Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Is the Debt Ceiling Standoff Different This Time?

Another year, another showdown in the U.S. over raising the debt limit. For many readers, it may feel like we're having the same conversations, rehashing the same talking points, and navigating the same risks on the debt ceiling as we have in past years past – a form of economic déjà vu.

Speaking from an economist and investor's viewpoint—and also as a columnist that has covered these debt ceiling standoffs on numerous occasions over the past several years—I can confirm that the debate itself is the same. It's the balance of power in the U.S. government that changes.

Before diving in, there is an important starting point in framing the debt ceiling issue, which is: raising the debt ceiling *does not authorize Congress to initiate any new spending*.[1]

On the contrary, raising the debt ceiling simply allows the U.S. Treasury to borrow in order to pay *existing* obligations. Thinking of it a different way, it would be similar to making the decision to buy a car, signing a contract to finance the purchase, and then debating several months later whether or not you should make the monthly payments. Other than Denmark—where the debt ceiling matter has yet to become a political flashpoint—no other developed country operates this way.

There is a perfectly fine and fair argument that the U.S. should have never "bought the car" in the first place, i.e., that there's been too much borrowing and spending on programs and entitlements in recent decades. With both parties responsible for big spending programs and deficits over this period, these are conversations worth having. But the debt limit is not the arena for it – instead, lawmakers should bring the debate to the federal budget, when tax and spending levels are determined.

Regardless, in this latest installment of the debt ceiling issue, the Treasury Department has warned that the U.S. could begin missing payments as early as June 1st. Other forecasts suggest the U.S. government may have until early August. It is unclear which payments would go unpaid first, but there's a strong indication that the Treasury could prioritize debt payments over obligations like government wages, VA benefits, Social Security, and the host of other payments owed – akin to a government shutdown, which has happened before.

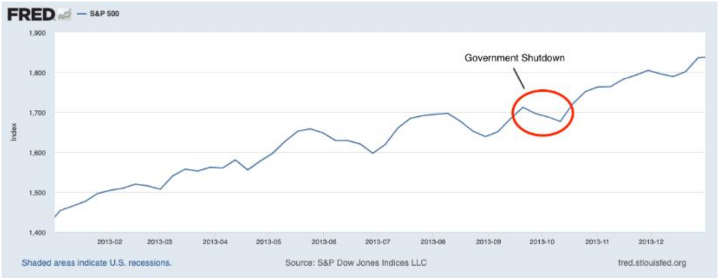
Being late on—or missing—a Social Security payment or a child tax credit payment is not good, but it is also not the same thing as missing a principal payment and/or interest payment on a Treasury bond. The former is an unfortunate lapse in a government entitlement program; the latter is "default" in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

I do not think the issue of missing a debt payment is on the table for this summer, despite media reports to the contrary. 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 interest payments, the Treasury can almost certainly prioritize these payments over the obligations described above, and they'd have plenty of cash available to do so. As seen below, current tax receipts (blue bars) are far higher than debt interest payments due (red bars), so technically speaking the Treasury could stay current on debt payments without a debt ceiling increase:

***Source: Federal Reserve Bank of St. Louis*[2]**

No one can predict how the current drama will unfold. Failure to pay obligations in relation to government shutdowns has historically contributed to short-term volatility for equity markets. The 2011 "fiscal cliff" scare dragged on for long enough 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 the U.S. about $1.3 billion for that fiscal year, which is small but still represents an avoidable cost. The stock market also endured a real correction in 2011, falling some -19% from the intra-year peak (though it ultimately finished flat for the calendar year and rose +13% in 2012).

In 2013, the standoff led to a U.S. government shutdown that lasted 16 days (from October 1 to October 17). In that instance, the stock market response was far more muted. The S&P 500 pulled back slightly during the shutdown (chart below), but did not waver from its overall upward trend for the year. The index finished up +30%.



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

Bottom Line for Investors

We should reasonably expect short-term volatility the longer the debt ceiling debate drags on, but I would stop short of worrying about the possibility of dire economic and financial market outcomes – which are almost always overstated. In all 'down-to-the-wire' government funding situations in recent years, 11th hour deals have always found a way to get done.

I would agree that politics has gotten uglier and more hostile over the years, but 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 it would only serve to disrupt financial markets and raise borrowing costs – an outcome neither political party wants. History shows a willingness to bring the U.S. economy to the brink – which is unfortunate – but never over the edge. The debt ceiling has been modified over 100 times since World War II, and it will be raised again.

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. May 9, 2023. https://www.wsj.com/articles/biden-gop-lawmakers-not-budging-as-debt-ceiling-meeting-convenes-2a58195?mod=hp_lead_pos4

[2] Fred Economic Data. March 30, 2023. https://fred.stlouisfed.org/series/W006RC1Q027SBEA#

[3] Fred Economic Data. May 9, 2023. https://fred.stlouisfed.org/series/SP500

Weekly Market Update

Important Market News We Think Worth Considering

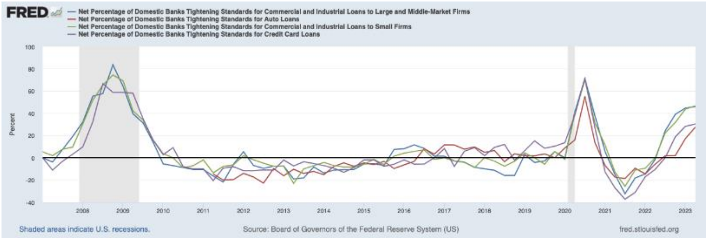
STEADY INVESTOR WEEK

Inflation Ticks Lower in April, But Not Convincingly

The Bureau of Labor Statistics reported this week that the consumer price index's (CPI) measure of inflation rose by 4.9% year-over-year in April. This inflation print marks a slight decline from March's 5% reading but remains a solid improvement from the 9.1% peak reached in June 2022. Core prices, which strip out food and energy, rose 5.5% y-o-y in April, a slight improvement from March's 5.6% increase. Higher core prices are largely a byproduct of pressure in services prices—and specifically, the shelter component, which makes up one-third of the index. The upshot here is that shelter prices measure what renters and homeowners are paying for new *and* existing leases, which means meaningful declines in rents will not show up immediately in the CPI number. Given that median rents in the U.S. have been falling, the shelter component should contribute significantly less to the CPI number by this summer and fall. Excluding shelter, food, and energy prices – the so-termed "supercore" inflation reading – prices were up 3.7% year-over-year in April. This latest inflation report supports the view that the Fed could pause rate increases at their next meeting. Even though inflation remains high, Fed officials have shifted to looking for signs that economic growth and inflation are stronger and higher than expected, neither condition of which is overtly apparent today. The labor market remains tight, but downward trending inflation and negative corporate earnings growth suggest the economy is not running too hot. According to the CME group, the market sees a 14% chance the Fed would hike another 25 basis points at the next meeting.[1]

Keeping a Watchful Eye on Lending Standards

The regional bank 'crisis' has tapered off since the fall of First Republic Bank, but the legacy of bank stress in 2023 may be one of tighter lending and credit standards. These factors will be key to watch throughout the year. If banks decide that a dollar in reserves is better than a dollar lent to consumers or businesses, it could choke off a key source of capital and credit that would otherwise fuel growth. The Federal Reserve publishes weekly loan activity for small and large banks, which will be important to watch. But the Federal Reserve Bank of St. Louis also conducts a Senior Loan Officer Opinion Survey, which polls lending officers at major banks on credit and loan standards. So far, the polls suggest that many major banks are indeed tightening standards, as seen in the chart below. The chart looks at the net percentage of banks tightening standards for loans to small-, mid-, and large-size businesses, auto loans, and credit cards. Standards are tightening across the board, which is likely to impact economic growth in the second half of the year.[2]



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

Still No Deal on the Debt Ceiling

Congressional leaders met with President Biden this week to discuss what it would take to raise the debt ceiling. So far, no progress on a deal has been reported. The two sides have agreed to meet again, however, which may factor as a positive sign. Debt ceiling standoffs have become more common in the last decade or so, the drama of which sometimes pushes up to the "X date" when the U.S. would need to start delaying payments on some obligations. It is unclear which payments would be missed first, but defaulting on debt – i.e., not making interest payments on bonds – would likely be last. Government wages, Social Security, Medicare, and other entitlement programs would likely see delays or "IOUs" happen first. For its part, the market does not seem to be too fazed by the posturing on the debt ceiling just yet. Stocks rose in April, and Treasuries were essentially flat – with both exhibiting relatively low volatility.[4]

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[1] Wall Street Journal. May 10, 2023. https://www.wsj.com/articles/us-inflation-april-2023-consumer-price-index-48f0eac5?mod=economy_lead_pos1

[2] Federal Reserve. 2023. https://www.federalreserve.gov/data/sloos/sloos-202304.htm?mod=djemRTE_h

[3] Fred Economic Data. May 8, 2023. https://fred.stlouisfed.org/series/DRTSCILM#

[4] Wall Street Journal. May 2, 2023. https://www.wsj.com/articles/treasury-secretary-janet-yellen-says-u-s-could-default-as-soon-as-june-1-without-a-debt-ceiling-increase-6714ed7c?mod=article_inline

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