Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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How the Debt Ceiling Showdown Could Affect Investors

The debt ceiling debate is once again flooding the national airwaves, as the U.S. rapidly approaches what is known as the "X Date" – or the date when the U.S. Treasury would run out of cash needed to pay bills.

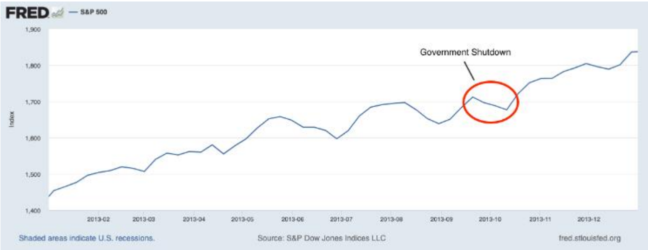
The Treasury owes interest payments on existing debt, but the department also needs cash to pay Social Security, veteran's benefits, and paychecks for federal employees and military families. It is important for readers to understand that raising the debt limit *does not authorize new spending* by Congress – it simply allows the Treasury to issue new debt to cover spending *already authorized* by Congress.[1]

As such, raising the debt ceiling is critical and necessary for the country to pay its bills on time, but it is also routine – the debt limit has been raised almost 100 times since World War II. Before the world wars, Congress had to approve borrowing every time debt was needed to finance new spending, but war spending changed the process – and in some cases, made it political.

Some readers may recall the "fiscal cliff" scare back in 2011, which was so down-to-the-wire that Standard & Poor's lowered the U.S.'s credit rating from AAA to AA. According to the Government Accountability Office, the lowered credit rating cost U.S. taxpayers about $1.3 billion for the fiscal year, which is small relative to total spending but still represents an avoidable cost. The stock market endured a real correction in 2011, falling some -19% from the intra-year peak but ultimately finishing flat for the calendar year and rising +13% in 2012.

Then in 2013 many readers likely remember the U.S. government shutdown that lasted 16 days (from October 1 to October 17). In that year, the government failed to appropriate funds for the fiscal year 2014 nor were they able to pass a continuing resolution to supply financing for government obligations.

Eventually – and as they always have – Congress passed a bill funding the government and raising the debt ceiling, but the process for getting there was politically fraught. Despite the very public debate and political infighting, the stock market (S&P 500 index) did not react much at all. As you can see in the chart below, the S&P 500 pulled back slightly but did not waver from its overall upward trend for the year. The index finished up +30%.[2]



Source: Federal Reserve Bank of St. Louis[3]

The debt ceiling issue is nothing new, and Congress has gone down to the wire with the issue before. Despite political tension, 11th-hour deals have always found a way to get done. While it appears that the politics has gotten uglier and more hostile over the years, I do not foresee a scenario where the U.S. government would be allowed to default on its debt – such an outcome benefits no one and would only serve to disrupt financial markets and raise borrowing costs.

The impact on the equity markets in 2021 may just depend on how far Congress lets the issue go, with the worst-case scenario being the Treasury running out of cash and missing payments on existing obligations ("X Date"). The Treasury estimates the X Date could fall somewhere between October 15 and November 4, so at the very latest Congress needs to act by then.

Bottom Line for Investors

For investors, the uncertainty surrounding the debate could lead to some short-term volatility, but I do not believe the medium to longer-term trajectory of the markets or the economy should be seriously affected. We're still on a strong path of growth, in my view, and corporate earnings should not be materially affected by a political process.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. September 24, 2021. https://www.wsj.com/articles/us-debt-ceiling-explained-11632429692?mod=djemRTE_h

[2] Wall Street Journal. September 27, 2021. https://www.wsj.com/articles/senate-republicans-set-to-block-bill-tying-short-term-funding-bill-to-debt-ceiling-11632772705?mod=hp_lead_pos1

[3] Fred Economic Data. September 27, 2021. https://fred.stlouisfed.org/series/SP500#0

IN FOCUS THIS WEEK

- **Slower than expected U.S. GDP growth in Q3**
- **Status of the government shutdown and debt ceiling standoff**
- **Soaring home prices**
- **Transitory inflation**

Slower than Expected U.S. GDP Growth in Q3

At the outset of the year, many economists were anticipating strong vaccine uptake would steadily decrease pandemic risk, giving way to booming growth in the second half of the year. The economic forecasting firm, IHS Markit, thought in mid-July that the U.S. economy would grow by 7.8% in Q3 – today, their forecast has fallen to 3.6%. U.S. consumer confidence has also sunk in recent months, also tied to the rapid spread of the Delta variant and re-introduction of mask restrictions and in some cases, vaccine mandates. The Conference Board's consumer confidence index[1] dropped from 115.2 in August to 109.3 in September, signaling those consumers were less enthusiastic about spending as the summer wore on. Supply constraints, which we have written about many times in this space, are also weighing on overall economic growth. Taken together, these headwinds are likely to show a marked slowdown in U.S. GDP growth in Q3, but the upshot is that economists across the board are in turn *raising* growth estimates for Q4 and the first half of 2022. The perfect storm for growth would be that Covid-19 cases, hospitalizations, and deaths continue to fall as supply chain issues slowly resolve themselves.[2]

Looming Government Shutdown and Debt Ceiling Standoff

Many readers are seeing news of a looming government shutdown and debt ceiling debate and think, "here we go again." Raising the debt ceiling has almost always been a routine affair – Congress has raised the debt ceiling close to 100 times in the postwar era. Raising the debt ceiling means enabling the U.S. Treasury to sell bonds in order to pay for spending *that Congress has already authorized.* Raising the debt ceiling also means staying current on existing government obligations, like Social Security payments, tax refunds, payments to military families, and so on. Treasury Secretary Janet Yellen told Congress this week that the government would be unable to pay its bills if lawmakers did not raise the debt ceiling by October 18, saying America could "default" for the first time if action was not taken. This is scary language, but there is also some hyperbole here – the U.S. Treasury is required to pay bond interest first, and tax revenues should allow the U.S. to continue making interest payments on time. Ms. Yellen's warnings of "default" are seemingly more designed to get Congress to act, versus being an actual risk for the U.S. in the near term. Not raising the debt ceiling would mean missing entitlement and other payments, which is by no means a good outcome and could lead to volatility. But talk of "default" needs to be examined more closely.[3]

Home Prices Continue Soaring to New Records

The U.S. housing market continues to remain strong. The S&P CoreLogic Case-Shiller National Home Price Index posted yet another record for year-over-year home-price increases, notching a 19.7% gain from July 2020 to July

2021. The index measures average home prices in major metropolitan areas across the U.S., so does not even factor sharp growth seen in emerging towns and small cities that have seen a surge of new buyers leaving the cities for bigger spaces. The 19.7% y-o-y gain marks the sharpest increase since the index began keeping records in 1987.[4]

Longer-Than-Expected Transitory Inflation

The Federal Reserve and Chairman Jerome Powell have long held that inflation in the U.S. is only temporary ("transitory"), as a surge in demand is being met with supply constraints and issues with the global supply chain. But what happens when "transitory inflation" lasts longer than expected? Is it then no longer transitory, but more permanent? Chairman Powell thinks not – in statements this week, Powell said the reopening of the economy is "a process that will have a beginning, middle, and an end," and that the U.S. has not yet moved through that cycle. In Mr. Powell's view, the economy will settle into a post-pandemic growth phase where supply chains run smoothly again, demand wanes slightly, and inflation settles back towards the Fed's target of 2%. Mr. Powell also defended keeping monetary policy accommodative, stating that there is a long history of the Fed not doing enough. Even still, the Fed appears poised to taper bond purchases later this year but remains split on when to raise interest rates, with half of the voting members favoring late 2022 and the other half wanting to wait until 2023.[5]

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[1] Wall Street Journal. September 28, 2021. https://www.wsj.com/articles/consumer-confidence-continues-slide-on-covid-19-inflation-worries-11632842406?mod=djem10point

[2] Wall Street Journal. September 29, 2021. https://www.wsj.com/articles/u-s-economy-set-to-pick-up-speed-after-delta-driven-downturn-11632907800?mod=djem10point

[3] Wall Street Journal. September 28, 2021. https://www.wsj.com/articles/yellen-says-treasury-could-exhaust-cash-reserves-by-oct-18-if-debt-limit-isnt-raised-11632835248?mod=djemRTE_h

[4] Wall Street Journal. September 28, 2021. https://www.wsj.com/articles/home-price-growth-hit-record-in-july-11632834044?mod=djemRTE_h

[5] Wall Street Journal. September 29, 2021. https://www.wsj.com/articles/powell-says-supply-chain-bottlenecks-could-lead-to-somewhat-longer-interval-of-high-inflation-11632934764

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*This information is supplemental to GIPS and is based off the composite
**The standard deviation shown here is calculated since inception

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