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Investment Strategy Group

Debt Ceiling Crisis Averted

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Derek Vasko, CFA, Senior Director, Investment Strategy
Will Shephard, Director, Portfolio Management

Over the Memorial Day weekend, President Joe Biden and House Speaker Kevin McCarthy struck a deal to increase the nation's debt limit. Despite subsequent grumbling from hard-liners in both parties, the bill managed to pass swiftly through both houses of Congress and is poised to hit the president's desk ahead of the revised June 5 deadline; the date which Treasury Secretary Janet Yellen indicated the nation would no longer have enough cash on hand to pay all its bills. In the weeks leading up to the announcement, performance in the bond market contrasted with the stock market. Here we look at some of the key terms of the bill, what drove the disparity in financial markets, and what we could expect over the balance of the year.

What's in the deal?

As expected, the terms failed to satisfy everyone, though both sides claim they got the better end of the deal. Here are some of the key provisions, some of which have additional caveats:

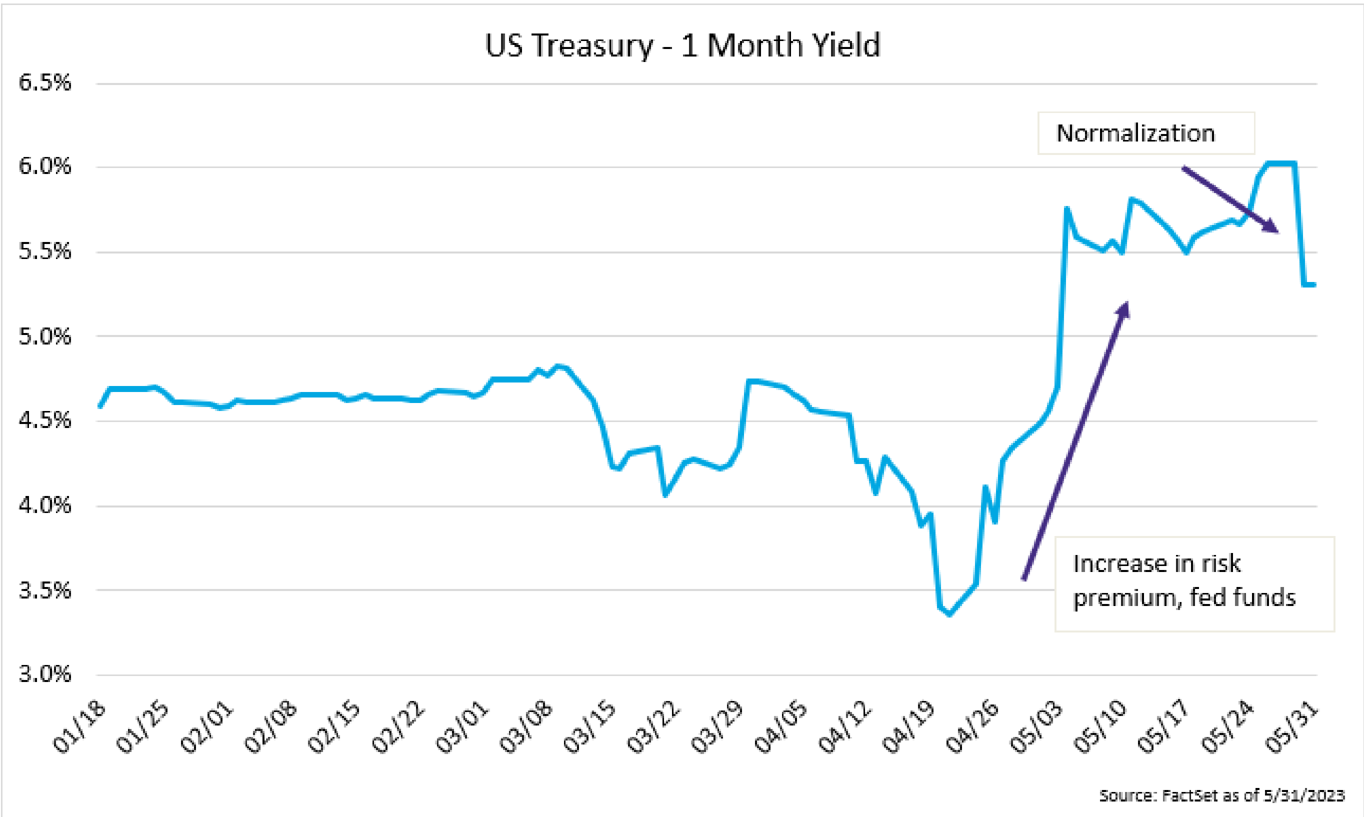
- **Suspension of the debt ceiling through January 2025.** That means Treasury effectively has unlimited borrowing capabilities over the next ~18 months, and the next set of negotiations will not take place until after the next presidential election.
- **Discretionary spending for federal agencies will be capped at current levels** for fiscal year 2024 and get a 1% increase in 2025. Excluded from this cap are mandatory programs like Social Security and Medicare, while spending on national defense will increase 3.3% next year and one percent further in 2025. While the budgets technically increase, it amounts to a cut since inflation is currently running well above those levels.
- **Recapture unspent Covid-19 funds.** Roughly $30 billion in unspent funds will be clawed back.
- **Additional work requirements for food stamps.** The working age requirement for eligibility for the Supplemental Nutritional Assistance Program (SNAP) will be raised from age 49 to 54, to be phased in over three years.
- **IRS funding repurposed.** $20 billion of the $80 billion allotted to the IRS in last year's Inflation Reduction Act will be reallocated to other non-defense discretionary programs.
- **Expedite energy-related permitting process.** This specifically targets a pipeline traveling from West Virginia to Virginia, though the terms will apply to future projects tied to both fossil fuels and renewable energy projects.

Treasury market volatility increased

Yields on the shortest dated Treasury securities increased dramatically in the weeks leading up to the Federal Reserve's (Fed) May 3 decision to raise its fed funds target rate an additional 25 basis points (0.25%) and as bond market participants began assessing the political hurdles to raising the debt ceiling. Investors turned cautious, demanding a premium for the risk that interest and principal payments could be delayed should lawmakers fail to strike a deal ahead of the Treasury's deadline.

Since the news of a deal broke over the holiday weekend, short-term yields have begun to normalize (Figure 1). However, even if/when the deal is approved the Treasury will need to increase issuance to meet funding needs and replenish cash held in the Treasury General Account. That will likely sustain upward pressure on yields. Per analysts at Morgan Stanley, Treasury bill issuance could spike to $730 billion through August and roughly $1.25 trillion through the end of the year. By flooding the market with additional supply, the Treasury will be forced to grapple with increased borrowing costs on top of the potential for an additional Fed rate hike.

Figure 1

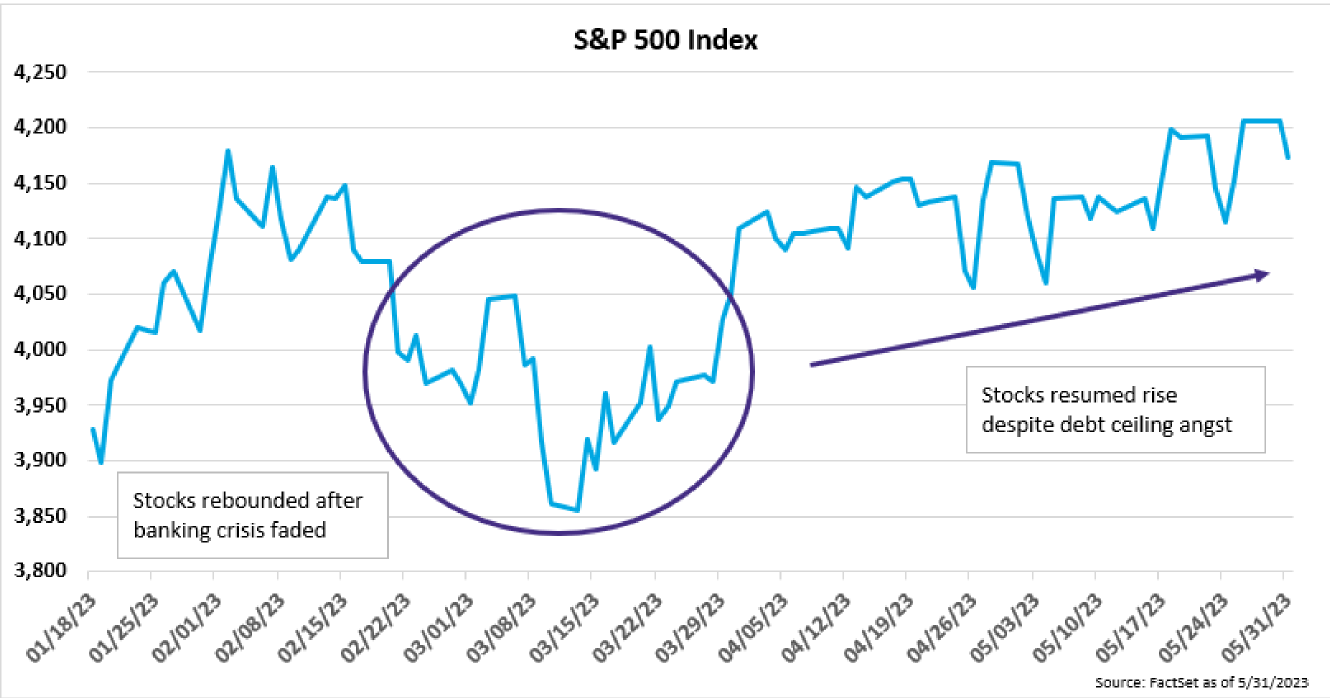


Averting a U.S. debt default is enormously important, however, that doesn't mean it will be smooth sailing from here. Heightened volatility in the Treasury market will likely continue as officials look to replenish the coffers by issuing substantial amounts of Treasury securities.

Equity market taking things in stride

In contrast to rising Treasury yields over the past couple months (as a result of downward pressure on bond prices), stocks prices have ticked higher as equity markets put little emphasis on the likelihood that a deal would not come to fruition. Since Treasury officially hit the debt ceiling in January, the S&P 500 Index is up six percent overall and has been trending higher — albeit amidst choppy trading — in the two months leading up to last weekend's deal announcement (Figure 2). Still, stock market investors have also grappled heightened uncertainty. Second quarter earnings season showed S&P 500 aggregate profit growth declined for a second straight quarter on a year-over-year basis; however, companies tied to discretionary spending continue to perform well and a still-strong labor market suggests the consumer — by far the largest contributor to economic growth — continues to spend. Looking ahead, aggregate earnings growth is forecast to turn positive by the end of the year[1], and the possibility of a Fed rate cut by year end is providing an additional measure of support.

Figure 2



Conclusion

Government officials appear poised to kick the can down the road, again. Through the end of 2024, Americans won't have to worry about another debt ceiling debate. However, a flood of Treasury issuance in the coming months could stoke further volatility in the bond markets, and an increasingly challenging economic environment will likely pose additional headwinds for stocks. Still, despite higher interest rates, still-high inflation, and decelerating corporate earnings, core bonds[2] have contributed positively to portfolio returns this year, and investors who remained in equities have thus far been rewarded. Our experience and long-term perspective leads us to view any near-term volatility as a potential opportunity to rebalance portfolios to better position them for long-term success.

[1] Source: FactSet. Third-quarter year-over-year growth is forecast to be 0.76% as of 6/2/2023
[2] Represented by the Bloomberg U.S. Aggregate Bond Index

Opinions are as of the date referenced and are subject to change based on market or economic conditions. There is no guarantee that any of these expectations will become actual results.

Diversification does not assure a profit nor does it protect against a loss of principal. Diversification among investment options and asset classes may help to reduce overall volatility.

S&P 500 Index is a capitalization-weighted index designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.