. A win-win? Yes, when viewed through a political lens.

Failure to reach a deal prior to the X-date means a technical default since it is unlikely that the president will invoke the 14th Amendment to continue constitutionally questionable borrowing. While measures would be taken to ensure interest payments on federal debt are prioritized and Treasury holders continue to be paid, a default could mean that the nearly $100 billion of Social Security, Medicare and military payments due the first few days of June would be missed. It should not be overlooked that the political pressure of potentially missing payments to retirees, active-duty military and medical providers may be too much for legislators to bear and could force an extension of the debt ceiling within days or hours of crossing the X-date.

While the path to resolving the debt ceiling remains uncertain, it's our view that an agreement will be reached that will prevent the U.S. from defaulting. However, we expect uncertainty surrounding the timing and outcome of the resolution to add to the volatile backdrop for risk assets over the next few weeks.

Index Definitions

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