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THE DEBT-CEILING DEBATE — WHAT'S AT STAKE FOR INVESTORS

February 28, 2023

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In our view, a deeply divided, fragmented Congress nonetheless is capable of a debt-ceiling agreement to avert a default. We see numerous off-ramps for compromise, and we expect sensitivity to financial turbulence created by past debt stalemates.

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Lingering negotiations raise questions about how a debt-ceiling breach may impact capital markets. Having endured many showdowns and false alarms before, we believe markets are unlikely to overreact to the day-to-day deliberations.

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Only 30% or so of the federal budget is made up of discretionary spending. With military spending making up half of that, it likely will not be easy to cut spending as global tensions remain a concern.

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Debt-ceiling déjà vu

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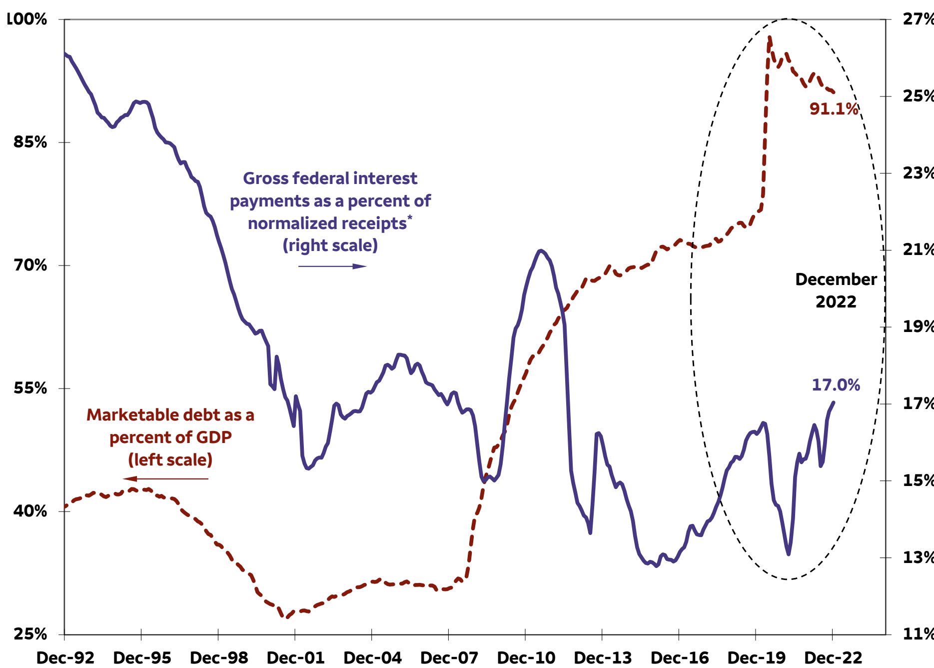
More than just a 2011 replay?

The U.S. hit its $31.4 trillion debt ceiling on January 19, triggering a series of extraordinary measures to fund spending.[1] These include a cash drawdown from the government's Treasury General Account and a temporary halt to pension-fund contributions for federal employees. The risk is that cash from these and other measures runs out before the consensus expectation of July or August, due to the weakening tax revenues and an accelerated rise in interest expenses tied to higher interest rates and outsized debt.

Revenue shortfalls and rising interest expenses on the federal debt could surprise the market with an unexpectedly early "X-date," defined as when the government runs out of cash.

Chart 1. Elevated debt and rising rates take their toll on Treasury interest expenses



Sources: U.S. Treasury Department and U.S. Commerce Department, data as of February 10, 2023.
*Normalized receipts based on rolling 10-year moving average growth. GDP = gross domestic product.

The debt ceiling has been a recurring theme in Congress, having been reached over 100 times since the end of World War II, including 78 times since 1960.

Sources: See "Q&A: Everything You Should Know About the Debt Ceiling," Committee for a Responsible Federal Budget, January 18, 2023, and "Debt Limit," U.S. Department of the Treasury, January 20, 2023.

Bumping up against the debt ceiling has been a recurring theme in U.S. government.[2] An economically disruptive shutdown has the potential to lead to an unprecedented U.S. default. Negotiations this time have all the earmarks of another high-stakes drama. A divided Congress even more politically

1. For a primer on the topic of the debt ceiling, see our January 25 Institute Alert: "Q&A on the Latest Debt Ceiling Standoff" by WFII Global Investment Strategy and Global Securities Research teams.
2. See "Q&A: Everything You Should Know About the Debt Ceiling," Committee for a Responsible Federal Budget, January 18, 2023, and "Debt Limit," U.S. Department of the Treasury, January 20, 2023.

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fragmented than in the past will try to bridge the gap between Democratic demands for a "clean" vote and Republican demands for spending cuts or, at least, limits to contain budget deficits.

Nevertheless, the political posturing around extreme positions early in the debate have often dominated the headlines, while more moderate discussions develop in the background. The good news is that lawmakers have always managed to avoid a default, spurred, at times, by financial-market turbulence threatening politically damaging economic fallout. Another encouraging sign is the array of possible off-ramps for a compromise. These include a concession by party moderates instrumental in developing 2022's infrastructure bill, special committees created to review spending growth, and short-term increases in the debt limit.

We believe an ultimate compromise will tie a debt-ceiling increase to caps on discretionary-spending growth (excluding outlays for Social Security, Medicare, and entitlements, which are effectively on autopilot). A House budget resolution in March or April would provide further clarity — potentially offering an early indicator of Republican unity on spending cuts. Talk of a payment prioritization plan by late spring could be a red flag signaling the increased possibility of a technical default.[3]

Likely macroeconomic consequences

At first glance, the fiscal and monetary policy backdrop is less economically supportive now compared with the worst of the debt crises in 2011. The Federal Reserve's (Fed's) quantitative easing was a calming influence in the run-up then, ending just after a debt agreement was reached that summer.[4] The combined factors led to rapid market deterioration during the third quarter. This time, debt-ceiling discussions are occurring while the Fed tightens financial conditions, and the economy seems headed toward a recession.

Ultimately, however, we believe that spending restraint — the most likely outcome of this debt-ceiling compromise — should shape, not reverse, a recovery from what we expect to be a moderate recession. Compared with past negotiations, policymakers are better positioned this cycle. First, the economy is not struggling with the extended balance-sheet adjustment that slowed growth during much of the decade after the 2008 financial crisis. Furthermore, inflation's unwind from its pandemic-induced spike should give the Fed scope to cut interest rates. In turn, lower rates would likely cushion the economic impact of any debt deal.

Key takeaways

- Compromise during policy debates tied to periods of extreme financial turbulence — most notably, the financial crisis in 2008 and gridlock during the 2011 debt-ceiling debate — could encourage a similar outcome if there is a standoff later this year.
- Ultimately, we believe that spending restraint — the most likely outcome of this debt-ceiling compromise — should shape, not reverse, a recovery from what we expect to be a moderate recession.

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3. A technical default involves a scenario in which the payment of principal and interest on debt would be prioritized at the expense of other obligations that would not be met in a timely manner. Even a technical default would heighten market volatility, increase interest rates on Treasury securities maturing on or around the "X-date," and more than likely result in another downgrade to U.S. sovereign debt (as was the case in 2011 when Standard & Poor's (S&P) lowered the U.S. credit rating from AAA to AA+).

4. "Debt Ceiling: The 2011 Market Playbook," Strategas, February 8, 2023

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Debt-limit deliberations and market implications

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Downgrade scenario of 2011

In 2011, as the economy showed signs of recovery and the federal debt approached its limit, Congress negotiated balancing spending priorities against outstanding debt. Contentious rhetoric split proponents of spending and fiscal conservatives. Congress resolved the 2011 crisis with the Budget Control Act of 2011, raising the limit from $14.3 trillion to $16.4 trillion. Yet, the extended and rancorous debate prompted the first-ever downgrade of the U.S. government's credit rating, from AAA to AA+. Although today's political milieu features more partisanship, and macroeconomic conditions may differ from the post-financial crisis, we believe insights from past debt-ceiling face-offs may help inform investors.

Based on a recent poll, 38% of respondents believe Congress should raise the debt ceiling while 33% say it should not.

Source: "Americans Are Split on Whether Congress Should Raise the Debt Ceiling," YouGov, December 8, 2022

Typically, when a debt issuer has been downgraded, many investors sell the bonds or require higher interest rates to compensate for added risk. Typically, prices fall and yields rise. But that did not happen. Instead, in September 2011 during the weeks following the downgrade, U.S. Treasury prices rose as investors fled to them. Despite the U.S. government's credit rating being downgraded, Treasuries were still perceived as less risky than stocks and corporate bonds, as a U.S. debt crisis threatened to spill over to global markets.

From 2013 to 2022, U.S. debt grew by 86% and the debt-to-GDP ratio, a gauge for measuring a country's ability to cover its debt, rose from 100% to 124%.

Sources: U.S. Treasury and U.S. News & World Report, February 7, 2023

What might happen this time

Our current base case is that Congress is likely to reach a compromise and avoid default and another downgrade. In our view, the U.S. has sufficient cash flow to cover interest payments. Withholding payments on financial obligations over partisan gridlock could lead to default, rattling rating agencies and the markets.

The form of an eventual deal is not yet clear. Equity and bond market reaction does not yet reflect strong financial market concern (more on that below). The House of Representatives is the most likely potential source for volatility. It's even possible that a majority could bring a vote to the floor without the Speaker's approval. This scenario seems unlikely, but its mere possibility expands the range of outcomes such that we prefer not to reallocate portfolios to anticipate the details of an eventual deal.

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Investment implications

Investors have encountered debt-ceiling showdowns before, which should help mitigate some downside risk. Even so, we do not favor making changes to portfolios ahead of reconciliation, for several reasons:

- *Volatility is likely to increase as the deadline approaches if a solution is not visible.* In 2011, although the S&P 500 Index fell 16.8% from July 22 to August 8, it recouped losses within six months and gained 15% within a year. Of course, past performance is no guarantee of future results. The Chicago Board Options Exchange Market Volatility Index (VIX) spiked to 48 on August 8, 2011, its highest reading since 2008.[5] We do expect greater near-term volatility in equity markets, partly because the debt-ceiling debate is likely to be contentious but also because the markets are still in the process of pricing in lower earnings and higher short-term interest rates for 2023. Our preference for quality is partially a defense against uncertainties of the debt-ceiling debate.[6] Nevertheless, we also believe that both political parties have both the tools (as discussed in the previous section) and a strong incentive to avoid default and further credit-rating downgrades.

- *Our guidance focuses on quality sectors* that we think will perform better during periods of volatility than sectors that connect more closely to the economic cycle. This includes a bias toward U.S. over international equities.

- *We do not advocate anticipating which equity sectors may be adversely affected by potential spending cuts.* It is difficult to predict which sectors will be impacted by cuts. We currently favor defense and managed care sub-industries, as we expect government commitment to both. We recommend using price pullbacks to add to these sectors.

- *Perceived safe-haven price distortions in long-term Treasuries and the dollar could arise due to investor demand,* while government bonds maturing near the debt-limit deadline, particularly short-term issues, could come under pressure as markets price in greater political uncertainty.

Key takeaways

- As the debt-limit debate lingers, questions arise about how a debt-ceiling breach might impact the markets and investors.
- Drawn-out negotiations are likely to push resolution down to the deadline this year.
- We do not favor making changes to portfolios ahead of reconciliation, as volatility may rise and distort asset prices.

5. The VIX is the ticker symbol for the Chicago Board Options Exchange Volatility Index, which measures the expected volatility of the S&P 500 Index based on options that trade on that index. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**
6. For complete details on our expectations and positioning, please see our recently published report, “2023: Breakouts and Breakdowns in Equity Markets,” Wells Fargo Investment Institute, February 9, 2023.

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Spending cuts?

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It won't be easy to cut government spending

Before trying to consider if Congress is going to go along with spending cuts as the debt-ceiling debate gains steam over the coming few months, one must first understand that the federal budget can be broken into three main pieces: mandatory spending, discretionary spending, and interest on the debt. Mandatory means exactly that; the U.S. federal government is required by law to spend money on benefits such as Social Security, health care, and pensions. Discretionary spending, on the other hand, includes a broad swath of budget items, including education, housing, homeland security, income security, transportation, and social services programs.

About 63% of the federal budget represents mandatory spending.

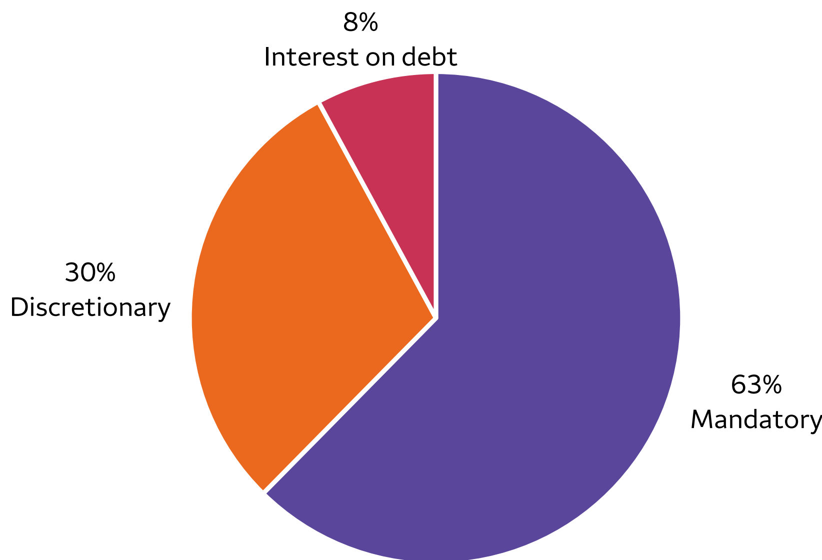
Source: Congressional Budget Office

When you consider that approximately 63% (see chart 2) of the budget is made up of mandatory spending and another 8% or so goes toward interest payments on the debt, the remaining 30% of the budget that is considered discretionary spending significantly narrows down the options and degree to which overall federal government spending can be cut, especially when one considers that approximately half of discretionary spending is on defense.

Approximately 8% of the budget goes toward interest on the debt.

Source: Congressional Budget Office

Chart 2. Federal spending in fiscal 2023



Sources: Congressional Budget Office and Center on Budget and Policy Priorities, "Policy Basics: Introduction to the Federal Budget Process," October 24, 2022

Note: Does not add to 100% due to rounding

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Industrials: The Defense sub-industry derives most of its revenues from the federal government and its various agencies. The recently passed 2023 defense budget boosts defense spending by 8% over the 2022 level, with supplemental funding for Ukraine. Additionally, the Department of Defense has noted a desire to restock depleted stores in certain areas, modernize numerous programs, and true-up for prior inflation.

The main reason that Defense equities have underperformed the S&P 500 Index recently is investor concern that Congress may settle on a debt-ceiling increase that sequesters discretionary spending. After the 2011 sequestration, defense spending did not exceed fiscal year 2011 levels until fiscal year 2019. We do not currently expect this outcome given the perceived needs due to global tensions that drove the 2023 budget increase. Nevertheless, we favor approaching this sub-industry with caution until this latest dispute is resolved.

We are maintaining our favorable view on the Industrials sector and the Defense sub-industry at present. Valuations have compressed and we expect a potential buying opportunity in Defense companies, if and when Congress reaches a debt-ceiling deal. We anticipate the Industrials sector to benefit after a relatively short and moderate recession and to benefit longer-term from spending allocated by the recently enacted Inflation Reduction Act.

Health Care: The Health Care sector, and the Managed Care sub-industry specifically, depend in numerous ways on federal funding, health insurance policy, and other regulations. During the 2011 debt-ceiling negotiations, a bipartisan commission recommended changes to federal health care policy. The U.S. health care system has grown significantly since 2011, especially since COVID-19. We expect the Managed Care sub-industry to maintain strong earnings stability and to benefit from an aging population. Strong and consistent organic growth is also likely from the Life Sciences and Medical Devices sub-industries.

Large-capitalization Pharmaceuticals could be an area to monitor, as this sub-industry relies heavily on federal spending. However, the industry was recently the target of new tax measures in the Inflation Reduction Act, thus possibly reducing incremental risk in the current debt-ceiling negotiations. We retain our neutral outlook on this sector.

No concrete policy proposals appear to have majority support in Congress yet, and any final deal may or may not include the proposals appearing most prominently in the media today. We do not favor changing any of the above outlook ratings. Neither do we favor reallocating among equity sectors based on the current media headlines. We do not believe that the threat of near-term volatility changes the likelihood of longer-term factors. We believe a protracted debt-ceiling debate likely will create volatility for equities, particularly sectors that are closely tied to government spending (such as Health Care and Industrials).

Key takeaways

- In the near term, investors will likely be analyzing which sectors and industry groups might be negatively affected by reduced federal spending.
- Less government spending would likely negatively impact GDP (gross domestic product) growth as it filters down to corporate earnings and consumer spending.

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Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation, and government regulations, among other things, all of which can significantly affect a portfolio's performance.

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CAR-0223-03369

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