Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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What Will a Debt Ceiling Standoff Mean for the Markets?

Another year, another debt ceiling showdown.

Some investors and readers may feel like it's Groundhog Day with headlines of "catastrophic" consequences if the U.S. government fails to pay its bills. And let me be clear: I agree that failure to pay interest and/or principal on Treasury bonds would have severe economic and market consequences.

I just don't think the U.S. will get there.

The debt limit was created in 1917 and has been raised over 100 times, with numerous instances where a political standoff made its fate unclear. Some would say the current political environment makes a negative outcome more likely with both parties dug into their respective positions – a fair point. But even the most extreme form of brinkmanship would not likely result in the U.S. defaulting on debt, which has never happened in history.[1]

One widely under-reported reason is that a debt default is unconstitutional, as per the Supreme Court's 1935 interpretation of the 14th Amendment's Public Debt Clause. "The validity of the public debt of the United States…shall not be questioned," the Supreme Court wrote in a ruling, which has long been interpreted as meaning that default is simply not an option.[2]

But another source of confusion in the debt ceiling debate is: what constitutes a "default?" This is a point the media – and even Treasury Secretaries – often deliberately fail to explain clearly.

In the media, there are obvious advantages to skipping the technical, granular, boring details of how the debt ceiling and bond principal and interest payments work. It's easier to just say that failing to raise the debt ceiling automatically triggers a default, which is not the case.

As for government communications, the acting Treasury Secretary – in this case Janet Yellen – almost always resorts to conflating government obligations, like Social Security payments or government worker wages, with defaulting on U.S. debt. Just last week, Treasury Secretary Yellen said, "*A failure on the part of the United States to meet any obligation, whether it's to debtholders, to members of our military or Social Security recipients, is effectively a* *default*." Ms. Yellen had to use the word "effectively" in her statement because the actual definition of default singularly means failing to pay interest or principal on U.S. Treasuries.

Being late on—or missing—a Social Security payment or a child tax credit payment is not the same thing as missing a principal payment and/or interest payment on a Treasury bond. The former is an unfortunate lapse in a government entitlement program; the latter is "default" in the true sense of the word.

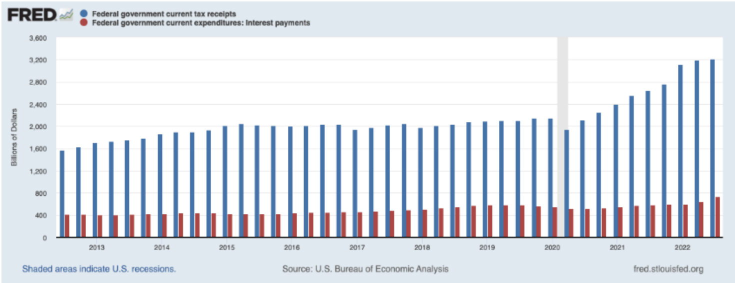
A little-known fact is that the last time the debt ceiling issue came to a head, in 2011, the Federal Reserve and Treasury officials privately made a plan to make on-time payments on Treasury debt while delaying payment on other government bills. A review of Fed transcripts at the time makes it clear that while the rhetoric almost always focuses on default – likely an attempt to influence public opinion and exert political pressure – behind the scenes government officials were ensuring a default would never happen. Markets understand this point.

The actual risk of not raising the debt ceiling would be missing entitlement payments and payments to other government programs—*which, again, is not the same thing as defaulting on debt.* Missing entitlement payments is not good, and a lapse can weigh heavily on sentiment, credibility, and potential markets. But Congress's failure to act would not necessarily trigger an actual default or credit event in financial markets, as is often framed in the media.

A natural follow-up question is, *how can the Federal Reserve and U.S. Treasury keep making on-time principal and interest payments without a raised debt ceiling?* It happens in two ways. For bond *principal* payments that come due, the U.S. Treasury is authorized to issue new debt to refinance a maturing bond—no Congressional approval needed.

For bond *interest* payments due, the Treasury receives far more in monthly tax receipts than it owes in monthly interest payments. As of the end of fiscal 2022, interest payments due on U.S. Treasuries accounted for just 9.7% of total tax revenue. This is akin to making $10,000/month in salary and having a $970/month mortgage payment, which would of course be easily manageable.

The U.S. Treasury Receives Enough in Paid Taxes (blue bars) to Cover Interest Payments on Debt (red bars)



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

Bottom Line for Investors

In my view, markets have seen enough debt ceiling standoffs – especially in recent years – to be able to price in some of the likely outcomes. According to the Treasury Department, there are enough funds available to pay all government obligations (Social Security, wages, etc.) and payments due to bondholders until June, even without the debt ceiling being raised. This runway may mean we'll have to spend months hearing about debt ceiling infighting in Congress, but it may also mean the actual threat of missing obligations is low assuming Congress can work out a deal in that time. For reasons explained above, it's these obligations that investors should weigh from a market's standpoint, not a default.

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. January 22, 2023. https://www.wsj.com/articles/what-is-the-u-s-debt-ceiling-and-what-happens-if-it-isnt-raised-11674135456?mod=article_inline

[2] Wall Street Journal. January 24, 2023. https://www.wsj.com/articles/janet-yellen-takes-measures-to-ease-debt-ceiling-woes-11674581734?mod=hp_listb_pos4

[3] Fred Economic Data. December 22, 2022. https://fred.stlouisfed.org/series/W006RC1Q027SBEA#0

IN FOCUS THIS WEEK

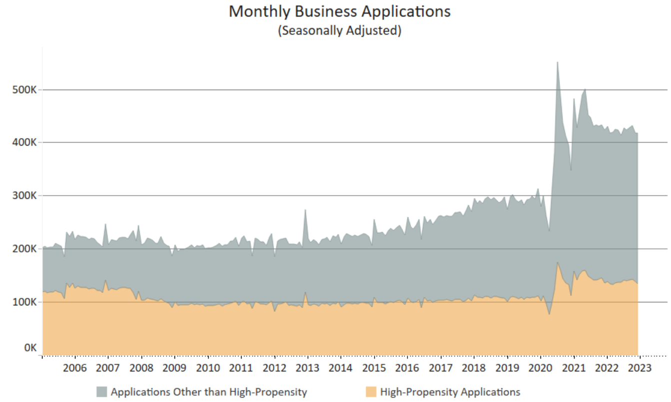
- **European economy picks up**
- **Small businesses are hiring**
- **Leading indicator in the labor market**

European Economy Shows Sign of Stabilizing

The worst-case scenarios for Europe's economy may have been avoided. For months, there were fears that energy shortages, high inflation, and rising interest rates would send Europe into a recession. But thanks to a mild winter, energy-conservation efforts, a shift in sourcing for natural gas, and hundreds of billions in new fiscal spending, Europe appears able to avoid a recession – at least for now. S&P Global's composite purchasing managers index – which gives a good read on activity in services and manufacturing – showed Europe moving from contraction territory (49.3) to expansion (50.2) in January. Germany, Europe's largest and most vital economy, showed strong signs of stabilizing which prompted the German Economy Ministry to forecast 0.2% growth in 2023. Last fall, the ministry called for a -0.4% contraction. December composite output data for the U.S. also improved, but the index remains in contraction territory (46.6). Europe's economic stabilization coupled with China's reopening could prevent the global economy from entering a recession in 2023, and the fact that the U.S. is nearing the end of its interest rate cycle may also provide support to a 'better-than-expected' outcome for growth this year.[1]

Still Innovating

Recent headlines have shined a spotlight on high-profile layoffs, mainly at the biggest technology companies like Google, Meta, Amazon, and Microsoft. But a major engine in the U.S. economy is one that often gets less coverage: entrepreneurs and small businesses. By these measures, the economy continues to look stronger than most appreciate. In 2022, Americans filed more than 5 million applications to start new businesses, the second-highest total on record.[2]



Census[3]

This boom in business formation suggests that innovators and entrepreneurs are not being fazed by the possibility of a looming recession. In fact, this has been true basically since the start of the pandemic. According to Labor Department data, small businesses (with fewer than 250 employees) have hired a net of 3.67 million people since February 2020, compared to large businesses shedding some 800,000 jobs over the same period. Today, 80% of available job openings are for positions at small businesses, underscoring this vital, yet underappreciated, feature of the U.S. economy.

A Leading Indicator in the Labor Market Points to Possible Weakness Ahead

Small businesses and new business formation look strong. But another overlooked aspect of the jobs market is starting to show weakness: the firing of temporary workers. In the final five months of 2022, employers parted ways with 110,800 temporary workers, including 35,000 in December alone. Many of the December workers were likely hires brought on to help with the holiday shopping season, which we now know was strongest in October and November but fizzled off in December. Trends in the temp worker market are worth watching because in the past they have been reliable leading indicators for economic weakness. In 2001 and early 2007, pullbacks in temporary employment preceded pullbacks in the broader labor market, which were both triggered by recessions. In a sense, this trend in labor markets may ultimately be good news, to the extent the Federal Reserve views it as a sign that tighter financial conditions are easing job and wage pressures.[4]

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[1] Wall Street Journal. January 24, 2023. https://www.wsj.com/articles/europes-economy-picks-up-raising-hopes-global-recession-threat-is-receding-11674559234?mod=djemRTE_h

[2] Wall Street Journal. January 25, 2023. https://www.wsj.com/articles/surge-in-hiring-by-small-business-complicates-feds-effort-to-cool-economy-11674627479?mod=economy_lead_story

[3] Census. 2023. https://www.census.gov/econ/bfs/img/business_applications.png

[4] Wall Street Journal. January 24, 2023. https://www.wsj.com/articles/companies-cut-temp-workers-in-warning-sign-for-labor-market-11674524006?mod=economy_more_pos3

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