

# The Debt Ceiling, Extraordinary Measures, and the Spectre of 2011



**Yung-Yu Ma, Ph.D.,** Chief Investment Strategist, BMO Wealth Management - U.S.

Friday, January 20, 2023

## Overview:

"Extraordinary measures" are becoming commonplace. As the debt ceiling, now \$31.4 Trillion, is reached once again the U.S. Treasury must undertake "extraordinary measures" of shuffling money around to finance the government since net new Treasury debt issuance will drop to zero. The fiscal gymnastics are expected to remain viable until June, give or take, at which time the government would be faced with starker set of choices – perhaps the starker of which is defaulting on its debt obligations. From 2011 to 2022, such "extraordinary measures" have occurred in several years with little in the way of lasting repercussions. Nonetheless, it is the events surrounding the debt ceiling negotiations in 2011 that is typically held out as the boogeyman. As we detail below, however, even that case has a very particular set of circumstances. *We believe that it is highly unlikely that lasting damage to the markets or economy will result from the current debt ceiling negotiations. We nonetheless remain vigilant for signs of negative scenarios gaining traction.*

## A game of chicken along side the abyss:

The stakes surrounding debt default are extremely high. That most people realize this is, ironically, a comforting thought. There will be no lack of drama, positioning, and using the bully-pulpit, but in the end – rather than a "grand bargain" – the debt ceiling is likely to be suspended for a year after negotiations that result in modest concessions on government spending caps. The deal may be "last minute" or even possibly extend beyond "last minute" where the Treasury can no longer move money around and is forced to choose which bills to pay and which not to pay. The whiff of financial Armageddon could be in the air, but even if pushed all the way to the edge, we expect with high probability that debt payments will be prioritized and a deal will be reached before default. Teetering on the edge is highly uncomfortable, but still much different than going over it.

## The spectre of 2011

*Since the President wanted to cut spending but also increase taxes and the Republicans insisted on cuts with no new taxes, they were for months too far apart to find much agreement on a budget plan to be attached to the debt ceiling increase—which had to be enacted by August 2 to avoid a default. No one could quite believe that this would happen, because it was so unthinkable; it was assumed that the two parties would reach agreement. Each side actually expected the other to be more flexible.*

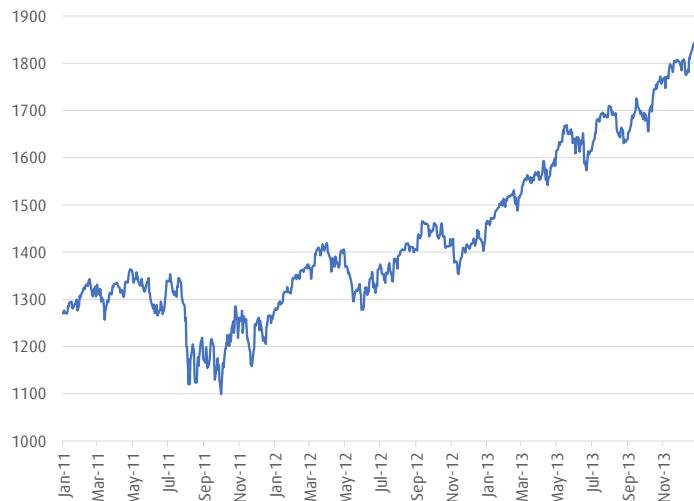
*"What were they thinking?", Elizabeth Drew, The New York Review, 8/18/2011*

Four aspects are noteworthy from the 2011 episode: 1) The unexpectedness of the negotiation developments; 2) the shock and awe of U.S. debt downgrade by Standard and Poor's (S&P), 3) that the debt downgrade was not due to default, but rather inadequate spending cuts and a gridlocked political environment that could make default possible, and 4) U.S. Treasuries actually rallied and rates fell sharply in a flight-to-safety trade despite the downgrade.

Equities fell sharply as well, but interestingly the decline in equities was much greater after the deal to avoid default was announced, driven by concerns surrounding the downgrade of U.S. debt that quickly followed the deal. Fragilities associated with the European debt crisis featured prominently as well. After dropping over 10%, U.S. equities bounced around at those low levels for a few months before embarking on a multi-year uptrend. The debt downgrade proved to be the last great opportunity to buy equities cheaply following the Great Financial Crisis of 2008-2009 (*Exhibit 1*). For the record, Standard and Poor's (one of the three major debt rating agencies) still has U.S. debt rated as AA+, so not AAA. Moody's and Fitch still assign a AAA rating to U.S. debt.

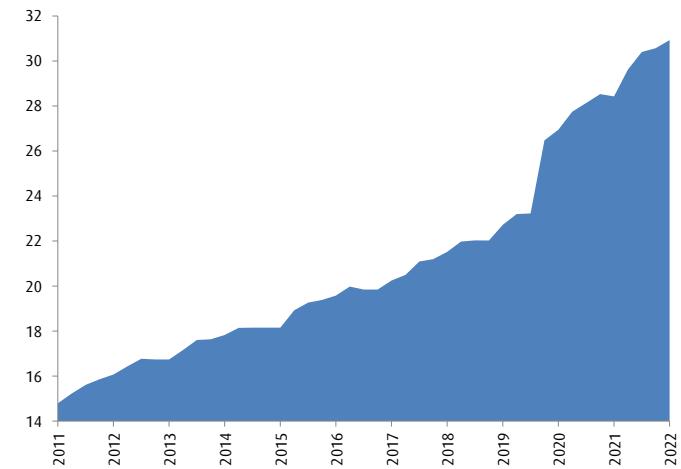


Exhibit 1: S&amp;P 500® Index: 2011 to 2013



Source: Bloomberg L.P. (2023), BMO Wealth Management (2023)

Exhibit 2: Total U.S. Debt as of September 30, 2022 (\$ trillions)



Source: Federal Reserve (2023), U.S. Department of Treasury (2023), BMO Wealth Management (2023)

We agree that should a default of U.S. debt occur that financial market turmoil could quickly ensue. Also, our assessment of “highly unlikely” is not the same as “completely impossible.” It is also unclear whether the same script from 2011 of a flight-to-safety trade into Treasuries would be repeated or whether – now that debt levels are so much higher than in 2011 (*Exhibit 2*) – the knee-jerk reaction would be to sell rather than to buy Treasuries. If debt default begins to increase in probability, Dollar weakness may be more likely to ensue, so currency markets may serve as a gauge to understand how such extreme tail risks are being viewed as the default timeline drawn closer. Market reaction to any statements or changes in outlooks by debt rating agencies will also be noteworthy in assessing vulnerabilities.

Compared with 2011, elected officials should better understand the implications of the debt ceiling negotiations. Conversely, the current political environment may be more polarized, offsetting the benefits of greater understanding. The spectre and imperfect memory of those 2011 events probably instills more fear than the actual events as they played out, which is also helpful for negotiations. We believe that a debt-defaulting fall into the abyss remains a very low probability scenario.



## Disclosure

The S&P 500® Index measures the performance of the large-cap segment of the market. Considered to be a proxy of the U.S. equity market, the index is composed of 500 constituent companies.

This report contains our opinion as of the date of the report. It is for general information purposes only and is not intended to predict or guarantee the future performance of any investment, investment manager, market sector, or the markets generally. We will not update this report or advise you if there is any change in this report or our opinion. The information, ratings, and opinions in this report are based on numerous sources believed to be reliable, such as investment managers, custodians, mutual fund companies, and third-party data and service providers. We do not represent or warrant that the report is accurate or complete.

To the extent this report contains information about specific companies or securities, including whether they are profitable or not, it is being provided as a means of illustrating the investment manager's investment thesis. The investment manager may or may not have invested in these securities at the time this report was prepared or is accessed by the reader. References to specific companies or securities are not a complete list of securities selected and not all securities selected in the referenced timeframe were profitable.

Other Bank of Montreal affiliates, and their agents and employees, may provide oral or written market commentary or trading strategies to clients that reflect opinions that are contrary to the opinions expressed in this report. These same persons and affiliates may make investment decisions that are inconsistent with the recommendations or views expressed in this report. We and our affiliates, directors, officers, employees and members of their households, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities referred to in this report. We and our affiliates, directors, officers, employees and members of their households, may have positions in the securities mentioned that are inconsistent with the views expressed by this report.

This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, a recommendation to buy, hold or sell securities, or a recommendation of any investment manager or investment strategy. Do not use this report as the sole basis for your investment decisions. Do not select an asset class, investment product, or investment manager based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Any forward-looking statements in this report involve known and unknown risks, uncertainties and other factors that may cause the actual performance of future markets to differ materially from the projections depicted in the report. Past performance is not indicative of future results and current performance may be higher or lower than that shown in the report. There can be no certainty as to the extent or depth of any market downturn, nor any assurance regarding the nature, extent or timing of markets rebounding. When evaluating the report, you are cautioned not to place undue reliance on these forward-looking statements, which reflect judgments only as of the date of the report. Investment returns fluctuate, and investments when redeemed, may be worth more or less than the original investment.

Any discussions of specific securities, investment managers, or strategies are for informational purposes only and should not be considered investment advice. The report does not constitute an offer to sell or a solicitation to buy any security or investment product. Any offer to sell or solicitation to buy an interest in any private security, investment product or fund may only be made by receiving a confidential private offering memorandum, prospectus, investment advisory agreement or similar documents from the investment manager, which describes the material terms and various considerations and risks relating to such security, investment product or fund.

Alternative investments, such as private equity and hedge funds, contain risks that are amplified when compared with other asset classes, such as illiquidity, stock or sector

concentration, financial leverage, difficulties in valuation, and short selling. Alternative investment vehicles have minimal regulatory oversight and alternative managers have the latitude to employ numerous investment strategies with varying degrees of risk.

International investing, especially in emerging markets, involves special risks, such as currency exchange and price fluctuations, as well as political and economic risks. There are risks involved with investing in small cap companies, including price fluctuations and lower liquidity. Commodities may be subject to greater volatility than investments in traditional securities and pose special risks. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, and international economic and political developments.

We are not licensed or registered with any financial services regulatory authority outside of the United States. Non-U.S. residents who maintain U.S.-based financial services accounts with us may not be afforded certain protections conferred by legislation and regulations in their country of residence with respect to any investments, investment solicitations, investment transactions or communications made with us.

You may not copy this report or distribute or disclose the information contained in the report to any third party, except with our express written consent or as required by law or any regulatory authority.

"BMO Wealth Management" is a brand delivering investment management services, trust, deposit and loan products and services through BMO Harris Bank N.A., a national bank with trust powers; family office services and investment advisory services through BMO Family Office, LLC, an SEC-registered investment adviser; investment advisory services through Stoker Ostler Wealth Advisors, Inc., an SEC-registered investment adviser; digital investment advisory and financial planning services through BMO Direct Invest Inc., an SEC-registered investment adviser; and trust and investment management services through BMO Delaware Trust Company, a Delaware limited purpose trust company. "BMO Family Office" is a brand name that refers to BMO Harris Bank N.A., BMO Family Office, LLC, and BMO Delaware Trust Company. The BMO Family Office brand provides family office, investment advisory, investment management, trust, banking, deposit and loan products and services. These entities are all affiliates and owned by BMO Financial Corp., a wholly-owned subsidiary of the Bank of Montreal. BMO Delaware Trust Company does not offer depository, financing or other banking products, and is not FDIC insured. You must be an existing customer of BMO Harris Bank N.A. and enrolled in BMO Digital Banking to qualify for services from BMO Direct Invest Inc. Not all products and services are available in every state and/or location. Family Office Services are not fiduciary services and are not subject to the Investment Advisers Act of 1940 or the rules promulgated thereunder. Investment products and services: **ARE NOT A DEPOSIT – NOT INSURED BY THE FDIC OR ANY FEDERAL GOVERNMENT AGENCY – NOT GUARANTEED BY ANY BANK – MAY LOSE VALUE.** Capital Advisory Services are offered by a division of BMO Harris Bank N.A.

BMO Private Bank is a brand name used in the United States by BMO Harris Bank N.A. Member FDIC. Not all products and services are available in every state and/or location.

BMO Harris Bank N.A. and its affiliates do not provide legal advice or tax advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

© 2023 BMO Financial Corp.

(Case No. #16305992)