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UPDATE: The narrowing path to legislative success

Key takeaways

- On October 7, the U.S. Senate passed a bill that we believe will lift the U.S. debt ceiling by enough that the Treasury can continue to make payments until early December. The measure now goes to the House on or about October 12.

What it may mean for investors

- The extension should buy time for Congress to finally hammer out legislation to cover higher taxes and spending, and also a higher debt ceiling. Still, as we described in our report published on October 6, the path to completing this task very likely will narrow as the now extended deadline approaches.[1] That narrowing could spark new risk aversion and bouts of volatility in financial markets.
- Despite the increased chance of some market swings, we believe the economic expansion ultimately will be the main influence on equity and bond prices through next year.

On October 7, the U.S. Senate approved legislation to extend the debt ceiling through early December. The bill will allow the Treasury an additional $480 billion in borrowing limit, an estimate of the department's cash needs through December 3.[2] We expect that the House will approve and that the president will sign the legislation into law by October 15.

The measure temporarily would skirt the task of approving a higher debt ceiling, before the Treasury's cash runs out, likely by sometime in the second half of October. By giving the Treasury more room to reach early December, Congress hopes to refocus on separate spending and tax proposals, which have been contentious and whose ongoing debate was threatening to delay the debt ceiling increase.

[1] Please see "The narrowing path to legislative success", Wells Fargo Investment Institute, October 6, 2021.
[2] Siobhan Hughes, Lindsay Wise and Eliza Collins, "Debt-Limit Bill Passes Senate, Heads to House", The Wall Street Journal, October 7, 2021.

Market reactions after the Senate leaders' announcement of the October 7 deal underscored that postponement alone does not guarantee a congressional compromise on the complex legislative proposals under discussion. The S&P 500 Index rose on the news that Congress seems on its way to averting a near-term crisis. Yields also reflected the postponement. The yield on the 1-month Treasury bill fell sharply with the chances of a near-term payment crisis. However, 3-month Treasury yields rose just as abruptly as the perceived risk moved out to December.

Our perspective

Deep disagreements persist over how and how much to tax, spend, and to increase the debt ceiling. Moreover, the new, early December deadline for raising the debt ceiling is likely to fall atop the time limit to approve another contentious issue, the 2022 fiscal year spending plan. Earlier this week, Congress used a continuing resolution to extend current spending rates until December 3. By early December, Congress again could arrive at a double deadline with two complex and related tasks still incomplete.

Timing should remain the driver for financial markets. We detect some potential compromises around tax and spending proposals in Washington, D.C., but any extended delay likely will create market pressure for a near-term solution or another extension. The S&P 500 Index fell by roughly 6% from September 2 through October 6, and another pullback is likely if the talks in Congress stall into mid-November. Likewise, if December approaches without a political consensus, near-term risk aversion probably would raise 1-month Treasury bill yields above 3-month yields. Still, we would expect investors to perceive longer-dated Treasury securities as potential risk havens, if the risks are mainly uncertainty about how quickly a legislative solution may come.[3]

A more serious timing problem would arise if Congress delays a solution until the Treasury defaults, although we continue to see several reasons why this is a low risk. First, congressional leaders again may extend more liquidity to the Treasury, pending a longer-term debt ceiling deal. Second, the Treasury is still collecting tax revenue, so government payments would not completely cease. Third, on only one occasion did the U.S. suffer a technical default (a temporary delay in paying debt service) during debt ceiling deliberation. However, that was due to an equipment failure, not a legislative failure.[4] As this latest postponement illustrates, the issue is not insolvency: Congress can provide the Treasury access to cash, but requires enough political pressure to find even a temporary cash or liquidity extension.

Even if Congress were to let itself run out of time and allow a Treasury default, we believe it would be a technical default, rather than insolvency (whereby Congress cannot find the means for the Treasury to pay). The difference is significant for investors. The Securities Industry and Financial Markets Association (SIFMA) deals with how securities trade and has written that the Treasury could help settlement processes continue to take place, if the Treasury can announce any inability to pay one day in advance.[5] A Monday coupon or maturity date could become a Tuesday date, Tuesday could move to Wednesday, and so on, extending the time to pay interest and principal. In this way, a technically defaulted security could remain tradable. Meanwhile, we would expect the pressure on Congress to build quickly for a debt ceiling increase. Financial market reactions still would be more negative than those in September, but likely limited in degree and duration.

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3 The reasoning is that a short-lived period of political stress is unlikely to permanently impair payments on securities that mature long after the current political anxiety.

4 The Treasury did miss three debt payments in April and May of 1979. At the time, Congress was debating a higher debt ceiling, but a complicating factor was that the Treasury experienced technical delays in printing checks. The Treasury paid principal and coupons after the delay. For more information, please see D. Andrew Austin, "Has the U.S. Government Ever "Defaulted"?, Congressional Research Service, December 8, 2016.

5 "Treasury Operations and the Debt Ceiling", Securities Industry and Financial Markets Association, 2018.

Investment implications

The odds of a technical default remain low in our opinion, but the extension does not lessen the complexity of the political negotiations over the next seven weeks. That complexity may generate additional market volatility. Looking beyond the current period of political uncertainty, above-average economic growth next year should be the main influence on equity and bond prices. We therefore reiterate our conclusions from our October 6 report:

- Economic and earnings growth next year should post above-average growth rates once again, even if somewhat slower than the very rapid pace of 2021. We favor equities over fixed income, and U.S. equity markets over international markets.

- Any short-term risk aversion should increase demand for longer-term fixed income securities, implying temporarily higher prices and lower yields. Following an eventual higher debt ceiling in the near term, we anticipate another half-point increase to the current 10-year Treasury yield next year, as Treasury issuance and Federal Reserve purchases both decline from their pandemic pace.

- Even some modest slowing in economic and earnings rates may increase the susceptibility of equities to pullbacks based on disappointing news. Volatility around the debt ceiling increase is likely to be part of that pattern. As the path forward is higher but bumpier, we favor dollar-cost-averaging to put cash to work in a disciplined and incremental way.

- We have maintained a neutral stance on bond duration (interest rate sensitivity), but we believe recent interest rate increases in the range of 3- to 5-year maturities represent an opportunity to add cash to portfolios underweight in Intermediate-Term Fixed Income.

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