# Investor's Guide to the Debt Ceiling

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Will this time be different?

## The bottom line

As the U.S. debt stand-off takes center stage, markets will be watching to see if Congressional leaders can reach an agreement and avoid a U.S. default. Ongoing recession worries mean many investors are already positioned conservatively to weather higher levels of expected volatility.

## Debt ceiling overview

Treasury Secretary Janet Yellen has warned that the U.S. Treasury will exhaust the measures currently funding the government by early June (the "X-date") if Congressional leaders are unable to agree on a plan to raise the borrowing limit.

This is not a first-time event – in fact, the U.S. has reached its debt ceiling limit 78 times since 1960. But today's divided Congress appears far from aligned on a path that would allow the U.S. Treasury to continue to meet its financial obligations.

### Market implications:

- Bond market volatility is elevated as a result of the combined effects of debt ceiling concerns and financial cracks from rate hikes.
- Significant reactions have not yet surfaced in broader risk assets, but higher volatility may emerge as the X-date approaches.
- As the debate heats up, short term disruptions may impact investor confidence in the U.S. as a sovereign borrower.

## This is not 2011

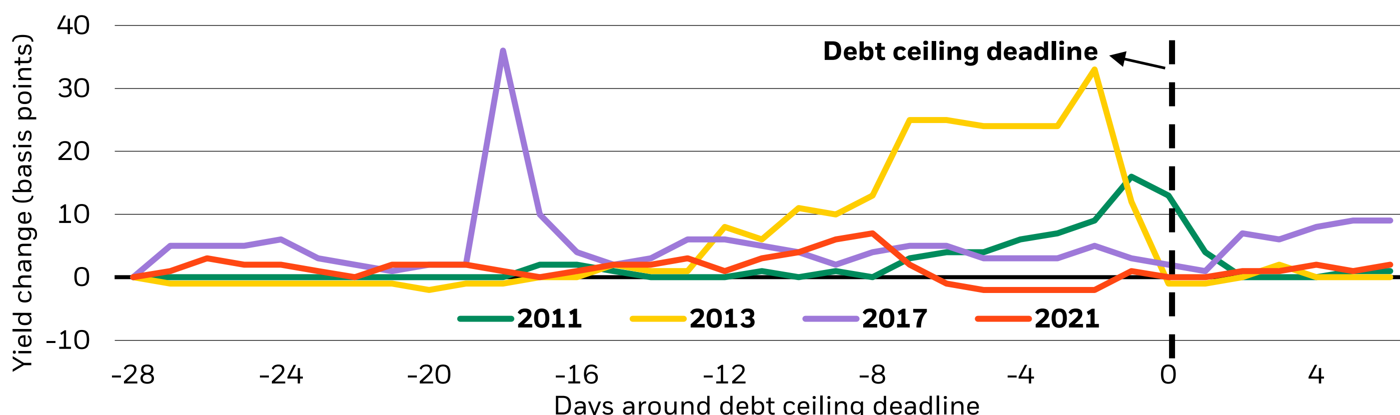
U.S. equity markets dropped precipitously following the S&P downgrade of U.S. Treasuries in 2011, we note the Euro-debt crisis and growth fears were also significant drivers of market prices at the time. Today's macro backdrop is very different.

Compared to 2011, inflation is higher, interest rates are higher, central banks are shrinking balance sheets, and investors are increasingly wary of a potential economic slowdown. We see the financial industry as more prepared today after past scares, with contingency plans in place. The U.S. Federal Reserve's (Fed) reverse repo facility means money market funds and other investors can benefit from the higher yields on offer without being exposed to U.S. Treasury bills.

Short dated T-bills due to mature around the time of expected disruptions have historically experienced the largest volatility shocks – then quickly normalized after resolution is reached. Pricing activity in short dated T-bills today suggests that investors are anticipating a potential disruption in treasury markets.

### Uncertainty approaching

Changes in 4-week Treasury Bill yields during debt ceiling episodes




Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2021. Notes: The chart shows changes in yields of 4-week Treasury Bill (T-Bill) yields from 28 days before the debt ceiling "deadlines", or the dates when the federal government exhausts its borrowing in selected debt ceiling episodes. These deadlines are August 2, 2011, Oct. 17, 2013, Sept. 29, 2017. We use Oct. 15 as the projected debt ceiling "deadline" for this year. **Past performance is no guarantee of future results.**

# Portfolio considerations

While we are cautiously optimistic that the debt ceiling stand-off is likely to be resolved, we are mindful it may spark renewed volatility across markets. The outlook for both risk and less risky assets remains highly uncertain, driving our selective view across asset classes.

## Positioning in Fixed Income

Our investors have generally maintained a more defensive portfolio positioning as a result of inflation uncertainty and the risk of recession. The debt ceiling standoff only adds to these concerns, bolstering our resolve in these defensive positions.

"We have tactically rotated to the intermediate part of the curve given more attractive portfolio hedging properties and further distance from the X-date."

**Rick Rieder**
Managing Director
CIO of Global Fixed Income

Our portfolios remain up in quality, stepping into duration selectively. We are limiting exposure to maturities in the next few months that could be exposed to downside risks, rotating to more intermediate duration securities for portfolio ballast.

Where appropriate, we are tactically adding volatility hedges in sectors that may be sensitive to the outcome of the debt ceiling debate and reducing risk in sectors where we do not feel risk is adequately compensated.

As active managers, we are closely monitoring the fixed income landscape for opportunities that may arise leading up to the debt ceiling debate – focusing on relative value plays across geographies and sub-sectors and favoring diversification in the face of ongoing market uncertainty.

"We have been maintaining more defensive portfolio positioning as a result of ongoing tightening in monetary policy and economic slowing pushing up the odds of economic recession."

**Jeffrey Rosenberg**
Managing Director
Sr. Portfolio Manager, Systematic Fixed Income

## Positioning in Equities

Both the debt ceiling debate and recession fears reinforce the need for a selective approach to equity investing over owning the broad market. Our portfolios are focused on identifying high quality companies with strong fundamentals.

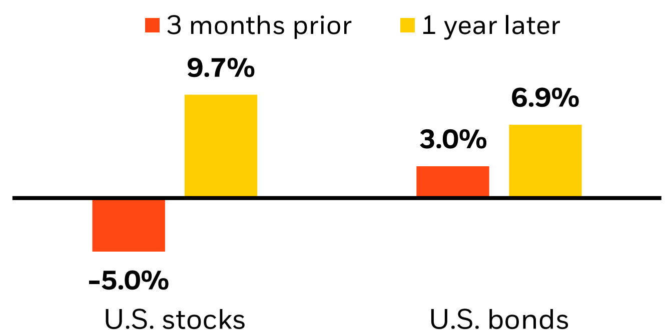
"We favor a selective approach focused on quality companies with strong balance sheets, healthy cash flows and sound business models with an ability to weather market gyrations."

**Tony DeSpirito**
Managing Director
CIO of U.S. Fundamental Equities

The downgrade of U.S. debt sparked a 17% decline in the S&P 500 Index between July and August 2011, but this was short-lived. The index swiftly rebounded, earning a 9.7% return one year later. With many portfolios already positioned cautiously, investors may be better able to weather a volatile summer.

For more commentary on the current debt ceiling showdown and the 2011 event, please view the full write-up from **BlackRock Investment Institute here**.

**2011 debt ceiling stand off**
In 2011, S&P downgraded the U.S. credit rating one notch citing the growing debt and the prolonged debate




Source: Morningstar as of 4/30/23. U.S. stocks represented by S&P 500 TR Index and U.S. bonds represented by Bloomberg U.S. Agg Bond TR Index. **Past performance does not guarantee or indicate future results**. Index performance for illustrative purposes only. You cannot invest directly in the index.

## A U.S. Treasury default is unlikely, but what if?

In the event no agreement is reached, there is the possibility that the U.S. government would prioritize payments, stopping outlays in certain areas to fund debt service, although this remains an unexplored capability. A potential ratings downgrade, the catalyst for the market reaction in 2011, could conceivably follow, but we believe markets would react less violently to this now precedented event.

Near-term portfolio positioning for this scenario may include avoiding short maturity treasuries where payments could be disrupted, an allocation to defensive equities or gold, and a tilt to securities that would benefit from U.S. dollar weakening. We believe that more money is lost than gained from attempting to time such dynamic and ambiguous risk events. We maintain a cautious stance, and the risks around the debt ceiling reinforce that position.

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