Markets in a Minute:
The Debt Ceiling

Here we go again! Democrats and Republicans are locked in a pitched battle over what used to be a fairly routine matter: raising the debt ceiling. While previous incidents have always ended in an agreement, the disruption could potentially introduce short-term risks and volatility to both the markets and the government's reputation.

What is the Debt Ceiling?

Simply put, the debt ceiling is a limit on how much debt the U.S. government can take on. Since the country was founded, the government has often spent more money than it generates through taxes and other revenues. But it is happening now more than ever. To make up the difference, the government sells bonds to investors ranging from American citizens to banks, insurance companies, local governments, and foreign investors.

Each month that the government spends more than it brings in, it creates a deficit that adds to the national debt and moves us closer to the debt ceiling. You can see a live look at the U.S. debt by going to https://www.usdebtclock.org/. When the limit is ultimately reached, it will prevent the government from taking on additional debt - even if those spending plans have already been approved - and will limit that government's ability to pay the bond investors mentioned above.

History of the Debt Ceiling

Up until the first World War, Congress had to vote each time the U.S. government needed to borrow money. To give the government more flexibility, it switched to a "ceiling" in 1917. While Congress sets a specific amount for the debt ceiling, it's important to understand that number isn't fixed forever. It can be changed, it has changed many times, and it will likely continue to change.

- Since implementing the debt ceiling, the U.S. has regularly come close to hitting it but has always managed to raise it.
- Congress has raised the debt ceiling 78 times in the last 63 years, 49 times under Republican presidents and 29 times under Democratic presidents.

- Raising it has almost become an annual task for Congress. However, it's not always a smooth process.

Current Situation

The U.S. officially hit the debt ceiling on January 19, 2023—but this was expected. Now, the Treasury Department has implemented "extraordinary measures," unique accounting tactics to allow the government to continue servicing its obligations. While these extraordinary measures buy Congress some time to push the ceiling higher, the clock is ticking. Estimates suggest the government will run out of cash sometime this summer.

With Democrats controlling the White House and the Senate and Republicans controlling the House of Representatives, even relatively straightforward agreements can quickly become shaky. Unfortunately, political showdowns related to the debt ceiling are starting to become familiar territory. Similar political theatre surrounding raising the debt ceiling reached a critical point as recently as late 2021, and these political showdowns are not without consequence. In 2011, a refusal by Congress to raise the debt limit prompted rating agencies to lower the U.S. government's debt rating from AAA to A+. Interestingly, despite the ratings downgrade, Treasury bonds increased in value during that time.

How Will It Impact the Markets?

The debt ceiling situation is just another factor influencing our 2023 theme of "Turbulence Ahead." Historically, the stock market has not reacted until the default deadline is fairly close. Back in 2011, the market started to dip about a month before the deadline, slipping further as the date grew closer. Three months later, stocks had regained their previous highs.
As of now, it looks like we are about six months away from a potential crisis point, so the predominant factors impacting market performance will likely continue to be inflation, interest rates, and earnings estimates.

What Now?

Ultimately, Democrats and Republicans will likely negotiate and find a solution to raise the debt ceiling and avoid defaulting. The U.S. has never defaulted, so it is unlikely that things will be different this time around. Negotiations will play out over the next several months, but neither party is in a rush currently. Until then, we will likely see discretionary spending cuts across government programs. Investors should continue to stay the course as we are likely months away from a resolution to the debt ceiling situation. But in the meantime, consult with your financial advisor to ensure your portfolio is diversified and ready to withstand a potentially turbulent year ahead.