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May Market Insights

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The Debt Ceiling – Round and Around We Go

With the $31.4 Trillion debt ceiling reached on January 19th, the U.S. Treasury has been undertaking "extraordinary measures" of shuffling money around to finance the government since net new Treasury debt issuance dropped to zero. Recent warnings from Treasury Secretary Yellen and the non-partisan Congressional Budget Office (CBO) indicate those cash management tools might be exhausted by early June, which could result in delayed payments or even default on debt obligations. An added twist is that quarterly tax receipts arrive on June 15th, which the CBO predicts would enable bills to be paid through the end of July . . . but this presumes that some combination of extraordinary measures and prioritized payments can get the Treasury to that June 15th date.

Our base case, which we communicated back in January, remains the same: *It is highly unlikely that lasting damage to the markets or economy will result from the current debt ceiling negotiations.*

The Latest

Negotiations between the White House and G.O.P. are underway, and the White House press secretary described meetings as "productive." Other recent developments include legislation passed by the House of Representatives to raise the debt limit and cut spending, which it hopes to use as an anchor in negotiations. President Biden has insisted on keeping spending negotiations and discussions of raising the debt limit separate, and the White House is reportedly even exploring a constitutional challenge to the debt limit.

The stakes surrounding debt default are extremely high. The recognition of this risk, however, is comforting. As we approach the "X -date" when the government has insufficient funds, the whiff of financial Armageddon could be in the air. But even if pushed 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 uncertainty around when the "X-date" will arrive, however, creates an added risk because negotiators do not have a completely clear deadline.

The Spectre of 2011

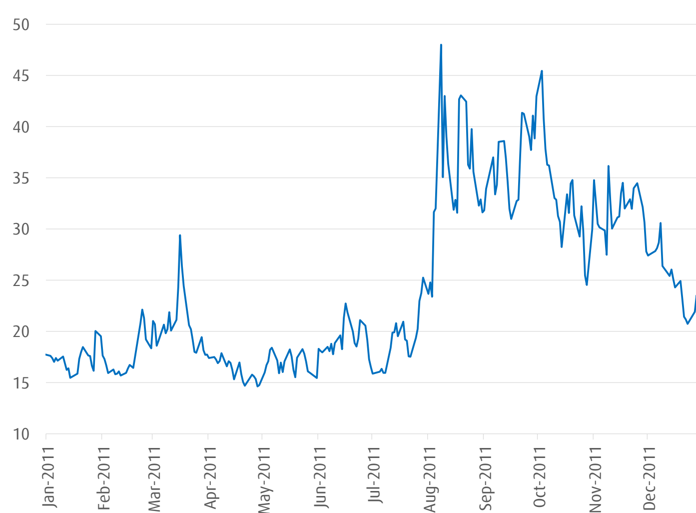
In 2011, there was heightened volatility and concern around the debt ceiling negotiations, which also occurred during a raw and fragile environment following the Great Financial Crisis and ongoing European debt crisis. At the time, the VIX, or Volatility Index, which is also considered a "fear gauge" for the market, spiked considerably *(Exhibit 1)* as the debt ceiling negotiations went down to the wire, and Standard and Poor's (S&P) downgraded U.S. debt from AAA to AA+. Commentary from that period illuminates the mismatch between expectations and the course of negotiations.

> *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 from the 2011 episode are noteworthy for thinking about the current situation: 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.

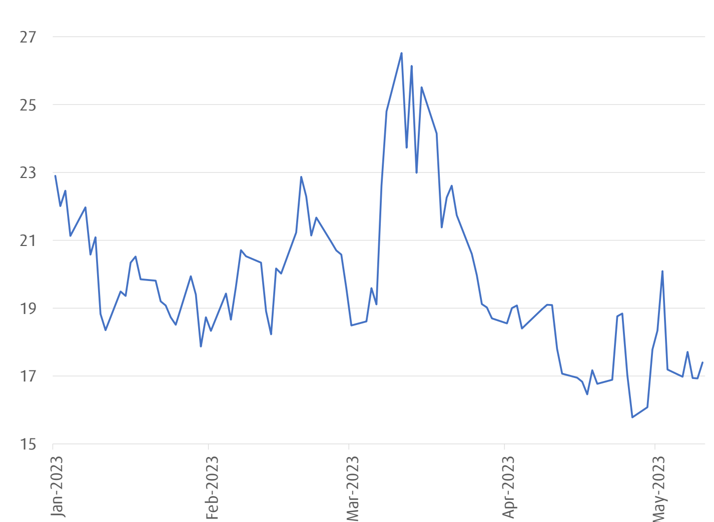
Please see disclosure on last page

Exhibit 1: VIX Index in 2011



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

Exhibit 2: VIX Index in 2023



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

Current Risks

We agree that should a default of U.S. debt occur that financial market turmoil could quickly ensue. We continue to believe this outcome is highly unlikely, and even more unlikely that lasting damage to the U.S. economy or markets would be the result. Short-term turbulence is much different than medium or long-term dislocation and could even present an attractive entry point for investors with cash that has been waiting to deploy.

Interestingly, the VIX is presently very subdued *(Exhibit 2)*. The market's consensus appears to be that the debt ceiling issue will get resolved without lasting damage. The T-Bill market is pricing in higher yields for securities maturing in early June, but also not showing signs of expected ongoing dislocation.

Compared with 2011, elected officials should better understand the implications of the debt ceiling negotiations. While the current political environment may be more polarized, 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.

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