Capital Market Review

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The Debt Ceiling Explained

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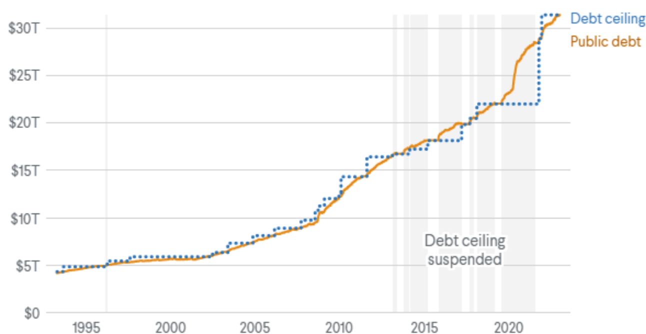
The U.S. debt ceiling has circled the news for months, and now we are approaching a more critical scenario. The debt ceiling is the amount of money the U.S. government is authorized to borrow, which is set by Congress. Think of the debt ceiling as a credit limit on a credit card. Raising the debt limit does not directly approve additional spending; it simply increases the amount of money the government can borrow to meet spending obligations Congress has already approved. Before the past decade or so, raising the debt ceiling was a normal occurrence that has happened 78 times since 1962. More recently, the debt limit become a political negotiating chip, creating market uncertainty.

Before we discuss why this time is creating angst, let's look at the history of the debt ceiling. Before World War I, Congress would approve funding projects for the U.S. Treasury Department and even controlled the issuance and structure of Treasury bonds. During war times, Congress would permit the Treasury more flexibility by setting a limit they could spend on each war. In 1917, Congress passed the first version of the debt ceiling that remains in action today, limiting the Treasury to a maximum amount of money they can borrow. The debt ceiling has not been decreased since 1957 and has grown from $275 billion ($2.8 trillion in today's dollars) to the current $31.4 trillion.



Source: Council on Foreign Relations: *What Happens When the U.S. Hits Its Debt Ceiling?*

Since January, the Treasury has been using "extraordinary measures" to meet its financial obligations, meaning the Treasury has focused on paying its most critical debts, and it will repay postponed obligations when a debt ceiling agreement is reached. Treasury Secretary Janet Yellen recently announced that these measures will become ineffective, and the government could potentially default around June 1 if an agreement is not reached. Most of the country's debt payments are due at the beginning of each month, which has led Secretary Yellen to push for a deal before the bulk of the June obligations are due. Congress has two options to avoid reaching the limit: (1) raise the debt ceiling or (2) suspend it for a defined period before ultimately raising it.

If Congress does not take either of these steps, the consequences could be detrimental. The government came close to hitting the debt ceiling in 2011 before Congress came to an agreement a few days prior. Defaulting on debt would be catastrophic and something no member of Congress should support. Since default has a very low chance of happening and has never happened previously, we should consider the risks of Congress waiting until the last minute for a deal.

Suppose the U.S. hits the debt ceiling and must forgo payments to social security recipients, the military, government contracts, etc. In that case, we can expect volatility in markets, not to mention an impact on those who depend on these payments. This scenario would likely be short-term as the markets expect a deal to pass and are unlikely to price in a default event. The Treasury will do everything possible to continue making interest payments on Treasury bonds to avoid default. If bond rating agencies approach this time as they did in 2011, the U.S. debt could be downgraded, which would also cause market volatility.

Not to sound like a broken record, but no matter how the debt limit situation evolves, we still believe in maintaining a long-term strategic allocation. A global allocation of stocks and bonds minimizes risk-inducing events' direct impact. Riskier parts of the portfolio may go down, but there will be more conservative areas to offset negative returns and provide balance.

The truth is no one knows exactly how markets will react. 2011 is the only similar situation in history. At that time, there was also an ongoing European debt crisis when the U.S. came close to the debt limit, making it difficult to know which had a greater impact on markets. Although political temperatures are incredibly high right now, we hope cooler heads prevail and that Congress realizes this is not a debate worth spending political capital on. We invest in line with the most likely outcomes, which remains that a deal will be reached, only for markets to move on to the next worrisome event.

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