

## MassMutual

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Alexander Pope, an eighteenth-century poet, once wrote “to err is human.” Mistakes, guffaws, errors, blunders, gaffes, inaccuracies...the methods of describing them are nowhere near the magnitude or quantity of their creation...but try we must. Those mistakes teach us and, if thoughtful about their introduction, also can improve us. Where humans are involved, there are, and will continue to be, mistakes.

Mistakes happen wherever humans make decisions: relationships, law, medicine, astronomy, robotics, driving, cooking, the list never ends. As a particularly staggering example, the National Institute of Health, in a groundbreaking study from 1999, estimated nearly 100,000 preventable deaths occur each year because of human error<sup>1</sup>.

As long-time readers of these updates will certainly be tired of hearing, decisions are probabilistic. Even above average decision-makers get decisions right far less often than we would hope.

A more recent example is the recent failure of Silicon Valley Bank (SVB), which was the 16<sup>th</sup> largest bank in the United States before its failure. Covered in our March 18 Market Update, SVB was shuttered not because its business model was flawed or its competitors more adept, or due to disruption by a more innovative bank model. Unfortunately, SVB went bankrupt because someone (finger pointing has begun) decided not to protect the bank against the risk that (very large quantities of) bonds go down. And yet, in 2022, that's exactly what happened and, when coupled with poor communication, put Silicon Valley Bank out of business.

This brings us to another looming mistake: the possible, but unlikely, default of the U.S. Government due to our debt ceiling.

Now, if you, dear reader, are not in the habit of following the various machinations and pathways of the interactions between Congress, the U.S. Treasury, the Federal Reserve, and laws that are 200 hundred years old...fear not.

What follows is a quick synopsis of debt ceiling fundamentals, an explanation of what is occurring currently, and an analysis of possible outcomes.

Let us begin.

## Debt Ceiling Fundamentals

Despite all its complexity, history, and nuance, the U.S. Government is, despite the perceived chaos, quite simple.

The U.S. Government receives money from its citizens (through various forms of taxation) and uses that money to pay for various services. When there is a shortfall (i.e., more money is spent than received), the government borrows money (from both domestic and foreign investors) to cover the shortfall.

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<sup>1</sup> <https://www.ncbi.nlm.nih.gov>

There are rules that govern the process, and various agencies are told to do certain things, but that is the essence.

The U.S. Government (for a handful of fascinating reasons following the end of the Civil War) adds two wrinkles (that most other countries don't have to deal with):

- 1) The money the government plans to spend must be approved by Congress, and
- 2) The money borrowed (overall) must stay under an arbitrary number also set by the government. This is called the "debt ceiling."

That's it. If you understand those paragraphs, you now understand more than most about the debt ceiling debacle that is currently at play.

To add some color, consider:

- a. The entire U.S. economy is around \$26 trillion dollars.
- b. The debt ceiling—\$31.4 trillion dollars—was reached in January of this year.

Based on various rules and current estimates of tax revenues, spending, and borrowing, our Treasury Secretary, Janet Yellen, estimates that, unless the debt ceiling is raised, the U.S. Government will be unable to pay its bills come June.

Yes, this is illogical and wildly unnecessary, so let's explore why we are currently in this predicament.

## Battles Lines Have Been Drawn...

To understand why this is currently happening, let's first explore who the Treasury pays.

First and foremost, the Treasury pays those that own our debt: individual citizens who have purchased Treasury bonds, for example, or groups like the Japanese or Chinese Central Banks (two of the largest holders of U.S. Bonds). The 14<sup>th</sup> Amendment mandates that we pay our debt (more on that later):

*"The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned."*<sup>2</sup>

Additionally, the U.S. Treasury pays Social Security to our retirees, our military, and other government workers...National Park employees, for example. In short, anyone the U.S. Government needs to send money to generally goes through the U.S. Treasury.

So, the U.S. Government (via Congress) has basically told the U.S. Treasury three things that are, in conjunction, now impossible:

- 1) You must pay the bills we agreed to.

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<sup>2</sup> <https://constitution.congress.gov/> 14<sup>th</sup> Amendment

- 2) You must honor the debt we agreed to.
- 3) You cannot take on more debt than the number we tell you...which, by the way, we already hit.

Hmmm....

So, Janet Yellen and her colleagues at the Treasury have done some pretty clever things (broadly known as "extraordinary measures") to kick this down the road...but those clever things are unfortunately running out of asphalt.

Which leads us to where we are today:

To raise the debt ceiling, there must be a majority vote in the Senate (currently controlled by Democrats) and a majority vote in the House of Representatives (currently controlled by Republicans). Republicans don't want to raise the ceiling without an agreement to limit spending, and Democrats want to separate those conversations (debt ceiling vs. spending) and not agree to limit spending until after the ceiling is raised.

Neither wants to give, and thus we get closer and closer to default.

## Implications of Default

For a minute, let's imagine there is no compromise, and the Treasury runs out of money. For those Treasury works among us, let us also ignore, for a moment, topics such as "prioritization," "trillion-dollar coins," and presidential veto power.

Not paying the investors who own U.S. debt would have several major implications:

- 1) Those that are supposed to receive payments would suddenly not have income (or coupons), which could have a material impact to economic growth.
- 2) Depending on how it was handled, the U.S. Government would no longer be deemed a credible borrower and be unable to borrow with the same ease it has historically. This would:
  - a. Raise the cost of borrowing on its existing debt.
  - b. Decrease the probability of funding our economy on new debt.

The Federal Reserve modeled this scenario in 2011 and 2013, and the results were not pretty. It would be, at a minimum, incredibly destructive.

## What Happens Next

And yet, my current synopsis is that while the outcome is enormously uncertain, it is unlikely to usher in an economic disaster.

Why? Throughout history, the debt ceiling has been raised 74 times during both Republican and Democratic presidencies. What's more, there are several possible paths to resolution (some are obvious, while others are more nuanced).

What makes "this time different" is the level of political posturing and bilateral animosity. While this

has softened in the last couple of weeks, it is nowhere near where it should be given the magnitude of the possible impact.

Is that enough to force a default? Unlikely.

Both Republicans and Democrats have material incentives to ensure the U.S. Government is well managed, able to pay its bills, and retains its credibility. While both sides are posturing, pushing this to the brink would be a massive mistake and, when combined with those incentives, I believe it is unlikely.

As long-time readers know, I profess very few certainties, but the idea that incentives drive behavior is certainly one of them.

In short, there are two likely paths:

- 1) A resolution occurs in the next couple of weeks. That would be the most straightforward and easiest, and this would fall into history as another one of the innumerable times the debt ceiling was raised.
- 2) A resolution doesn't occur in the next couple of weeks, and this drags on for months of headache, posturing, and confusion, but is still resolved in the end.

Under the second scenario, the Treasury would likely stop (or reduce) payment to government employees and would continue to pay its bills through a handful of mechanisms to save money...at least for the near term. Remember, default doesn't occur until the U.S. Government doesn't pay its debt, and we are not at that point.

During this time, government employees would likely continue working, as they would expect to be made whole eventually. This would also mean the cost of borrowing would increase slightly as the world adjusts to this new regime, and Democrats and Republicans would blame each other. Important to note, there would be risk of litigation of the more clever ideas being bantered about (trillion-dollar coin, prioritization, veto power, and the like), but it's possible one of those ideas either works, or at least decreases the severity.

And yet, this is unlikely to cause a severe recession (although a technical and more shallow recession is likely), crash markets, or disrupt the U.S. Dollar as the world's reserve currency. It is, however, frustratingly distracting and wildly unnecessary. There is only one other country in the world that has a similar debt ceiling (Denmark) and there is very little evidence to show the debt ceiling is accomplishing what it was intended to do.

In closing, let me offer one final thought. While this issue is clearly unnecessary, in many ways, this is "another one of those." Week after week, month after month, year after year, crises or problems occur, and yet incentives drive behavior to produce desired outcomes over the long term. Where there are humans, there are mistakes, sometimes chaos, and this is a perfect demonstration of that concept.

As investors, we analyze and optimize what we know and understand, and yet we prepare for that which we don't. Thoughtful investors recognize that the short term is remarkably confusing and

unpredictable, and therefore, we should, as much as possible, try to stay focused on the long term.

What drives strong investing returns over the long term are structural incentives. Capital markets, as extensions of capitalism, provide those incentives. I, as an investor, provide a company with capital for productive purposes. If that company is effective with my capital, I will benefit as the company produces its goods and services, and provides me with a return of, and on, my capital. That is as true now as it ever was and has been true during the 74 other times the debt ceiling was reached.

We, then, as investment professionals, build portfolios to take advantage of those structural incentives, while striving to protect from the unknown as much as possible.

In short, control what can be controlled. Save, mitigate taxes, minimize expenses, and be quite cautious and thoughtful about taking unnecessary risks...for it is those risks we haven't contemplated that put our capital in the greatest peril.

We remain at your service and watching closely. Please let us or your financial professional know how we can serve you.

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