HFP
Independent Financial Advice and Planning

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In association with BROOKS MACDONALD

The debt ceiling dilemma

The debt ceiling has come under intense scrutiny in recent weeks, especially as the U.S. Treasury Secretary Janet Yellen has warned the government could 'run out of money', potentially as early as 1st June. We have put together an explainer on the debt ceiling and its implication for investments.

What is the debt ceiling?

When tax revenue is not enough to cover government spending, the government needs to borrow money to make up the deficit. The US Treasury borrows money by selling US Treasury bonds to global investors, and the borrowed cash is used to support government spending including items such as healthcare to military expenses. The debt ceiling is a limit imposed by Congress on the amount of total debt the Treasury can borrow. If the government needs more money, the debt ceiling must be raised by the Congress through bipartisan approval.

What are the implications for financial markets if the debt ceiling is breached?

If the debt ceiling was reached and the Treasury ran out of cash, the government would be forced to restrict spending obligations - perhaps introducing a hierarchy of payment priorities with a default on Treasury debt and interest payments likely as a last resort. At the very least initially, essential services such as public health and security would likely be interrupted. In the event of a US government default on its debt, investor confidence in the US would be heavily impacted. This could cause significant depreciation in the value of the US dollar and US Treasury bonds. As the US makes up around 60% of the global equity market (by value), such an event could trigger contagion and bring prolonged periods of heightened volatility across all asset classes.

What is the situation now and is it different from previous instances?

Historically, the debt ceiling has always been a hot topic for debate amongst Congress members. It is often used as a political tool to push partisan agendas by constraining certain government spending. To date, there have been several instances where delayed approvals led to brief government shutdowns, but Congress has, to date, always avoided default by raising the debt ceiling at the so-called '11th hour'. The closest the U.S. has come to a default was in August 2011, where following an eventual agreement in Congress, credit rating agencies downgraded the U.S. from its top AAA credit rating to AA+.

Currently, neither the Democrats nor the Republicans appear to be targeting a short-term extension of the debt ceiling which is good news if they find a deal. However, it raises the bar as a longer-term solution will require more compromise from both sides. With the 2024 US presidential elections looming on the horizon, the two parties appear to be jockeying for control over the near-term political narrative. As June quickly approaches, the timeframe seems rather short to find a legislative solution to the debt ceiling, but Congress is known to reach a bipartisan approval at the last minute.

What is our view and how does this affect our portfolio positioning?

The debt ceiling poses a 'low probability, high consequence' risk to financial market stability. The consensus expectation in financial markets still seems to be that the US government will ultimately refrain from an act of self-harm and a resolution will be reached before the government runs out of money. In the meantime, we are likely to see heightened volatility in very-short-dated Treasuries in particular, as market participants factor in the uncertainty over the next few weeks.

In terms of positioning, while our decisions were not driven by US debt default concerns, earlier this year we reduced our exposure to US Equities (by reducing our International Equities exposure), in favour of adding to Developed Europe (excluding UK) Equities. This reallocation was driven by more attractive relative valuations in Europe, as lower energy prices began to alleviate some inflation pressure.

On balance, while we are mindful of tail-risks, our positioning assumes a central (most likely) scenario that a political solution is found, where US Congress ultimately raises the debt ceiling with concessions likely from both political parties around the level of government spending going forwards.

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