U.S. Policy Watch

What Investors Need to Know About the U.S. Debt Ceiling

The impasse over raising the debt ceiling may roil markets.

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Congress has taken action to raise the debt limit, temporarily suspend it, or revise how it is defined on 78 occasions since 1960.[1]

Given the potential consequences, failing to raise the debt ceiling should not be an option. However, this year, the process of reaching a resolution could roil the markets, akin to 2011, when brinkmanship around the debt ceiling contributed to one agency's decision to downgrade the United States' sovereign credit rating.

Let's explore why this year's debt ceiling debate could be especially contentious and examine the possible implications for investors.

The Stage Appears to Be Set for Political Brinkmanship

As in 2011, we have an impasse.

Now that Republicans control the House of Representatives, some have been vocal about using the borrowing cap to push their goals of cutting government spending and lowering the national debt.

Democrats, meanwhile, have said they won't negotiate on expenditures that have already been approved by Congress.

Two factors could intensify the political jostling and take the negotiations down to the wire.

1. Speaker of the House Kevin McCarthy (R-Cal.) needed an unprecedented 15 ballots and significant concessions to win the role, highlighting the challenges he may face as he seeks to unify his caucus. This drawn-out process of naming the House Speaker suggests that the debt ceiling debate could be especially contentious. And McCarthy reportedly weakened his hand by agreeing to rule changes that lowered the threshold for initiating a motion to dismiss him from the speakership.
2. Because Congress ultimately has raised the debt ceiling so many times in the past—even when the process has moved haltingly because of political wrangling—investors may have grown too complacent.

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[1] Source: U.S. Department of the Treasury.

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If markets shrug off the stalemate in Congress, some lawmakers may be emboldened to push even closer to the edge of crisis. A sharp sell-off in the market, on the other hand, would likely command their attention and push both sides to find a solution.

The Question of Timing

The Treasury Department has started taking steps to keep meeting its obligations without additional borrowing. Historically, these "extraordinary measures" have included tapping available cash balances and preserving cash by pausing certain programs.

Payments to bondholders would likely be prioritized throughout this period of uncertainty. Depending on how long Congress takes to resolve the debt ceiling impasse, meeting these obligations could come at the expense of sending vital checks to households—a development that, politically, would be thoroughly unpopular.

Treasury Secretary Janet Yellen asserted that the Treasury could run out of cash as early as June, but this date is a moving target that depends on the timing and amount of tax receipts, among other factors.

Potential Implications for Investors

Volatility in the bond and stock markets would likely increase as the U.S. Treasury gets closer to running out of money to pay its obligations.

And investor sentiment could take a bigger hit if peak fears about the debt ceiling were to coincide with a marked deterioration in economic data.

The worst-case scenarios would be if the fracas led to a downgrade to the United States' credit rating or the government missing a debt payment. So many assets are priced off U.S. Treasuries—the resulting turbulence would be felt in markets worldwide.

What I'm Watching Next

As a policy analyst, I will be paying close attention for updates on when the Treasury Department expects the headroom provided by its extraordinary measures to run out and how potential solutions to the impasse over the debt ceiling are shaping up.

Republicans, for example, may push for a stop-gap measure that prevents a near-term default but aligns the vote on raising the debt ceiling with the annual process of funding the federal government. In this scenario, Republicans could more easily negotiate spending cuts in exchange for a long-term debt ceiling fix. Naturally, Democrats are likely to oppose this solution.

Given the consequences of failure, Congress should find a way to extend the debt ceiling. But the journey to get there is unlikely to be smooth.

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