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MARKET PERSPECTIVE

Debt-Ceiling Diversification

By James M. Walden, CFA

The United States hit the debt ceiling on January 17, 2023. Since then, the Treasury Department has provided some breathing room by using "extraordinary measures," or accounting maneuvers, to keep paying the bills. Nonetheless, politicians are on the clock to raise or suspend the debt ceiling. A couple of weeks ago, Treasury Secretary Janet Yellen warned the U.S. could hit its "X-date" (the date the U.S. really runs out of money) as soon as June 1. On May 12, the nonpartisan Congressional Budget Office provided guidance that the government can continue to finance operations through at least the end of July. Still, it acknowledged the risk of default in early June. Either way, the situation is urgent.

We think an actual debt default by the U.S. is doubtful. We base our opinion on the observations over the years that the Washington way is for politicians to engage in down-to-the-wire brinksmanship before cooler heads prevail and reach a compromise.

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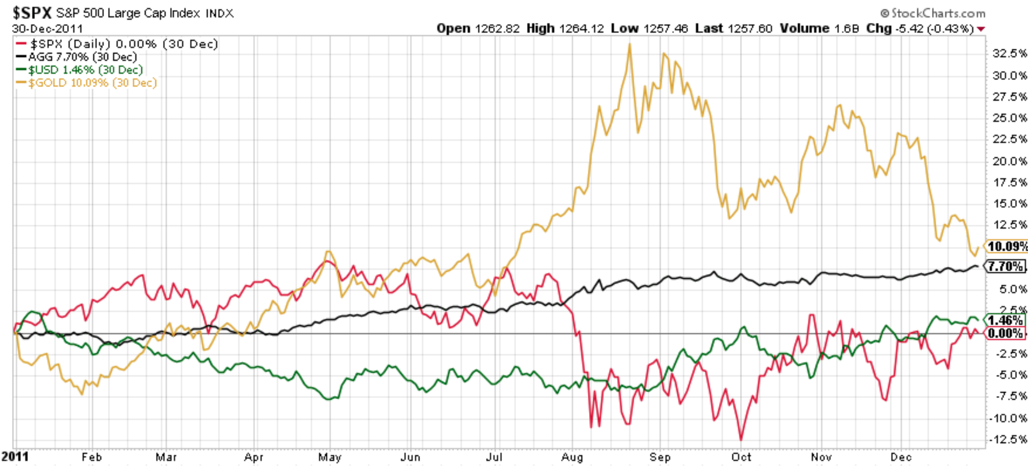
While history suggests a default is unlikely, it would very likely be a significant event that could hurt the global economy. No one knows for sure, of course, since the U.S. has never defaulted before. But financial markets are likely to get more volatile as the X-date approaches.

A U.S. debt default, or the increasing likelihood of one, would likely result in a decline in equities. And in theory, U.S. Treasurys and the dollar should sell off.

The debt-ceiling crisis of 2011 could provide some clues about what we might expect, although it's not a perfect parallel for today's as-yet-resolved situation. On July 31, 2011, Congress agreed to raise the debt ceiling, with just a couple of days of borrowing authority to spare. Standard & Poor's downgraded the U.S. credit rating that week for the first time ever, which sent shockwaves through the markets.

The chart on Page 2 shows how various asset classes performed in 2011. It's no surprise that the S&P 500 (red line) sold off hard after the August downgrade. What might be a surprise is how high-quality U.S. bonds (black line) continued to appreciate throughout 2011. Also, the dollar (green line) marked its low for the year on the downgrade and began to appreciate afterward. (We believe that U.S. bonds and the dollar benefited in 2011 from their perceived relative safety from the European debt crisis involving several of the eurozone's weakest members. There's no guarantee that U.S. debt and the dollar would benefit from safe-haven status in such a manner today.) Meanwhile, gold (gold line) was the absolute winner of the asset classes observed here, up more than 30% in 2011 through the end of August.

Chart: Asset Class Returns in 2011



Appropriate diversification is a cornerstone of our investing philosophy. If 2011 is any indication of what lies ahead, it's a good reminder of how important diversification can be.

Source: StockCharts.com, Clayton Wealth Partners.

Bullish

- Significant pent-up consumer demand
- Reasonable equity valuations
- The most attractive yields for fixed income in years
- Fed progress toward reducing inflation
- China's lifting of Covid restrictions could provide a lift to its economy

Bearish

- The current debt-ceiling situation is likely to introduce near-term market volatility
- Slowing global economic growth with recession pressures mounting
- Tightening bank lending standards among regional-bank turmoil
- Deterioration in leading indicators of unemployment, such as a lower number of job openings and increasing layoffs and initial jobless claims
- Wall Street is cutting estimates of corporate profits
- Global inflation remains too high
- Ongoing deterioration in housing
- Global central banks tightening
- Russia-Ukraine war and other geopolitical concerns

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As Partner & Chief Investment Officer, James Walden strives to maximize our clients' long-term, risk-adjusted portfolio returns. This includes determining strategic and tactical asset allocations, as well as specific investment analysis and prudent rebalancing. Jim is also a partner and management team member. His expertise includes advanced investment research and valuation, and he is passionate about his role in helping clients reach and exceed their financial goals.

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