Debt Ceiling Brinkmanship

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Last month's barrage of headlines around COVID and Afghanistan obscured the late-summer news of a different battle brewing in Washington: a standoff between Republicans and Democrats over the U.S. debt ceiling. The debt ceiling – a statutory limit set by Congress on the level of U.S. government borrowing – was temporarily suspended as part of a 2019 legislative agreement, but that suspension lapsed on August 1st. Since that date, the Treasury Department has engaged in a variety of accounting maneuvers and other so-called "extraordinary measures" to keep the government afloat and bond holders paid. Without a debt ceiling increase, these stop-gap measures are expected to run dry sometime in October or November. Inaction would set the stage for a possible worst-case scenario: a U.S. debt default.

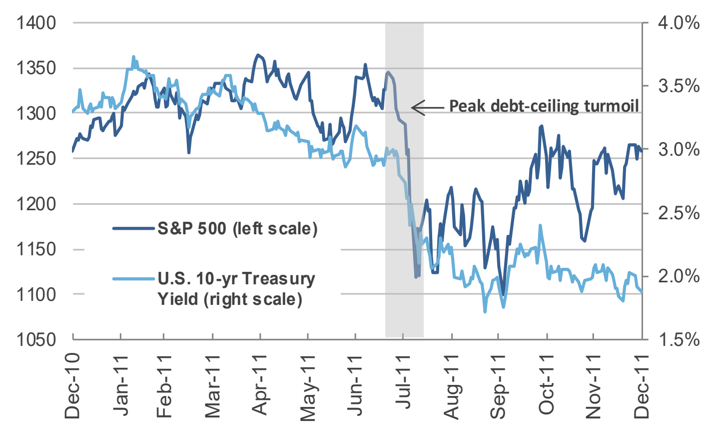
Complicating matters, the debt ceiling debate is linked to other near-term legislative hurdles. There is potential for a government shutdown after September 30th if an appropriations bill or "continuing resolution" is not passed. Additionally, in this same general time frame, Democrats hope to pass a multi-trillion-dollar social infrastructure package through budget reconciliation without Republican support in either the House or Senate.

The debt ceiling standoff centers around voter perception of the party responsible for any further increases. Democrats believe this should be a bipartisan effort, as was the case during the Trump administration. Republicans believe Democrats should "own" the debt ceiling increase purely by party-line voting as they did with the $1.9 trillion American Rescue Plan earlier this year, and as they plan to do on the multi-trillion dollar social infrastructure plan now in development. Both sides appear set on increasing the pressure while waiting for the other to blink.

If this feels a bit like déjà vu you're not alone. Similar situations have occurred in the past. The most substantial recent episode came in 2011, when an impasse lasted weeks and kept financial markets on edge throughout. The standoff was ultimately resolved at the 11th hour, but the consequences were painful. Over the course of two weeks the U.S. debt-ceiling debate – amid a parallel ongoing crisis in European debt markets – sent the S&P 500 into a 17% nosedive *(Exhibit 1)*.

Controversially, the United States was downgraded from its AAA credit rating by Standard and Poor's (but not Moody's or Fitch).

Exhibit 1: 2011 Debt-Ceiling Fiasco Financial Market Fallout



Source: Bloomberg

While the 2011 events created a few quarters of turbulence, markets eventually rebounded. Since then, debt ceiling standoffs have been taken largely in stride. Today, however, those last few experiences may be creating excessive market complacency. Indeed, the risk of default seems higher now than at any time since 2011. A true default has never occurred in U.S. history — but were it to happen, complacency would quickly give way to concern and ripple through global markets. Additionally, these tensions are not happening in a vacuum, but rather on a path with other distinct risks that include ongoing inflation, interest rate uncertainty, and coming corporate tax increases.

The debt ceiling standoff could play out in multiple directions from here. Both sides are likely to gauge public sentiment in determining how to respond, and it's unclear at this point the direction voters will tilt blame. We believe the most likely outcome is for a resolution of some type; perhaps a temporary measure that kicks the can down the road a bit. A bout of volatility remains possible as this plays out, but we do not expect a repeat of 2011 given the ultimate stakes.

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