SHOULD WE FEAR THE DEBT CEILING DRAMA?

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Welcome to February! Every month, we like to impart some perspective on the financial markets or shed light on a current headline or two, all in an attempt to help our clients sift through the noise and become slightly more educated investors. We welcome your comments and suggestions, and as always, we invite you to share this piece with anyone you believe may find it of interest.

With little doubt, the financial markets are off to a great start in 2023 and are behaving considerably better than they were last year. The S&P 500 gained 6.2% in January and sector leadership took a decidedly "risk on" tone, something we haven't seen in a while. Technically, the markets are improving as well, with fewer stocks making new lows on pullbacks and with less downside volume, and with the percentage of stocks above their long-term averages at 14-month highs[1]. A composite of the market models we follow are showing their best readings since January 2021[1] and stocks are beginning to look like they're entering another bullish phase.

Yet just to keep ourselves honest, risks remain, and there are two we want to bring to your attention here.

The first is the debt ceiling issue, something we've been hearing an awful lot about lately. For starters, the debt ceiling is the maximum amount of money the U.S. can borrow to pay its obligations. It was created under the Second Liberty Bond Act of 1917 in an attempt to keep the federal government fiscally responsible. Over the years, as the federal debt has grown and bumped up against this limit, Congress has met and hammered out agreements to raise the ceiling. Of course these agreements haven't always been without drama or a few government shutdowns along the way – most recently in 1995, 2011 and 2013[2] – but lawmakers have always been keenly aware that failure to raise the ceiling could lead to the U.S. technically falling into default, with broad implications for the country's credit rating, borrowing costs, and financial markets stability.

Once again we're bumping up against the debt ceiling and some economists and analysts believe this time the outcome may be different. In our view, the recent election of California Republican Kevin McCarthy as House Speaker raises the possibility that Congress may vote against lifting it later this year, ratcheting up concerns over a potential default. As recently as two weeks ago, McCarthy was firm in his refusal to take Social Security and Medicare cuts off the negotiating table, yet at the same time Democrats were equally resolute in their refusal to accept spending cuts. We're used to tension and drama in Washington, but since this issue has such massive implications, the financial markets are right to take notice.

The Washington analysts whose perspectives we respect are saying the probability of a last-minute agreement looks likely, and history supports[4] this notion as eleventh-hour deals appear to be the norm with these debates. In a cordial meeting earlier this week, Speaker McCarthy and President Biden noted "common ground" for the makings of a possible deal, an encouraging sign. Both Biden and McCarthy are masterful dealmakers and there may be meaningful progress by spring. But since we're in the early stages and much remains to be done, we should expect the markets to be hypersensitive to any signs of trouble.

We also need to point out where the markets stand today relative to the overall economy and the Fed's tightening cycle. In a continuing effort to tame inflation, the Federal Reserve has raised the effective Fed Funds rate by over 3.5 percentage points during the last year and short-term rates now sit at the highest level since 2007[3] . Many are asking when the Fed will stop raising interest rates; we on the other hand are asking what effect the last twelve months have already had on the economy that isn't yet evident. Remember, Fed policy has a lagging effect. We believe that much of the year-to-date optimism in the markets has likely stemmed from the so-called "soft-landing" scenario, an idea that the Fed might not actually stall the economy into recession. But we're not so sure. We're not about to place odds on a recession, but we will say that many of the telltale indicators that have served us well over the years continue to show signs of significant economic slowing[4], so our inference remains that some variety of recession – most likely mild – lies ahead. With the markets off to a great start, we wonder whether they've gotten a wee bit ahead of themselves and have perhaps ignored these present risks.

We've stated this many times: recessions are never to be feared. They're a critical part of the business cycle and they're always, always temporary. So too with debt ceiling issues. Since 1960 the debt ceiling has been raised or extended 78 times[5] – a staggering admission of our government's propensity to spend, yet supportive of the likelihood it will be raised once again.

Neither of these risks, nor investors' apparent indifference to them, are enough to sway our belief that broad market conditions are improving or that this year may end up with a better outcome than last. But as always, we pay heed to the idea that markets which are priced for good news can very easily be spooked by bad. Tis the nature of these things.

Onward.

[1]Ned Davis Research [2]Investopedia [3]Macrotrends [4]The Bahnsen Group [4]U.S. Department of the Treasury

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