BARRON'S

APRIL 7, 2023

POLITICS | OTHER VOICES

The Debt-Limit Fight Could Hit Markets Sooner Than You Think

COMMENTARY By John Flahive

Investors have been complacent about the looming debt-ceiling debate, but that may soon change—perhaps sooner even than investors who are keeping an eye on Washington realize.

The expectation in Washington is that the "X-date," when the government will probably run out of funds, will come by August. But the exact timing depends among other factors on how much money the government takes in before then. The Congressional Budget Office has warned that the X-date could be as early as June if tax receipts disappoint in April. If history is a guide, that means the debate could start contributing to volatility by late spring.

This year's debate will probably be reminiscent of 2011, when Congress was also gridlocked and Republicans demanded a raft of spending cuts in exchange for raising the limit. Back then, we saw volatility ramping up about a month before an Aug. 2 X-date.

The impasse was so great between the Obama administration and Republicans in 2011 that it took a 200% spike in equity volatility, a global flight to quality in bonds, and the loss of the U.S.'s coveted AAA rating by Standard & Poor's before Congress signed a deal, just days before the X-date.

If anything, the debate this time could be even more acrimonious than it was in 2011. The political divide is deeper today, and the fiscal and economic stakes are higher. Although a default on Treasury debt is highly unlikely, it could take the real threat of default to get a deal done. We also cannot rule out the possibility of another credit-rating downgrade, and possibly the loss of Moody's highest, Aaa rating.

But there's more at stake for investors than a simple yes or no on default. The debt-ceiling debate comes at a time when interest-rate increases and inflation have contributed to a rapid deterioration of the government's fiscal position, and as global investors become increasingly concerned about the enormous growth of global sovereign debt over the past decade. The United Kingdom's financial crisis in 2022 demonstrated how quickly investors can abandon a sovereign bond market if they decide a government's actions are fiscally irresponsible.

The U.S. government's net interest outlays for fiscal-year 2023 are expected to be $181 billion, according to the CBO, which is 42% higher than what it had forecast last May, before the full extent of rate increases were known. The CBO expects that some $1.7 trillion of net interest costs will be added to the federal deficit over the next decade, 20% higher than what it projected last May. The CBO sees debt in the Treasury market climbing to $46 trillion and total national debt reaching $52 trillion by 2033.

With this kind of fiscal backdrop, it isn't so much the risk of default that investors should be concerned about as the likelihood that the debate kicks off a new era of fiscal austerity, which has implications for stocks, taxes, and economic growth.

That said, the issue of default shouldn't be ignored altogether. Investors may want to take precautions by avoiding Treasuries that mature near the X-date, whether that's before or after that date.

In our opinion, it would be a mistake for investors to eliminate Treasury exposure, even if Congress is still far from a deal as the X-date approaches. Standard & Poor's downgrade of U.S. debt in 2011 caused a massive flight to quality into Treasuries, to the surprise of some investors.

That's likely to happen again, because the Treasury market is still the largest, most liquid sovereign bond market in the world. Even though the U.S. lost its AAA rating in 2011, Treasuries are still among the highest-rated sovereign bonds, at Aaa/AA+. Treasury yields might also rally if investors expect spending cuts to be significant enough to weaken economic growth.

When it comes to equities, it's hard to draw directly from the 2011 playbook. We don't know where and to what extent spending cuts would hit sectors. Even so, looking back at 2011 provides insights into both the risks and opportunities that might arise this time.

In 2011, the S&P 500 index declined by about 17% in just over four weeks, from July 7 to Aug. 8. The greatest underperformance was in sectors most vulnerable to spending cuts, such as defense, healthcare, and information technology.

Investors became increasingly defensive as the debate dragged on, which favored sectors like utilities and staples over cyclicals.

It is tempting for investors to say, "Just wake me up when it's all over." We have been here many times before, and legislators have always ultimately chosen to raise the debt limit rather than risk a default, albeit at the 11th hour in most circumstances. Volatility is also relatively short-lived.

But staying complacent would be a mistake for investors going into the debate. The U.S. is already likely to experience a mild recession later this year, and it's possible that the market outlook for the economy will deteriorate further if we see significant spending cuts come out of the debate.

Investors should be cautious as we get closer to summer. We are advising our clients to stick to long-term investment plans, and to use active management and bottom-up analysis to find opportunities that could arise from volatility.

Guest commentaries like this one are written by authors outside the Barron's and MarketWatch newsroom. They reflect the perspective and opinions of the authors. Submit commentary proposals and other feedback to ideas@barrons.com.