Debt ceiling negotiations driving market volatility

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As Congress negotiates on the looming debt ceiling, markets are responding with some volatility. We continue to monitor and adjust accordingly. Here is our take on the current situation and likely outcomes.

What is the debt ceiling?

The debt ceiling is a limit set by Congress on the amount of debt the U.S. government can borrow. The current limit on outstanding debt is $31.4 trillion. Congress has repeatedly needed to raise the debt ceiling in the past as government spending has exceeded revenue such as taxes, fees and other sources.

Currently, the government is very close to the debt limit. The Treasury Department estimates that the debt ceiling limit will be binding in early June, or the so called "X-date", when the government has exhausted extraordinary measures to create space under the debt ceiling and no longer has a high degree of confidence it can pay all of its bills. The precise date is subject to uncertainty and depends in large part on the incoming flow of tax revenue.

Why does it matter?

Failing to raise the debt ceiling likely would spark market volatility. Markets are most focused on the risk that the government could be forced to delay interest and principal payments on U.S. Treasury debt, or to prioritize payments, which could impact Social Security, Medicare, defense spending and other categories. The result of delaying debt and other payments likely would damage investor and consumer confidence, which in turn could slow the economy.

What has happened in the past?

Congress has always raised the debt ceiling in the past, though with varying degrees of negotiating brinkmanship as the deadline approached. Usually, the market and economic impact has been transitory without severe disruptions despite some volatility.

One exception was in 2011 when there was a protracted debate over the debt ceiling and fiscal spending. Standard and Poor's, a credit rating agency, downgraded its rating of U.S. debt from AAA, the highest rating, to AA+, citing less predictability in the process of raising the debt ceiling. Markets sold off, with the S&P 500 declining about 17% before bottoming. Other factors, however, contributed to that market volatility, especially an ongoing debt crisis and economic turmoil in Europe. Counterintuitive to investor expectations, U.S. Treasury bonds rallied with the yield on 10-year Treasuries falling sharply due to a flight to what markets deemed as safe assets as well as concerns over slower growth.

What is the most likely scenario in the current environment?

The most likely outcome is that the debt ceiling is raised, but not without some brinksmanship as the estimated X-date approaches. Some spending caps and cuts appear likely in a compromise deal. Another possible outcome is that Congress agrees to suspend the debt ceiling for a year or more. If an agreement is not reached in time, it's also possible Congress extends the deadline a few weeks or months to hammer out a deal that can pass in Congress.

How might markets behave as we near the June 1 deadline?

We expect volatility as news over Congressional negotiations ebbs and flows. Market volatility likely will steadily ramp up the closer the calendar gets to June 1st until there is a deal to raise or suspend the debt ceiling.

What happens if the deadline passes?

We believe markets expect a deal, so failure to raise the debt ceiling by the deadline likely would send equity and other markets lower and spark a flight to quality, resulting in lower yields on long-term Treasuries. The resulting volatility and negative headlines likely would dent consumer and business confidence.

In the event the deadline passes, the Treasury is expected to prioritize payments, with interest on U.S. debt and payment of principal for maturing debt taking precedent over other government obligations. Payments on Social Security, Medicare and other programs could be delayed, which would put enormous pressure on Congress to come to an agreement.

What if there is a default?

We believe a default—defined by the U.S. government not honoring its debt obligations—will not happen. The repercussions would be severe for markets, the economy and the government's ability to issue future debt on reasonable terms. The most likely outcome is that the debt limit is raised. However, if the debt ceiling is not raised in a timely manner, one possibility could be a technical default where interest and principal payments are delayed until the debt ceiling is raised.

Market reaction likely would be significant with a delay in payment. The credit ratings of U.S. Treasuries could be downgraded. Currently, credit rating agencies Moody's and Fitch rate U.S. debt at the highest level, Aaa and AAA, respectively. S&P rates U.S. debt as AA+. Fitch recently placed U.S. debt on rating watch negative, saying it could downgrade the rating if the debt limit is not raised by the X-date.

Failure to raise the debt limit by the X-date, and especially a delay in payment, could erode confidence in the U.S. government's willingness to pay its obligations in a timely manner. We believe U.S. Treasuries, however, are likely to remain dominant globally as a safe asset, and the U.S. dollar is likely to remain the dominant global reserve.

How about market behavior after a resolution?

Markets likely would experience a relief rally with a resolution and the removal of uncertainty and risk. The Treasury would issue a significant amount of debt over the coming months, with estimates running greater than $1 trillion. Heavy debt issuance could pressure rates somewhat higher. However, we believe other factors, including corporate earnings, the Federal Reserve's next moves on interest rates, and the economy, will ultimately drive markets after Congress reaches a resolution on the debt ceiling.

How are Thrivent Asset Management leaders thinking about managing investments as the debt ceiling deadline looms?

Thrivent Asset Management is tracking the debt ceiling debate closely, analyzing the potential outcomes and risks and adjusting portfolios accordingly. The debt ceiling is one of several risks we manage, such as rising interest rates, the possibility of a recession, geopolitical risks, and others.

Additionally, we believe any significant sell off in assets could present an opportunity as ultimately the debt ceiling will be raised, and any market impact would be transitory.

If you are concerned about market volatility in light of the debt ceiling situation, it's a good idea to consult with a financial advisor. They can answer questions and help navigate near-term uncertainty with your long-term goals in mind.

All information and representations herein are as of May 26, 2023, unless otherwise noted.

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