FS INVESTMENTS®

Episode 51

Debt ceiling looms large: Economic and market impact

The U.S. debt ceiling is once again back in focus. Our team of experts break down what exactly is happening in Washington D.C. and how it might affect our economy and financial markets.

Jason Cole (00:00):
I mean, I'll, I'll just start the spoiler alert. I do think this will get worked out. The, the question is <laugh>, the question is, and the risk is, and it's not a zero risk, is does it get worked out before we hit a technical default?

Kara O'Halloran (00:20):
Welcome back to FireSide, a podcast from FS Investments. On today's episode, the debt ceiling is once again back in focus. The U.S. government reached its statutory debt ceiling on January 19 and is currently enacting extraordinary measures to pay the country's bills and service its debt. We seem to talk about this every couple of years, and invariably, Congress raises or suspends the debt ceiling before the U.S. defaults on its obligations, but in some ways, things feel a little bit different this time around. So, on today's episode, I wanna focus on whether and how this time could be different, and most importantly, what all this means for our economy and financial markets. It is a lot to cover. So, I have brought in a few experts from around our firm to dissect all of this. But first, I am really excited to introduce you to Ginevra Czech, who you'll be hearing a lot more from going forward. Ginevra runs our client value add programs and is the new host of the FS Thrive podcast, which you can get right here on the FireSide podcast feed. Ginevra, welcome to FireSide, you're making your podcast debut.

Ginevra Czech (01:21):
Yes, I'm very excited. Hello everyone. Uh, like Kara said, I am Ginevra Czech, the director of our client value add programs and the soon-to-be host of FS Thrive. Uh, I've actually been a longtime listener and fan of the FireSide podcast, so it is very exciting to be here live with the team recording. Um, and I'm actually even more excited to introduce another one of our guests today, who is Jason Cole. He is the FS Executive Director of Public Policy and Corporate Social Responsibility, and I could read his bio all day. Um, it's impressive, it's extensive about his background in government affairs, but it would take a lot of our very precious time. So, trust me when I tell you we've got the exact right person, uh, for the topic ahead of us. And, uh, I am very excited to hear his thoughts on how, what's happening in DC impacts not only the economy, uh, and our financial markets, but more importantly what that means for our advisors and their clients. So, we're gonna focus on the, the topic at hand today that we've been hearing about a lot from, from our advisors, um, the U.S. debt ceiling like Kara said. So, I'm excited for the conversation and Kara, let's kick it off.

Kara O'Halloran (02:30):

Awesome. And, uh, rounding out our lineup. You know her, you love her, the one and only Lara Rhame, um, to get the economic perspective. Um, so let's dive right in. Thank you also much for being here. Jason, I wanna open with you, as I said, the U.S. hit our debt ceiling last week. We're now enacting these extraordinary measures, is what they're called. Very briefly, what is the government doing right now and what happens when these measures run out?

Jason Cole (02:57):
Yeah, it, it's pretty typical and Treasury Secretary Yellen, um, on last Thursday, on the 19th of January, um, sent a letter to Congress outlining the two extraordinary measures she's taking or the Treasury Department's taking right now, um, to help manage the debt. And, and that is a suspension of payments to two federal government retirement funds, the Civil Service Retirement Disability Fund, and the Postal Service Retiree Health Benefits fund that should provide a headroom for a couple of hundred billion, um, to help treasury manage cash flow and payments over the next couple of months. There are other options available to treasury, um, should that not be sufficient. Um, there's another federal government trust fund that, or, or a retirement fund that they can, they can suspend payments to. Um, they're, they can suspend, uh, the daily reinvestment of securities held by the Treasury Exchange stabilization fund, a series of other things that could get the Treasury Department up to maybe 450-500 billion worth of headroom. Um, importantly in her letter, Secretary Yellen indicated that the suspension period would last until June 5th. Now, I don't think that she's saying we are going to run out of money on June 5th, but I she is putting a date out there that should begin focusing the tension of Congress to begin finding a solution to this problem.

Kara O'Halloran (04:22):
Yeah, cause I'm hearing, I'm hearing August as kind of the X date too, but I think it's really, things are gonna start ramping up, you know, later this year towards the summer, but we're definitely talking about it now. It feels like we're talking about it a little earlier than we have in the past, which I think is probably a good thing. We're hearing, I'm hearing a lot of comparisons to 2011, which is the last time or another time I should say we had a major debt ceiling issue. Um, and there are certainly some similarities, right? We had a Republican controlled house then with a Democratic Senate and White House. We had to use these extraordinary measures back then as well, and Congress and the White House eventually did reach a deal in August of that year, but two days later, even though that deal had been reached, the S&P down, or S&P downgraded, the US government's credit rating, um, from AAA to AA where it's remained since. So while there are some similarities between this go around and back then, I think there are a lot of key differences as well. So I think it'd be helpful if you could kind of put into context what this environment looks like versus kind of the historical precedence.

Jason Cole (05:28):
Yeah, I think you're spot on on the similarities, right? We just had an election just like we did in 2011, where house flipped control from Democrats to Republicans. Um, the key difference there, however, is that the margin of control is much slimmer today than it was in 2011. In 2011, the, the Republicans held a 24 seat margin, which gave them a little more wiggle room on votes. Today it's four. Um, we also saw, not an unprecedented, but for the first time in a century, um, a great difficulty in electing a speaker of the House and Speaker McCarthy, um, went through 15 rounds of voting to become elected speaker and gave up a lot. And I, I think it's safe to say that he's in a weakened position. And one of the big things that he gave up was this very inside baseball, but very important process called the Motion to vacate.

(06:23):

And what that ultimately means is that any one member of Congress, if they're unhappy with the speaker's performance, can go to the floor and offer a privilege resolution, which means everything stops. And you have to consider that motion at that moment in time to effectively depose the speaker. It's a, it's sort of like the, the American equivalent of the British vote of no confidence. And so this is a sort of les kind of hanging over McCarthy's head that he's gonna be cognizant of as he negotiates the debt limit. And, and if he's seen by a certain level of his conference to be giving away too much to Democrats, um, that could complicate his ability to stay speaker. And I think it's a very important difference, um, between now and 2011. Now, interestingly, this motion to vacate existed in 2011. Nobody knew about it. Um, it's very much in the consciousness of Speaker McCarthy and the 20 folks who held out their vote for him for speaker.

(07:23):
And I think it's gonna loom large over the negotiations. I think the other big difference is we can't sleep on the Senate. I mean, the media's talking about the motion to vacate. The media's talking about McCarthy's difficulty in cobbling together a deal. The Senate, I think, unlike 2011, you may have a difficult time getting 60 votes. And in, remember in the Senate, you've gotta get 60 votes to file what they call cloture in order to move to the actual vote On the question at hand. In 20 11, 28 Republicans ultimately voted for to increase the debt limit of that 28. Of those 28 members, only 11 remain in the United States Senate. And we had a test vote on the debt limit. It was raised without a lot of fanfare. In 2021, only five of those 11 Republicans voted to proceed to fore cloture, if you will, um, to the debt limit question.

(08:20):
None of them actually voted to raise the debt limit. So I don't think it's a foregone conclusion that there's 60 votes in the Senate right now to raise the debt limit and we shouldn't be sleeping on it. The final thing I would say is that in 2011 when President Obama was in the White House, there was an open-eyed understanding that there needed to be a negotiation around debt and deficits. President Biden has repeatedly said, I'm not negotiating. We need a clean debt limit. We're not holding this sane hostage. And I think that's, that's a troubling posture coming out of the White House. And I think ultimately the deal has gotta come between a negotiation between McCarthy and Biden.

Kara O'Halloran (09:05):
Yeah, yeah. It seems like we can't, we need them even at the table. They're unwilling to get to the table first to, oh gosh, lots to, lots to unpack. Lara, I wanna bring you into the conversation because I think it's really important as we're talking about this debt ceiling issue to consider the economic and market implications. So I wanna ask you the same question that, you know, 2023 versus 2011, what are you seeing similarities or differences in the economic end market backdrop?

Lara Rhame (09:36):
Um, yeah, thanks. I mean, it's just, and Jason, I just can't say how happy we all are to have you here with us at FS Investments. I know you're sort of new to the firm and, um, I hope this is the first of many podcasts that we do together because absolutely, um, I think is a resource and your knowledge base and your experience is just tremendously helpful and impactful and insightful. So thank you. Um, alright, so, you know, when I look back at how our economy was doing in 2011, there are some similarities. Um, and I think the key similarity is we were at points of higher economic uncertainty. There are some key differences. Remember back then we were coming out of the devastating financial crisis, great recession. Um, our unemployment

rate then was at 9%. Today it's just three and a half percent. So to some degree, well growth sort of that top line GDP number looks pretty similar around 2%.

(10:38):
The underlying, uh, supports for the economy today are much better. That doesn't mean that actu uh, interestingly, uh, you know, it's always, that's why I love the economy, Kara. It's always sort of a <laugh> a little bit of a human behavioral piece to it because consumer confidence is not necessarily much better today despite the fact that the unemployment rate is so much lower. Um, you know, we, we've had come off of a period of very high inflation that was not a problem back in 2011. Um, and I think as we look ahead, people are worried we are going to slip into recession. Remember last year we had two quarters of negative growth. Um, our economy is not really lighting, uh, a lot of fires right now. It's actually, um, it's actually PR feels a little bit stagnant still. So, um, our, the economic forecast for the coming year is lackluster.

(11:36):
So, um, that economic uncertainty is higher. And of course, uh, we're still coming off of a period last year, um, where we just had a tough year in markets and it, I think it's got households focused on the fact that they have good wage and salary gains. Inflation is a challenge. And on the wealth side, the housing market has gone through a troubling period. And, um, and frankly, um, you know, the, we've seen our wealth erode from a tough market last year. So all of those things have left consumers with a similar level of unease. And I think that to me is the backdrop against which we need to look at what impact this uncertainty could have. You know, it's, it's not, they're not good headlines, um, concerns about the dead limit. Yeah,

Kara O'Halloran (12:32):
And I think we saw in 2011 how much that economic uncertainty can bleed into markets. The

Lara Rhame (12:39):
Yes

Kara O'Halloran (12:40):
Credit spreads really widened back then the s and p 500 fell about 17% in just over two weeks. I think, um, back in those, you know, kind of the, the tail end of those negotiations, so we really can see what's going on, uh, in DC have a very, very real impact on markets that

Lara Rhame (12:58):
Is deeply painful. I mean, I think you and I have spent a lot of time talking about volatility. We've seen volatility in bond markets over the prior, you know, in 2022 be severe. The, we saw the average move or we saw intraday moves of the two year treasury go from sort of five or six basis points to days where we've had 20, 30 basis point moves. Um, you know, you can't dismiss the impact that volatility has on a portfolio and the psychological impact that it has on households in increasingly the larger number of retirees that we have. The volatility speaks directly to household wealth and to household budgets. Can you imagine if your wages and salaries were changing 17% in two weeks? You know, when, when you're a retailer,

Kara O'Halloran (13:55):
I would never spend dollar,

Lara Rhame (13:56):
That's what it's maintenance, right? Yeah. Um, so I think it, it speaks directly to the target that it paints on the consumer via that confidence channel. Yeah,

Kara O'Halloran (14:05):
Absolutely. All right, so Jason, I wanna toss it back to you. I don't wanna say that it feels like there's complacency over the issue right now because we're definitely talking a lot about

Lara Rhame (14:14):
It. I feel like there's complaint. Okay,

Kara O'Halloran (14:16):
That's

Lara Rhame (14:16):
Fair. No's fair. I think, you know, as I'm on the road, I was on, you know, Bloomberg TV the other day, I think, you know, when when the anchor says to you, oh, is aren't they just gonna work this out? I do feel like there's a lot of complacency.

Kara O'Halloran (14:28):
That's a very good point. A and that's what I was gonna say is that it feels like, I feel like everyone I've brought this up to, they say, oh, you know, it always gets worked out. I'm gonna, I'll pay attention to it a few months from now, whatever. So Jason, what do you think the next few months look like? And then how likely is it in your view that we don't re reach a resolution and we have some sort of default? I

Jason Cole (14:50):
Mean, I'll, I'll just start the spoiler alert. I do think this will get worked out. The, the question is <laugh> and the, the question, the, the, the question is, and the risk is, and it's not a zero risk, is does it get worked out before we hit a technical default? And I, I think given the dynamics in the house that we j you know, I just described with Speaker McCarthy needing to deal with, um, members of his conference and not being perceived as cutting deals with Democrats, the posture of the White House of not wanting to negotiate. I think, I think it's possible that the, that the two leaders here, namely Speaker McCarthy and President Biden, miscalculate incentives, miscalculate each other's relative position and inadvertently slip us into default. I think that is a not, I think that's a non-zero risk.

(15:42):
Um, and, and that there is a possibility of that it would be a very short-lived possibility because I think I, I harken back to 2008, um, back during the depths of the financial crisis when the house voted, um, to, to bring down tarp the first time markets blew up, what I think 800 points, something like that. Spectacularly Yeah, it was spectacular blow up the next day, Congress came back in and narrowly passed the tarp. I I think that could be a situation here where there is a technical default because there's a miscalculation, there's a misstep, there's a, there's lack of an agreement that comes together in a timely manner, um, that could then result in that. And, and then people will get very focused very quickly if the markets react to how, like, I think how you believe they may react, Lara. And so, um, so between now and then, I mean, I think the first step is we've gotta get to the negotiating table.

(16:38):
And, and, and that's not apparent to me yet. I think on the one hand, again, we've talked about it, the president is saying, I'm not negotiating. On the other hand, you've got house Republicans not sort of agreeing to what they want someone dollar for dollar spending cuts, some want entitlement cuts, some want to touch defense, some don't. And so until they gel in, in the

house, um, in the house Republican conference on what they want, it's very difficult to start a negotiation. So I think you're gonna see a lot of grandstanding and posturing by both sides. I think back to differences, the big difference this time around is in 2011, Twitter was in its infancy. And now you've got a platform where any one of 535 members of Congress can take to Twitter and voice their opinion and be unhelpful in negotiations.

(17:30):
And you've already seen some of that by certain members of Congress one last week tweeted that this was a Democrat's problem and they made this bed, they should lie in it. And I'm not voting for the debt limit period, full stop. And so I think to the extent that there are members out there freelancing in, in that regard, and because they have their own political incentives to do so, that's not gonna be helpful in this negotiation. You're gonna see a lot of that in the coming weeks. I think you will also sometime this spring, see the house vote on a bill. You'll hear a lot about it coming up on to prioritize the debt. It will give treasury permission to pay bond holders first and then go down the line to protect other classes. Social security, Medicare, veterans, I don't, you know, who knows what will all be contained in that bill, but I expect the House of Representatives surpass that.

(18:15):
It won't go anywhere in the Senate, but it'll be sort of the opening salvo from the, from Republicans that this is our position. We've created dynamic whereby we won't technically default. If Senate Democrats would just vote for this and the President would sign it, we would will be out of the woods. I don't believe that to be the case. I think if you don't honor your obligations, you're effectively defaulting. But, and that's gonna be the debate that probably ensues. But you, you will see the House of Representatives pass that bill. I think you also see talking heads come up with other solutions. You've, you, everybody's heard of the trillion dollar coin. And if we just manage a trillion dollar coin and deposited, well all of our problems will be solved. It's gimmicky. It's also probably default in another name. You'll hear people say, well, why not use the 14th amendment, which says the country show an honor its debts or something to that effect.

(19:03):
Uh, which would mean, you know, the Biden administration just ignores the debt limit and starts paying bond holders. And then I think you've got a lot of lawsuits then enue and big separation of power questions and constitutional issues. And you know, instead of a debt crisis, we have a constitutional crisis. So there's a lot of bad options out there. And ultimately, in my opinion, the only option is a negotiation between the White House and House Republicans. And until that begins in earnest, um, we're not gonna get a lot of clarity on how this is gonna unfold.

Kara O'Halloran (19:33):
Yeah, I thought about bringing up some of the trillion dollar coin or 14th Amendment things and I was like, no, no, no, we could go down a yeah, too, too deep of a rabbit hole. I've listened to full podcasts on all of those, so they're out there. But, um, no, that's, that's helpful. Um, I think, you know, Lara, I wanna think now about kind of the economic outcome of all of this over the next couple of months. I mean, just the idea, listening to Jason talk and saying the possibility of the government not paying social security, I just think about what's that gonna do to our growth? People aren't getting their money. Are they gonna spend it gov the government spending makes up a lot of our G D P? Yeah, I mean, I just think about all of the economic outcomes. It feels like we've, and to Jason's exact point, it's a non-zero probability. Obviously when we're investing, we're kind of trying to price in probabilities in some way. Yes. And we've, we've had to price in these events that felt like once in a lifetime and totally unprecedented.

Um, but we do have to think about them. So obviously the US defaulting on our debt is a very bad outcome. <laugh>. Um, but really specifically Lara, what does that look like? What does that mean?

Lara Rhame (20:39):
So, you know, I I thi you know, remember our economy is such a large entity, even in 2011 to this arguable, you know, market disruption that contains some similarities to some of the challenges that are ahead was not very significant again, at a time when our economy was not doing particularly well. So our economy's in better shape today than it was then. Um, but you know, given everything that, um, Jason said, I think the headlines are going to feel worse than the economic data will reflect, especially if, you know, the, any kind of potential market disruption leads to a fast resolution. You know, we've seen things like prior shut government shutdowns, um, which, you know, impact things in the month, but we snap back pretty fast. I can think of, you know, mortgages being disrupted because we couldn't issue the Federal Home loan Bank was closed for a month and then sort of reopened and it all comes back, or, um, you know, the TSA kept operating when they weren't being paid.

(21:52):
Um, and flights continued. So, um, and they, they showed up to work, thank goodness, because <laugh>, that would be truly disruptive. So I think, you know, we have shown resilience in managing through these, um, politically inspired disruptions. Um, so I'm hopeful that the broader economic impact, if there even is one will be short-lived and will, will, we will continue to show resilience. I think the bigger risk is this more insidious erosion of consumer confidence at a time when our economy is grinding along. It's in positive territory, but remember the Fed is trying to slow our economy down. Um, so that to me is, is the bigger impact. And of course on markets and on, you know, those of us who are really worried about preparing investor portfolios to manage through this, I just cannot understate the impact that volatility has had Anybody who wasn't paying attention last year, you need to manage for this. So I think that to me is the bigger issue. I think the bigger issue is market based, less than less than economic. Yeah,

Kara O'Halloran (23:07):
No, I think that makes sense.

Ginevra Czech (23:08):
Lara, to that point, uh, Kara, I have a question for you. You are obviously out in the field talking to advisors a decent amount. What are you hearing from them? What are their concerns around this topic?

Kara O'Halloran (23:17):
Yeah, I mean, I will say in the last week alone, I have heard a lot of advisors starting to talk about this issue. Um, specifically examining in their portfolios what their treasury exposure is. Just again, we have to price that non-zero probability. Um, so first of all, I think the fact that advisors are thinking about it, are talking about it is a good thing in and of itself and really trying to prepare portfolios accordingly. What I will say is that duration has become a very popular trade recently as, as we've seen rates really back up. I think it just induces, as Lara said, really induces a lot of uncertainty and volatility on, unfortunately on the fixed income side of a portfolio that is supposed to be the ballast to equities. And then as we said, it can really, all of this uncertainty can really weigh on the equity side of portfolios as well. So I not to, you know, just kind of keep saying the uncertainty thing, but I think it really just elevates that uncertainty, injects more at it already very uncertain time, injects more volatility. I think advisors are really starting to, you

know, they really need, they need alternatives. You know, we, we've said it before. It's really looking at things that are going to be being able to monetize and capitalize on that volatility while also protecting assets. Mm-hmm.

Ginevra Czech (24:36):
<affirmative> makes sense.

Kara O'Halloran (24:38):
Thank you all for joining. Thank you. And this I learned so much, Jason, thank you for making your podcast debut with us. We, um, this was

Ginevra Czech (24:46):
A lot of fun. Thanks

Kara O'Halloran (24:47):
For having me. Yeah, good. No, I mean, we will, we will have you back for sure because I think that we're gonna be talking about this a lot going forward. And obviously Lara, I mean, you're, you're a, you're a standby, so you'll, you'll be there all the time. I,

Lara Rhame (24:58):
I, I, I just like to keep myself in good standing so I always get an invitation to come back. Karas just a lot of fun.

Kara O'Halloran (25:03):
Awesome. Well thank you for joining

Ginevra Czech (25:06):
And I wanna thank you guys for, for having me on. Hopefully, uh, this won't be my last podcast. I'll be having some stuff coming out with FS Thrive. And again, Jason, thank you so much for joining us. Um, you know, this is the type of thought leadership that we like to provide in our value add programs, so definitely we're always looking for ways to partner together with you, your teams, your business and communities. Um, so get to know us at fs investments.com/fs thrive, or shoot us an email at fs thrive fs investments.com. And uh, it's been a lot of fun.

Kara O'Halloran (25:38):
Awesome, thank you. This episode was recorded at the FS Investments headquarters in Philadelphia's historic Navy Yard. It was produced by Kara O' Halloran. It was edited and engineered by Aaron Sherman. Special thanks to show coordinator Ellie Zhang. If you enjoyed this episode, be sure to like and subscribe wherever you get your podcasts. Thanks for listening.