What the Debt Ceiling Negotiations Mean for the Markets, Economy, and Investors

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Key Points:

- A default on the national debt would be unprecedented, and even getting close to the deadline without Congress having raised or suspended the debt ceiling could have potentially serious consequences for global markets and economies
- Given a default's potentially severe market and economic consequences, we believe that compromise will be found again in Washington. Such developments occurring amid an already slowing economy will make the potential scenario more critical to avoid.
- We've been at this point many times before, and we can look at this history for some perspective. Historically, the stock market has ultimately resumed its course, notwithstanding some short-lived volatility around debt ceiling negotiations.

The clock is once again ticking on U.S. debt ceiling negotiations. The debt ceiling, or debt limit, is the statutory limit on the amount of debt the U.S. Treasury can have outstanding to help pay for the government's bills, obligations, and current and past expenses that Congress has already approved. Treasury Secretary Janet Yellen has informed Congress that the U.S. government would run out of cash and be unable to pay its debts (i.e., default) by early June.

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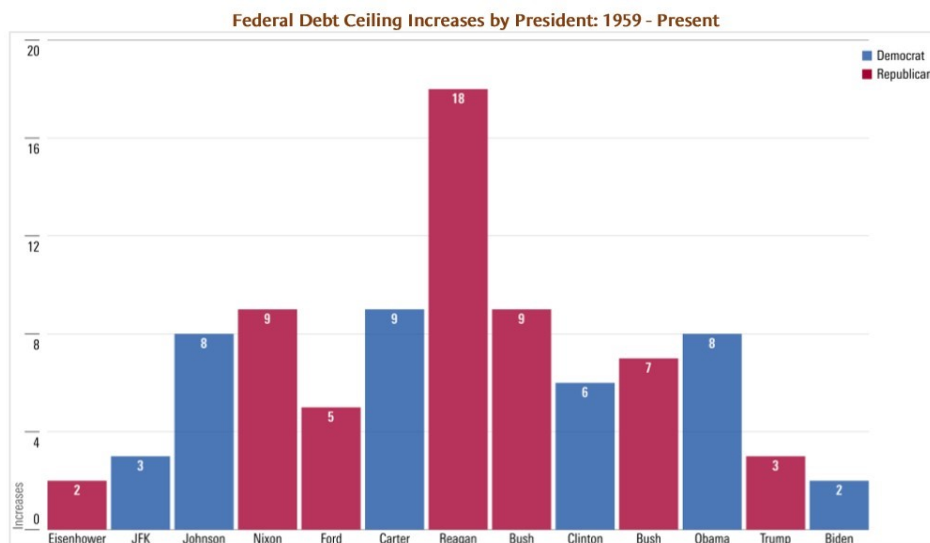

FIGURE 1: Over the past 60 years, changes to the debt ceiling have occurred 53 times under Republican presidents and 36 times under Democratic ones.

Source: Morningstar

The vast majority of these increases occurred with little impact on markets. However, the episode in 2011 was more contentious, with the government increasing its borrowing capacity just days before it would have exhausted its cash balance. This last-minute political brinkmanship led a major rating agency to downgrade the United States' credit rating from AAA (the highest credit rating) to AA+. Although the U.S. did not enter a technical default in 2011, the downgrade created a lot of short-term market volatility. (See Figure 2.)

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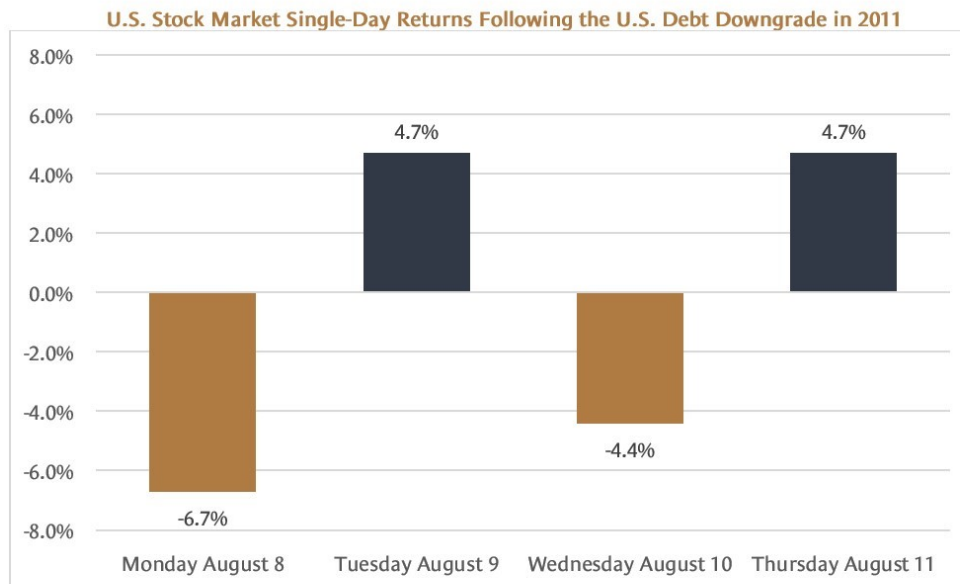

FIGURE 2: The downgrade was made public on Friday, Aug. 5, 2011, after the market closed. The market went for a wild ride the following week.

Note: The U.S. stock market represented by the S&P 500 Index price return. Source: S&P, YCharts

As such, the current tense political backdrop means the process might once again induce volatility for markets. This will ultimately get resolved, and we believe default is unlikely. A more likely outcome is some 11th-hour Congressional deal resulting from frenzied negotiations, particularly if markets show severe strain. However, once a deal is stuck, markets will likely start recovering from any short-term losses, as they did in the months following the debt ceiling increase in 2011, despite the U.S. being downgraded. (See Figure 3.)

FIGURE 3: By October 2011—only three months after the downgrade—the U.S. stock market had declined 8%, but a furious rally followed. By the end of 2011, the stock market had recovered over 15% from the October low.

Note: The U.S. stock market represented by the S&P 500 Index total return. Source: S&P, YCharts. Date Range: 08/05/11 to 12/31/11.

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What could happen

If the threat of a default grew and a downgrade to U.S. debt were to happen again, interest rates could increase and the interest that the government would need to pay on Treasury bonds could increase further and bring urgency to raise taxes. Likewise, interest costs would increase for consumers and businesses, further slowing the economy. Global investor faith in U.S. Treasury securities and the U.S. dollar could be shaken, leading to less demand for U.S.-issued securities. Stock markets would experience heightened volatility as higher discount rates for future cash flows would lower equity valuations, similar to last year amid central bank-induced rate increases.

If Congress doesn't raise or suspend the debt ceiling, the federal government couldn't meet all of its spending obligations, such as interest on existing treasury securities, Social Security benefits, or all federal government payment, including military salaries. This scenario would represent an unprecedented default with unknown economic consequences.

What will likely happen

Given a default's potentially severe market and economic consequences, we believe that compromise will be found again in Washington. Such developments occurring amid an already slowing economy will make the potential scenario more critical to avoid. Most elected officials in Congress are aware of the possible consequences, and in the end, no one will want to be responsible for this unprecedented event.

Even though a compromise is likely to be found, it could still come with potential market volatility. However, it's important to remember that volatility goes in both directions—up and down—and that the markets are generally efficient at processing news. So even if markets decline amid a standoff period, they could quickly and sharply reverse course to the upside as soon as a resolution is reached.

What investors should do:

As deadlines draw nearer, the political theater and dramatic media reporting will likely continue to intensify. For investors, the brinkmanship in Washington adds to the uncertainties and questions around the market and economic outlook. However, investors may find it helpful to remember that we've been at this point many times before, and we can look at this history for some perspective. The U.S. government has never defaulted on its debt and it doesn't intend to. Historically, the stock market has ultimately resumed its course, notwithstanding some short-lived volatility around debt ceiling negotiations. Instances in which the U.S. approaches its debt ceiling are mere footnotes in market history.

As such, we firmly believe that the best course of action for investors is to avoid the temptation to "time the market" around an event like this. Instead, history has proven that through market-moving events, including debt ceiling negotiations, the most successful investors are the ones who stick to their investment plan with a diversified portfolio of growth and defensive assets; employ a disciplined approach to take advantage of elevated market volatility; and most importantly, keep focus and perspective on their long-term goals and objectives.

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