Sevens Report Alpha Webinar – What Can We Expect from the Debt Ceiling Showdown?

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What to Expect from this Debt Ceiling Drama

- The debt ceiling drama will begin to impact stocks and bonds more forcefully over the next two months, so I want to examine what happened the last time markets faced a debt ceiling deadline.
- Specifically, I want to clearly identify the history of the market performance during the last debt ceiling drama back in 2011, so that we have a guide through this looming debt ceiling battle.
- That way, we can have a general expectation of:
  - When volatility should increase
  - What assets or sectors could see the biggest impacts and
  - When this might become a bearish gamechanger.

Two Important Notes

- First, and foremost: No one, and this includes me, expects the debt ceiling to actually be breached and for a limited U.S. default.
  - The current market expectations are that, as has been the case in the past, politicians will debate and argue right up until the last minute, at which point a deal will get done. **While this is the most likely case, the near universal expectation of this does make me think the market is complacent about default risks.**

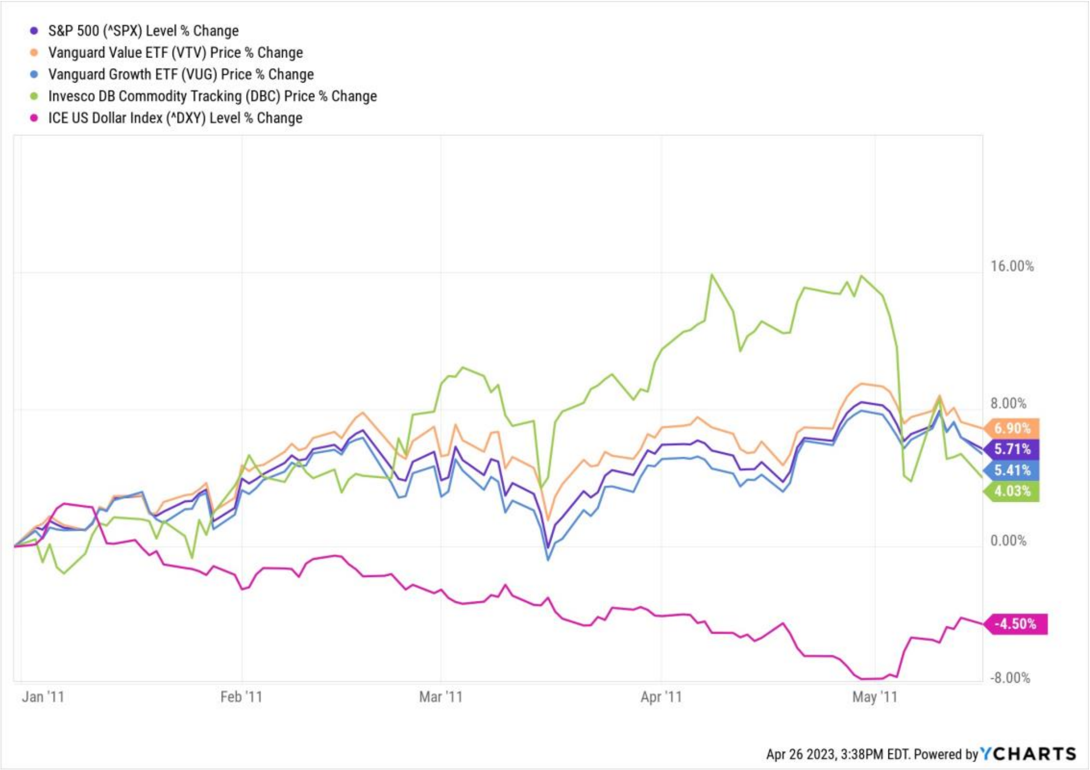
- Second, a debt ceiling breach is not a government shutdown. I want to specifically clarify this point because in multiple conversations with friends about the looming debt ceiling battle, several of them have confused this with a government shutdown, which happens every few years. There are several key differences, and all of them make a debt ceiling breach much, much worse for the economy than a government shutdown.
  - In a government shutdown, Congress essentially runs out of money to fund the day to day operations of the government. But, while that delays federal employees' pay and other payments, government shutdowns don't impact the Treasury Department's ability to sell debt to fund interest payments or other essential activities.
  - A debt ceiling breach **<u>does prohibit the Treasury from selling bonds to fund current interest payments, and that would essentially see the U.S. in a limited default on its debt, which has numerous implications. That's why a debt ceiling breach is so potentially negative.</u>**

The Last Time: The Debt Ceiling Drama of 2011

- For analytical purposes, I've essentially broken this drama down into four timeframes:
  - The lead in: This is the period during 2011 when markets knew a debt ceiling battle was coming, but it was largely ignored because it wasn't an immediate issue. **This is where we are now for the current debt ceiling battle.**
  - The drama: This period is when the U.S. hit the ceiling and Treasury used extraordinary measures to squeeze a few more weeks of funding out. This was the height of the debt ceiling fight.
  - The aftermath: After extreme market volatility, Washington raised the debt limit but damage was already done, including a downgrade of the U.S. credit rating.
  - The recovery: Performance of markets after the issue had left investor's minds.

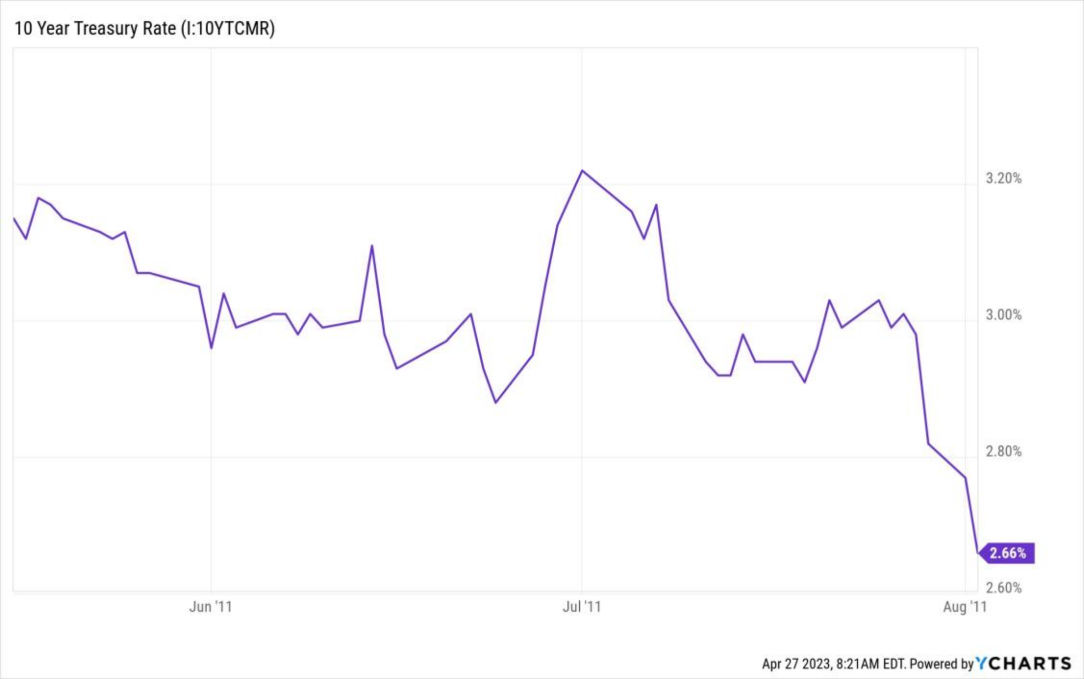
The Lead In. January 1, 2011 – May 16, 2011

- Markets were aware of a potential debt ceiling battle throughout the first half of 2011, but similarly to now, it did not weigh on markets.
- All the major indices were solidly higher through the first half of May, at which point the U.S. hit the debt ceiling.
- The U.S. hit the debt ceiling on May 16th, at which point the Treasury undertook "extraordinary" measures to fund the government.
- This time, the U.S. hit the debt ceiling on January 19th,2023, and since then the Treasury has been using "extraordinary measures to fund the government.

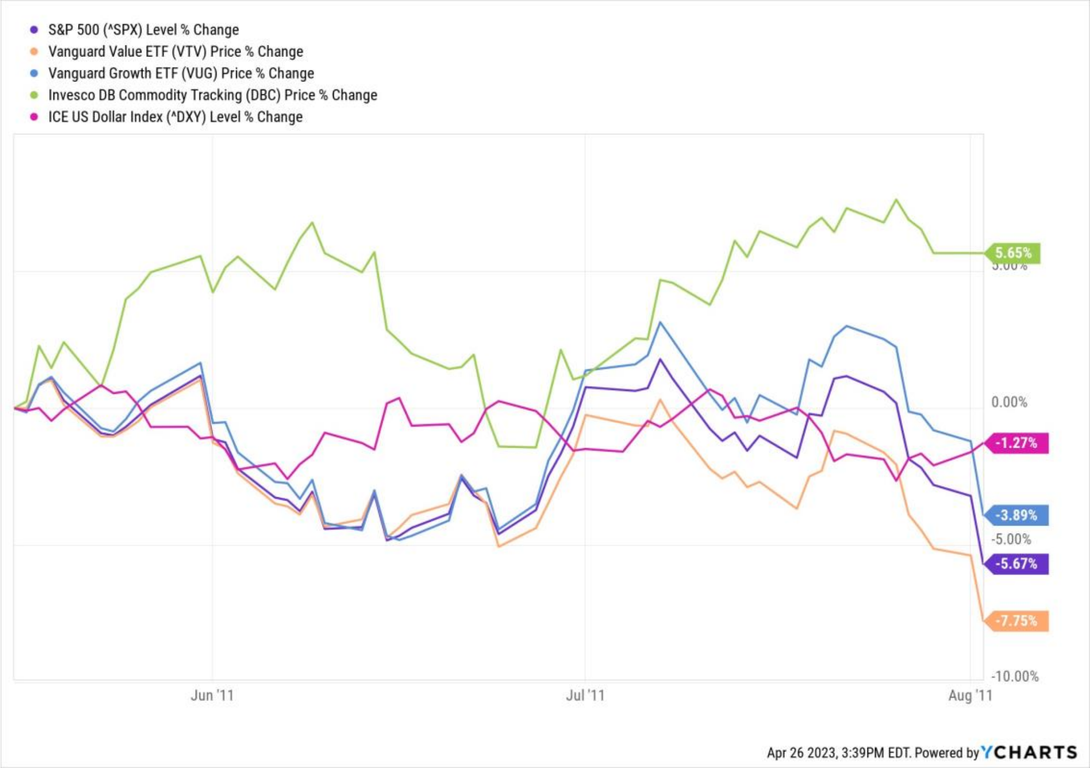


The Drama. May 16, 2011 – August 2, 2011

Longer dated treasury yields dropped sharply despite default risk.



Stocks gave up their gains during the height of the drama, although commodities rallied on a weaker dollar.



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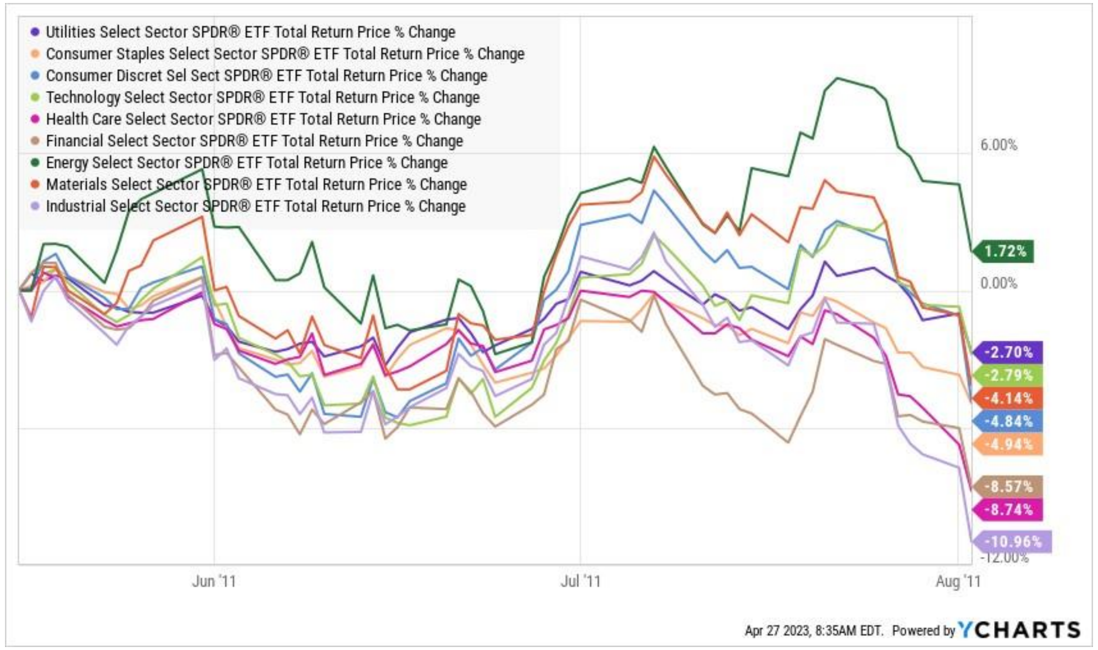
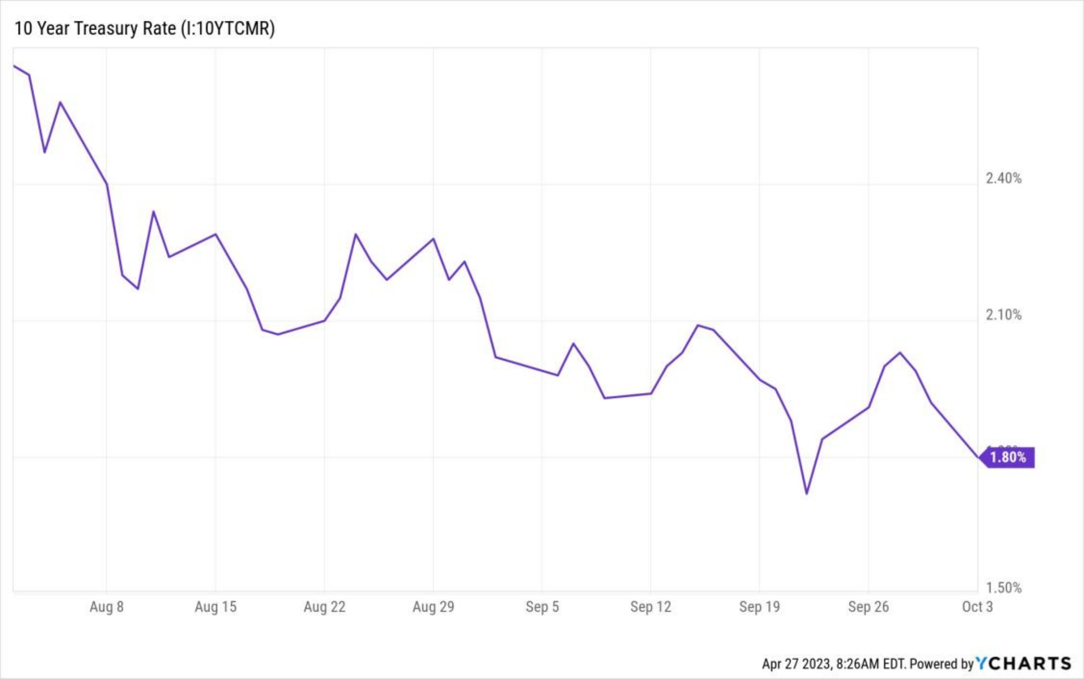


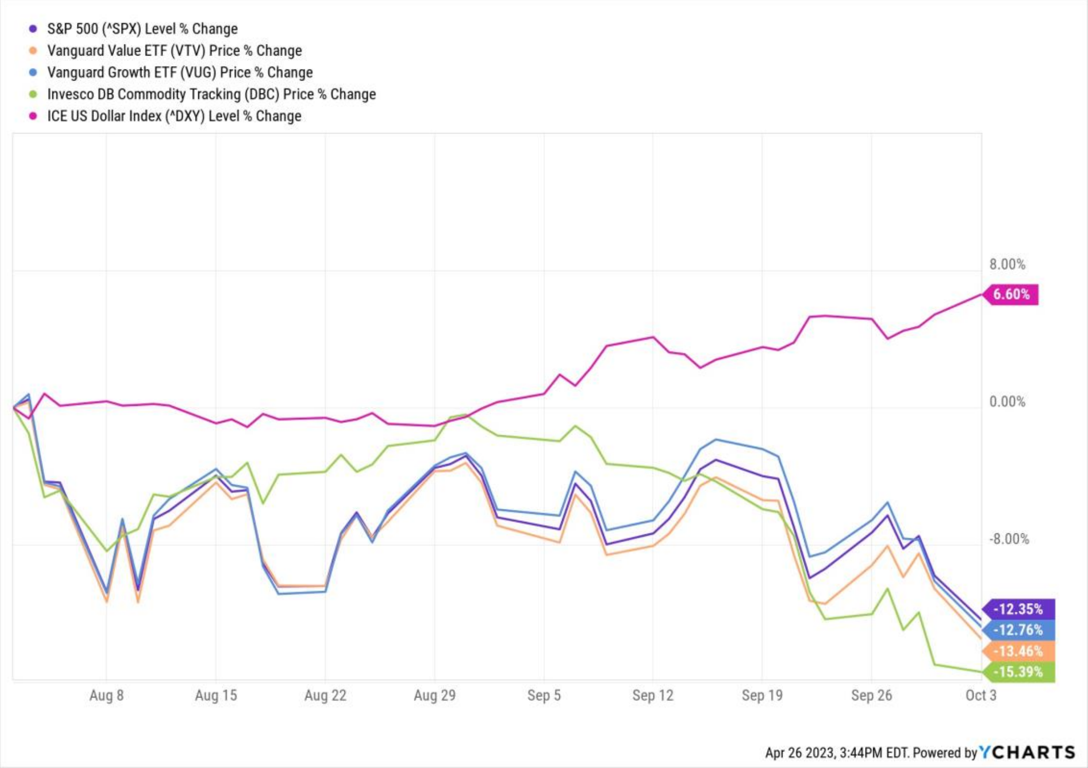
- The anxiety surrounding the debt ceiling drama created a typical “risk off” reaction in markets.
  - Buyers flocked to long term Treasuries as markets viewed this as an isolated event. The 10 year Treasury yield fell nearly 50 bps during this time.
- Stocks were solidly lower across the board.   The S&P 500 gave up the YTD gains while every S&P 500 sector declined except energy.
- Financials, healthcare, and industrials badly lagged markets, while commodity related sectors and defensives traded mostly in line with the S&P 500.

The Aftermath: August 2nd – October 3rd.

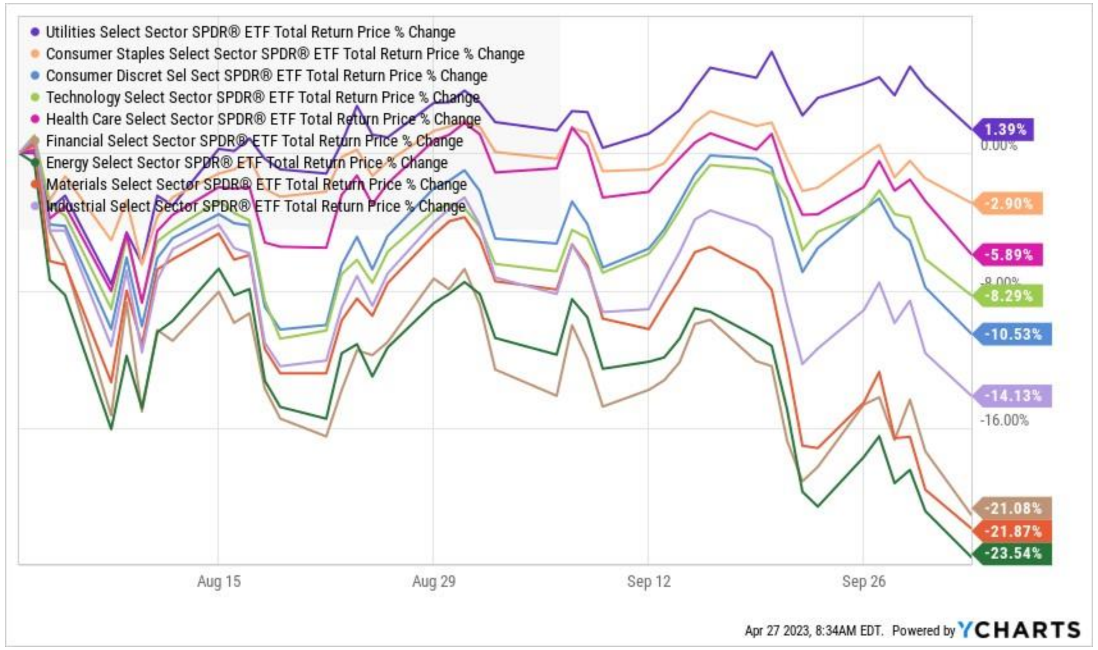
The 10 year Treasury yield declined further as investors went into "Risk Off" mode.



Stocks continued to drop even after a debt ceiling deal had been reached.



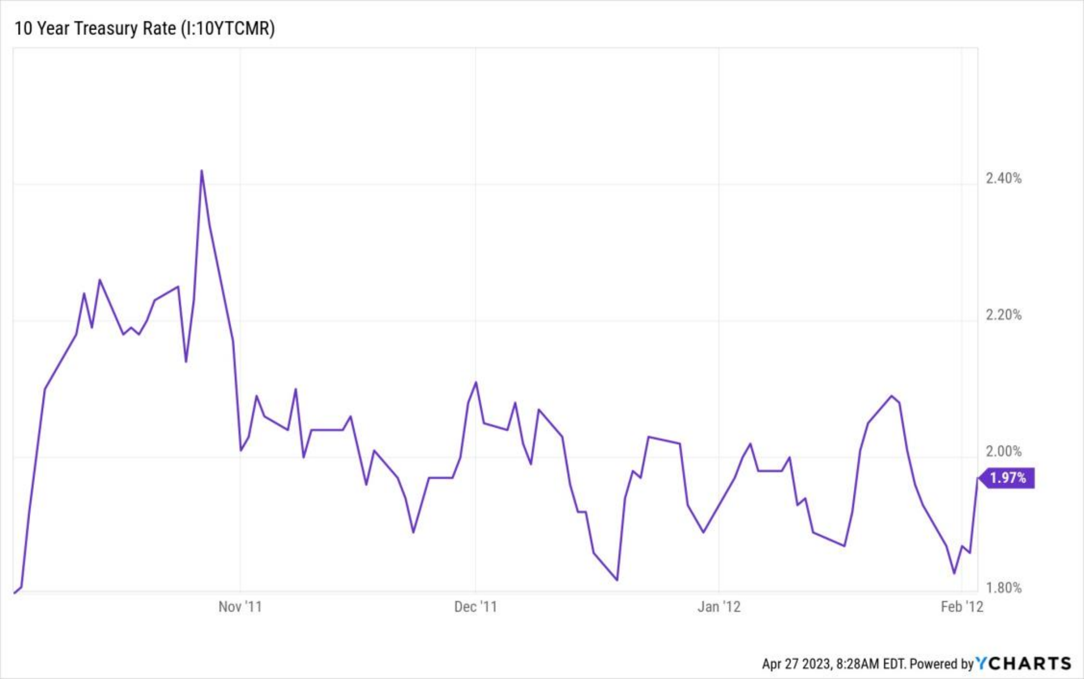
The Aftermath: August 2nd – October 3rd



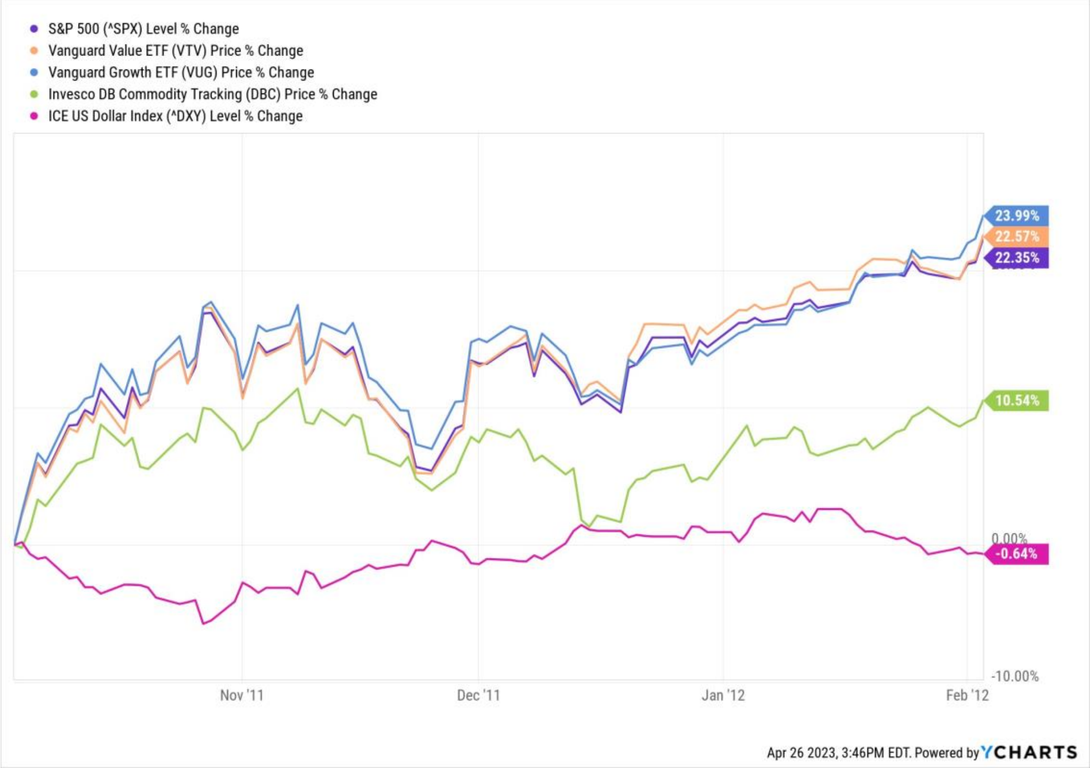
- On August 5th S&P downgraded the U.S. debt rating and put it on a “negative” watch.
- That exacerbated the existing volatility and markets dropped sharply in early August, and never were able to generate any upward momentum until late October.
- Once again, classic “Risk Off” asset moves emerged:
  - The 10-year yield collapsed to 1.80% (it started the drama solidly above 3%).
  - The S&P 500 and other major indices kept falling, hitting a low in early October and down more than 12% YTD (remember the S&P 500 was up 5% before the drama).
  - Defensive sectors outperformed with utilities, consumer staples, and healthcare rallying or relatively outperforming during that period.

The Recovery: October 4th – Early 2012

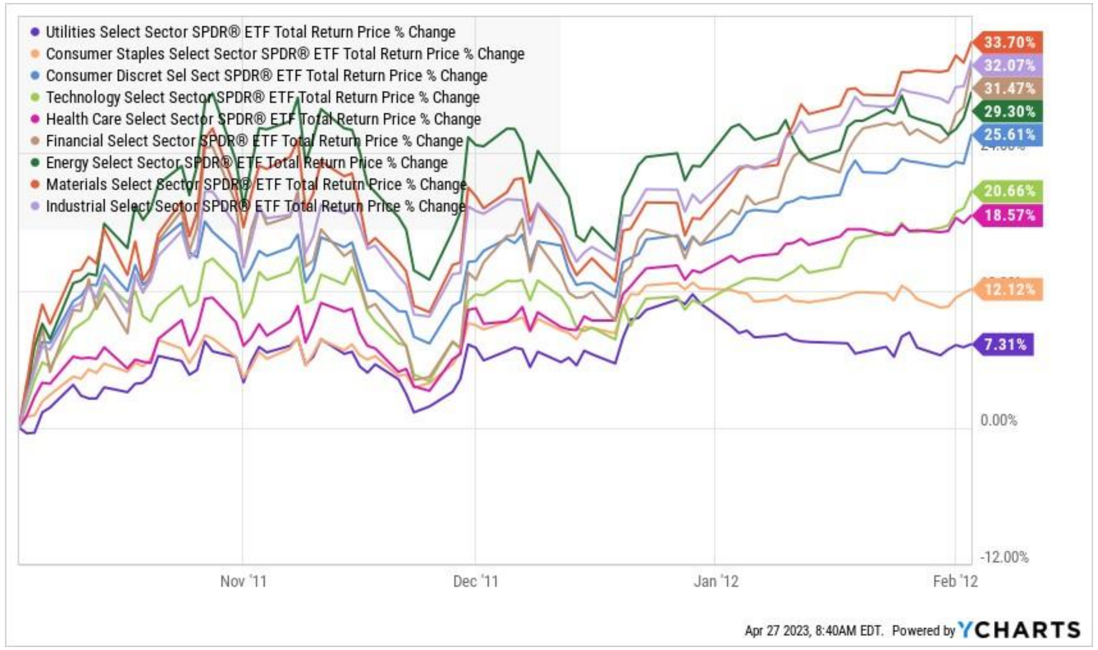
Treasury yields rallied although the Fed's "Operation Twist" kept longer dated yields capped.



Stocks staged a solid rally into year-end, aided by more Fed stimulus.



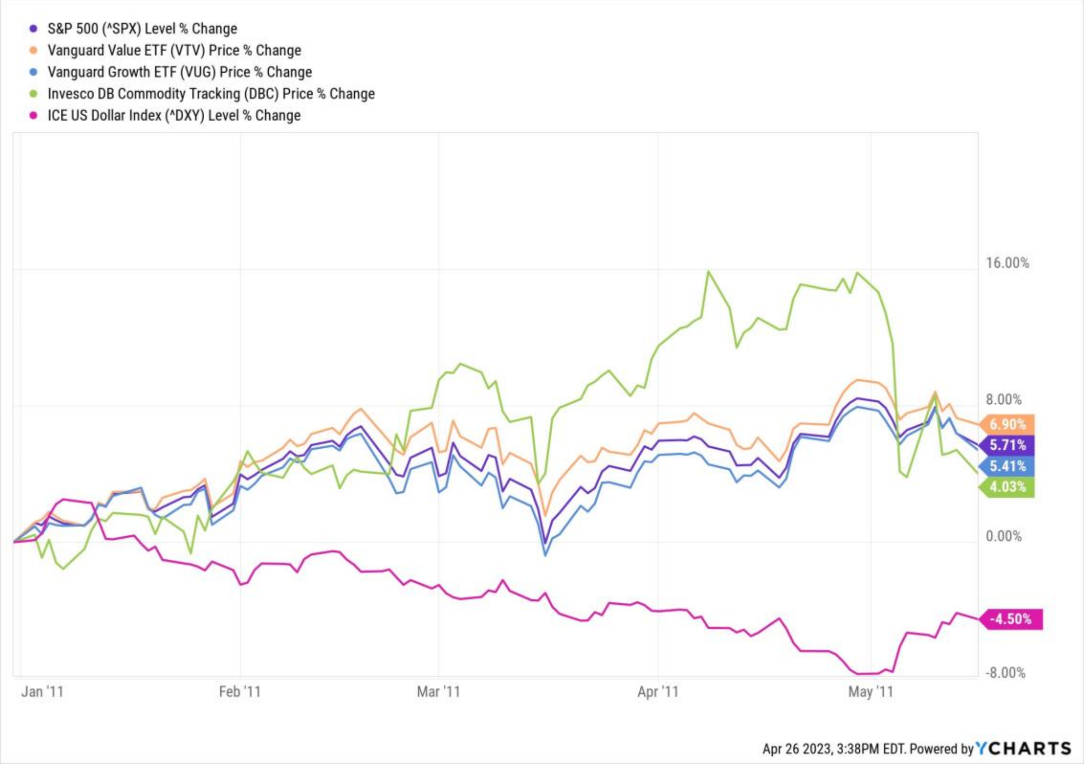
The Recovery: October 4th – Early 2012



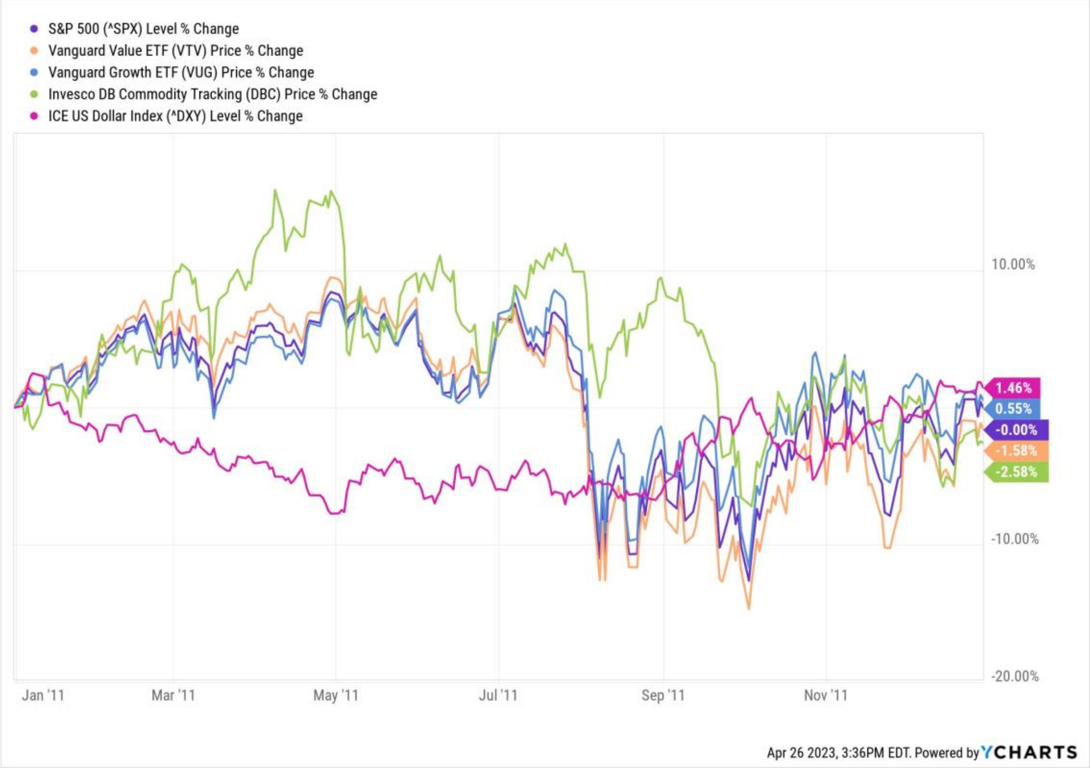
- In September 2011 the Fed announced more stimulus via the initiation of "Operation Twist" where the Fed would use QE to flatten the yield curve and keep longer term borrowing costs low.
- That stimulus helped, and stocks rallied solidly into the end of the year.
- However, the damage was already done and the major indices finished below pre-debt ceiling battle levels.

Impact of the Debt Ceiling Drama

Major indices and styles were solidly higher before the debt ceiling drama.

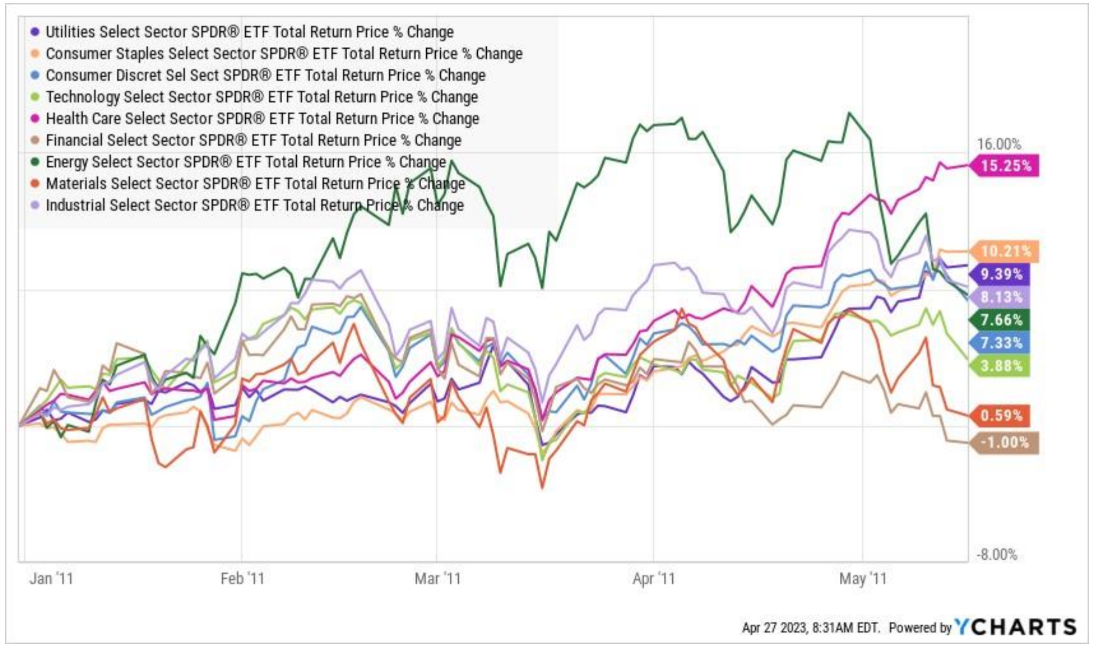


Major indices and styles were flat to down slightly on a YTD basis, as the debt ceiling drama erased early gains.

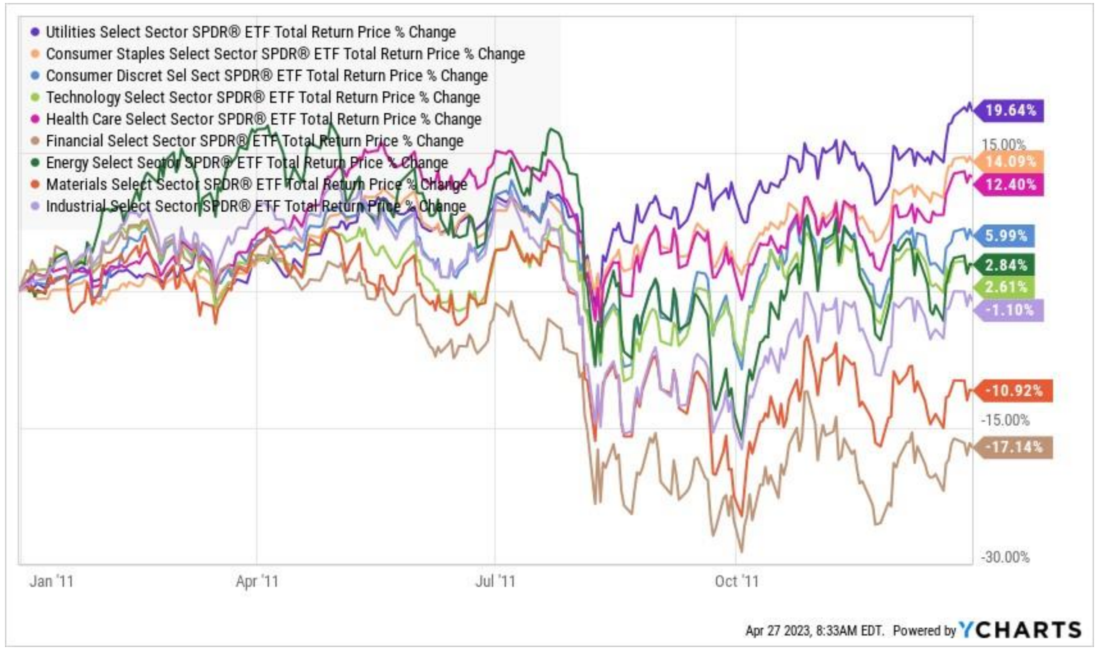


Impact of the Debt Ceiling Drama

Virtually all S&P 500 sectors were solidly higher prior to the debt ceiling.



Defensive sectors massively benefitted and outperformed following the debt ceiling.



Lessons for Today

- First, the debt ceiling impacts markets and can erase gains. The 2011 debt ceiling drama erased positive YTD performance, and that's something we should think about given current YTD gains. The debt ceiling can reverse those gains.
  - **Practical takeaway: If you are looking to lock in gains via hedges or options, it makes sense to do it ahead of the debt ceiling drama.**
- Second, the debt ceiling is <u>not</u> automatically negative for U.S. Treasuries. Longer-dated Treasuries benefitted from the debt ceiling drama as investors rotated out of the yield curve.
  - **Practical takeaway: Positive for TLT and longer-dated Treasuries.**
- Third, defensive sectors benefitted most following the debt ceiling drama and the aftermath, as utilities, staples, and healthcare handily outperformed into year-end. Conversely, cyclical sectors lagged following the debt ceiling drama.
  - **Practical takeaway: Despite YTD underperformance, this reinforces our belief that defensive sectors and low volatility ETFs are good places to stay long but "hide" in the current environment.**
- Fourth, the recovery from the October lows in 2011 came in part because of Fed stimulus. There is no "Operation Twist" lurking (at best, markets can hope for late year rate cuts). Point being, we should not expect help from the Fed, which means there's more risk of declines if there's a debt ceiling default.
  - **Practical takeaway: The rebound from October into year-end in 2011 saved the year. The S&P 500 was down 12% YTD at the lows and it took Fed help to cause a rally. While the Fed may be cutting rates by then, that's not the same type of help as Operation Twist, so we should not be expecting that type of recovery.**
- Fifth, the dollar rallied from the onset of the debt ceiling drama into year-end, as again "Risk Off" trumped default worries. However, the dollar was weak during the most intense phase of the drama (and that benefitted commodities and DBC specifically).
  - **Practical takeaway: If you're of the trading ilk, there could be an opportunity on the long side in DBC and GLD as the debt ceiling drama hits its apex, but if that's followed by an economic slowdown (as we think it will be), then those longs need to be closed out as "risk off" sentiment will boost the dollar.**

What Happens if There's a Default?

- None of this prior analysis assumes a default actually takes place.
- No one knows what will happen, but here are a few thoughts:
  - A dramatic slowing of the economy.
    - U.S. economic growth is driven by a simple equation: Consumer spending + business spending + government spending. If there's a default, U.S. government spending would collapse, likely including wages to federal employees, benefit payments, contractor payments, etc. It'd be a massive hit to growth.
  - A dramatic increase in practical interest rates. If the U.S. defaults, yields on U.S. treasury debt would likely surge. Most consumer loans are tied to rates on U.S. Treasuries, so even if the Fed cuts rates to 0%, consumer loans wouldn't necessarily benefit.
  - Sticky inflation: Consumer demand would implode, but so would the dollar. And, since most consumer goods are imported, that could keep inflation stickier than one might think.
  - Financial market turmoil. Declines of 20% or (much) more in the stock market can't be ruled out, again as government payments are halted and the economy grinds lower.
- To say an actual default would be a practical economic disaster is likely an understatement, and that's why markets (and the populous) remain confident it won't happen, simply because it's in no one's interest for it to happen.

What’s Next

- Republicans passed their version of the debt ceiling bill by four votes last night, so now negotiations can begin between the two parties on extending the debt ceiling.
- The key is the “X” date. That’s the date the Treasury actually exhausts all its “extraordinary measures” to keep payments flowing despite already hitting the debt ceiling. **This “X” date is the point of no return.**
- When is it? No one knows exactly, but it’s looking like sometime in late June, so we have two months to get this issue settled and not have Washington shoot the economy or markets in the proverbial foot.