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FIRST ANALYSIS
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News or events that may affect your investments | September 7, 2021

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Investment implications of a new debt ceiling debate

Key takeaways

- The path to a debt-ceiling increase is not yet clear, and brinksmanship has been a part of past debt ceiling debates.
- Still, we believe that leaders in both parties have a variety of possible compromises and strong political incentives to avoid a government shutdown and nonpayment of public debt obligations.

What it may mean for investors

- We believe debt-ceiling uncertainties may generate short-term financial market turbulence. However, we anticipate a compromise that should allow financial markets ultimately to refocus back on the economic expansion, which we believe is still the most compelling part of the investment environment. Our investment preferences remain oriented to that economic expansion, which we believe will extend through at least 2022.

A white-knuckle issue

Congress has given itself a challenging combination of four fiscal tasks this autumn. Bipartisan support for an infrastructure bill makes its passage less an issue of "if" than "when." Even the controversial $3.5 trillion spending bill provides fertile ground for compromise as a partisan, intra-party issue among Democrats. Regarding the third task, avoiding a government shutdown when this year's budget expires at the end of September, we anticipate that Congress again will use a continuing resolution to extend spending beyond September 30 until it can pass a new fiscal 2022 budget.

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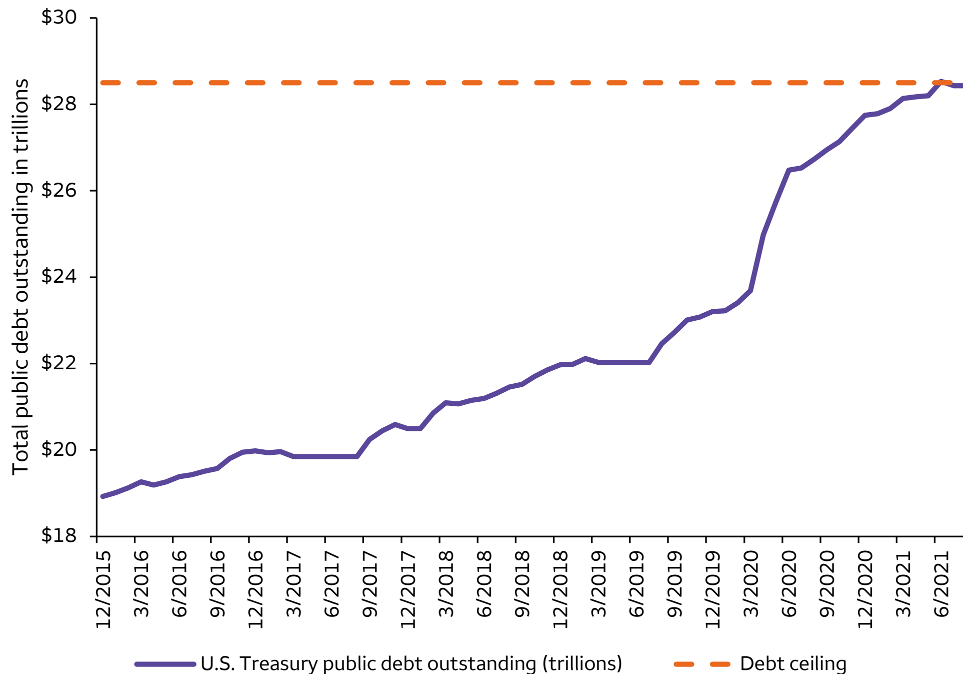
The debt ceiling, the fourth task, may become the most disruptive for financial markets. A two-year suspension of the debt ceiling ended on July 31, resetting the debt ceiling at its $28.5 trillion level at the start of August (see chart). While this year's debt drama unfolds, the U.S. Treasury has kept the government funded through the usual cash-preserving measures it used during past debt ceiling negotiations. Actions by the Treasury have centered since August 1 on a drawdown of nearly $460 billion in Treasury cash balances and $350-$500 billion in savings from suspended rollovers of government pension-fund investments. We believe these measures will be enough to keep the government open until early or mid-November.

The current debt ceiling may be just a whistle stop for rising federal debt



Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data as of August 31, 2021.

A checkered past…

A statutory debt limit, around since 1917, morphed into a broader limit on total accumulated debt in 1939. The debt ceiling only became a highly charged political issue in 1995, as part of a budget stalemate between Democrats and Republicans leading to two government shutdowns between November 1995 and January 1996. Other close calls on the debt ceiling were averted — a day before the ceiling was to be hit in October 2013 and just weeks before the anticipated deadline in September 2017 and February 2018.

However, the real nail-biter occurred just hours before the government was set to bump against its debt ceiling in early August 2011. That episode raised the specter of a debt default more than any other such incident thus far, prompting Standard & Poor's to downgrade its Treasury debt rating to AA+ from AAA in response to the government's handling of the issue. The threat also was immediate enough to have a material effect on investor and household sentiment. The S&P 500 Index tumbled 17% between the pre-crisis peak in early July and the market's early-August low, accompanied by a 24% drop in August consumer confidence. Worries over a debt default also triggered a spike in rates on short-term Treasury bills maturing around that time. Less predictable was the dollar's rise in the days leading up to the 11th- hour debt accord, benefiting more from its perceived safe-haven role than hurt by the specter of a default.

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…leading to an uncertain present

Like the budget stalemate, failure to raise the debt ceiling could curtail federal spending and cause a government shutdown. Beyond that, an impasse over the debt ceiling risks a debt default or suspended payments on other government obligations. It is not yet clear how congressional leaders will proceed, though political costs to both parties make it likely that an agreement on the debt will emerge before the government has to pull back on debt payments or other spending.

That said, a deepening divide between Republicans and Democrats, narrow Democratic majorities in both Houses, and divisions between the progressive and moderate wings of the Democratic Party could make this year's debate noisy. Congress could resolve — or defer — the debt ceiling issue, either by raising the debt limit or by suspending it again. Debt suspension requires a bipartisan vote in Congress, given its closely balanced makeup. Republicans have refused to favor a suspension or an increase in the debt ceiling unless accompanied by structural changes in the budget process limiting the future growth of spending.

Democrats could move unilaterally by including a debt increase in their reconciliation bill for the proposed $3.5 trillion spending proposal. However, party opposition to this approach is based on the added cost of the increase atop the proposed $3.5 trillion, making the plan even less palatable to Democratic moderates. Rolling a debt ceiling clause into the spending bill also could add to the risk of default if the legislation isn't signed into law until after the ceiling is breached. Politically, the party has little desire to "own" the debt problem by bearing full responsibility for raising the ceiling. The likely path: legislation brought to the floor by Democrats — sometime before the government runs out of cash in November — daring the Republicans to vote against it, knowing that past confrontations have been politically damaging to both parties.

Our perspective and investment implications

The market weakness in late 2011 did not persist much beyond the early August legislative solution to raise the debt ceiling. After declining between late July 22 and August 10 of that year, the S&P 500 Index traded in a narrow range for the balance of 2011. However, the debt ceiling increase and the economic recovery redirected investor sentiment more constructively. The S&P 500 Index regained its August 2011 losses by early February 2012 and posted gains in 2012, 2013 and 2014.

The unclear path for the debt ceiling poses a significant risk of market turbulence in what historically has been a volatile September and October. We also see potential for increased market volatility in the final week or two leading up to a hard deadline for the debt ceiling sometime in November, followed by a gradual decline in volatility during the weeks thereafter. In our view, what today appears as a Washington stalemate is more likely political posturing that we expect to give way to compromise. One example of a solution would be to raise the debt ceiling in exchange for new rules affecting future spending bills. We believe that the budget showdowns and the debt ceiling extensions and suspensions of the past several decades demonstrate that both parties want to avoid political responsibility for a shutdown, or worse, a failure to extend the debt ceiling. Compromise is the most likely outcome, given the stakes involved in any miscalculation.

We expect an eventual political solution that will allow investors to focus on the economic recovery, as they did in 2011 after that most contentious of recent debt ceiling debates. Market sentiment again could react negatively to political turbulence, but this recovery appears even stronger than the expansion in place in 2011. In fact, today's economic recovery is even stronger than the average since World War II and is the basis for our tactical investment preferences, which favor equities over fixed income; U.S. Large Cap and Small Cap Equities; and, among equity sectors, Industrials, Materials, Financials, and Energy.

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Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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