

A Note From Your Advisors

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THE MAIN, GOWIN, FISCHER, RICE GROUP

May 18, 2023

We write often in this space about whatever the latest “headline risk” threat to markets is at the time: recent examples have included the banking system, rising interest rates and inflation.

The latest example of this dynamic is the risk that the Federal Government of The United States of America will reach its legal debt ceiling limit and be forced to default on debt (fail to make scheduled interest payments to bondholders). Obviously this situation, were it to play out in reality, would be dramatic and perhaps catastrophic. A default would damage the reputation of US Treasury bills, notes and bonds as “risk free” investments. Credit ratings agencies would certainly downgrade the rating on US bonds, which would raise the interest rate the Treasury has to pay to issue bonds in the future.

The dispute hinges on disagreement between members of Congress and the President. While disputes about budget priorities are actually quite normal in Washington DC, in this case the disputes about potential spending cuts have resulted in a big game of “chicken” being played out on a national stage. Republicans insist on significant spending cuts. Democrats initially insisted that the debt ceiling be raised before any spending cut discussions would ensue.

It’s important to remember that this drama has played out SEVERAL times in recent decades, under both Democrat and Republican Presidents. Congress has raised the debt ceiling 17 times from 2002 to 2016: 7 times during President George W Bush’s administration (total increase of \$5.365 trillion), and 10 times during President Barak Obama’s administration (total increase \$6.498 billion). Please note that these dollar figures are unadjusted for the inflation. It was also raised 8 times under President Bill Clinton and 18 times under President Ronald Reagan.

So now we know that this particular game of “chicken” isn’t an unusual one. What will happen this time? Baird’s Market Strategists and our partners at Strategas continue to keep us well-informed with daily updates. We are encouraged by recent meetings and developments, as the two sides have met several times to establish priorities and a timeline. A meeting at the White House between President Biden and Congressional leaders is currently scheduled for Tue May 16th. There is some indication that outlines of a potential deal have emerged involving some spending cuts. For example, Democrats have reportedly showed some willingness to tap unspent Covid relief funds and streamline permitting for energy projects.

As an investor it’s wise to keep in mind that public statements provided by either side to the media are usually bargaining tactics, and often not a completely accurate reflection of real negotiating positions. Thus, in the short term, we should expect continuing market volatility, as tomorrow’s headline has the potential to shift trading sentiment back and forth. Our current take is that enough people on both sides of the negotiations understand the potentially catastrophic result of an actual default. The Treasury Department has other last-ditch tools at its disposal to react (remember the shut-down of many departments of the Federal Government in 1995?). We remain hopeful that a responsible compromise, built around sensible and balanced spending reductions, will be found. But it’s also very likely that this won’t be the last time we see this kind of thing play out.

We encourage you to be aware of developments in this area, but not to fundamentally change your long-term investment plan because of daily headlines. In other words: talk to your advisors, have a plan, and stick to that plan.