The Crescent Group

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January 2023 Crescent Commentary

Many of you have questions about how the current U.S. debt ceiling negotiations could impact your investments and retirement planning. In this commentary, we'll help you gain a better understanding of the debt ceiling. We'll then explain our belief that although debt ceiling negotiations could cause short-term financial market volatility, we don't expect a lasting negative impact. As always, we will look at this issue from the standpoint of retirement planning and finance, and avoid the political side of things.

Over the decades, our government has formed the habit of borrowing to pay for spending that its revenue doesn't cover. Since 1939, Congress has imposed a limit on how much the government can borrow. For most of U.S. history, increasing the debt limit was routine. As a result of continuous increases in government benefit spending, as well as the impact of inflation, Congress has increased the debt ceiling nearly 100 times since World War II. On January 19, 2023, the U.S. hit its current debt limit of $31.4 trillion.[1][2]

Now that our government has reached its debt limit, Congress must raise or suspend the debt ceiling before the Treasury can issue more debt to pay for legislated spending. As many of you know, politicians have used the debt ceiling as a bargaining tool in recent years – and this is where the potential impact to financial markets comes into play. If you think back to 2011, you may or may not remember that the U.S. stock market fell 21% between August and November. This was a memorable time when politicians politicized the debt ceiling. As a result of the political impasse, credit rating firm S&P downgraded its rating of U.S. debt. The U.S. credit rating had never been downgraded before, and the 21% stock market decline reflected a knee-jerk reaction to this unprecedented event. Congress ultimately voted to raise the debt ceiling two days before the Treasury estimated it would run out of funds. Stocks began a swift recovery after that.[3][4]

Another more recent impasse over the debt ceiling occurred in 2013, when Congress waited until the last minute to raise the ceiling. There was no exogenous event like a U.S. credit rating downgrade, and stocks didn't react heading into the deadline. The main reason for the muted market reaction was investors didn't think politicians were rash enough to cause a default of U.S. debt and be held responsible for financial turmoil and a potential recession.[4]

As we just alluded to, the biggest risk with debt ceiling negotiation is if politicians fail to raise the debt ceiling in time to avoid a default on U.S. government debt. We think this risk is very low. No politician wants to be held responsible for financial market declines and potentially tipping the U.S. economy into a recession.

Now that the U.S. has hit its current debt limit, the Treasury is following a contingency plan created by the Treasury and Fed during the 2011 debt ceiling negotiations. Under this plan, there would be no default on Treasury securities. As securities mature, the Treasury would pay the principal by auctioning new securities for the same amount, and thus avoid issuing new debt above the debt ceiling. Tax receipts would be more than enough to cover interest payments on debt. This plan requires the Treasury to delay payments on all other obligations – payments to agencies, contractors, Social Security beneficiaries, Medicare providers, etc. This priority of payment could result in legal challenges, although the legal challenges would provide time for politicians to understand the seriousness of resolving the debt ceiling, and we're confident that they would resolve it.(2)

The big question for everyone is what's the financial market and economic impact of all of this? Looking at past debt ceiling negotiations, U.S. stocks didn't really show any reaction to the settling of the Fiscal Cliff on New Year's Eve 2012. Nor was there much of any reaction leading up to the debt ceiling resolution of October 17, 2013. This leads us to conclude that the 21% drop in U.S. stocks in 2011 was a result of the unprecedented downgrade of the U.S. credit rating, and not the actual debt ceiling negotiations. Applying these learnings to this year's negotiations, we wouldn't expect much of an impact to financial markets unless there's some exogenous event that occurs beyond the negotiations themselves. As we already mentioned, the U.S. breached its debt ceiling on January 19th, and yet U.S. stocks have moved higher since then. Even if an exogenous event did occur – such as a temporary delay of principal or interest on Treasury securities – we would expect the financial market impact to be temporary since the market reaction would motivate politicians to resolve the situation quickly. We also think any market reaction would reflect the fact that delay of principal or interest payment would be a result of legislative inaction, and not a result of the U.S. lacking the fiscal strength to pay its debts. So while the debt ceiling has and continues to generate financial news headlines, we don't think investors properly positioned for the long term should spend time and energy worrying about it. (4)

One final note: some of you might be worried about the U.S.'s debt levels, and what impact any potential future weakening of U.S. financial strength could have on your retirement planning. For one thing, we've already seen a weakening of U.S. financial strength in the sense of a credit rating downgrade in 2011. A knee-jerk 21% market decline was followed by an epic bull market. When we look at once-powerful countries that no longer dominate the global scene – i.e. Great Britain or France – while the countries themselves have diminished in power and influence, nothing of the sort has happened with their corporate giants. The corporate giants domiciled in those countries that hold dominant positions in their industries have never been stronger, despite the weakening influence of their domiciled countries. If there were a waning of U.S. financial strength and global influence in the future, we would expect a similar dynamic where our currently dominant U.S. companies would remain globally dominant. Many dominant U.S. companies already earn the vast majority of their revenue outside the U.S. and are thus less dependent on U.S. economic strength. To be clear – we see no waning of U.S. economic strength for the foreseeable future. We're just mentioning this to help put some investors at ease.

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Sources:

(1) RBC
(2) The Wall Street Journal
(3) US Bancorp
(4) Yahoo Finance

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