The Debt Ceiling Debate and Financial Market Impacts

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Summary

Raising the debt ceiling is a regular feature of the US political and financial landscape. Since June 1942 the Federal borrowing limit has been raised or suspended a total of 93 times. The US government hit the statutory debt ceiling on January 19, 2023, which has prompted debate over what will ultimately be the 94th increase in the Federal government's borrowing limit in the past 81 years.

Decade	# of Debt Ceiling Adjustments
1940s	7
1950s	5
1960s	15
1970s	15
1980s	20
1990s	7
2000s	9
2010s	12
2020s thru 2021	3
Total	93

Source: JAG Capital Management, SEC Filings

Many if not most of these debt ceiling adjustments were enacted with little fanfare, outside of political and economic circles. In December 2021 the debt ceiling was increased by $2.5 trillion to its current level of $31.4 trillion without much notice by the public. However, the necessity to raise the ceiling can be used as leverage when there are political disagreements between the houses of Congress or between Congress and the Executive Branch. This year, House Republicans are looking for limits on spending, while Senate Democrats and the President are insisting on a no-strings-attached increase in the ceiling. These two opposing views have created the ingredients for protracted and contentious negotiations. By using "extraordinary" measures, the Treasury says it can keep the Federal government operating normally until about June. This provides enough room in the calendar for several months of negotiations in Congress.

The full effect on financial markets remains to be seen. The details of an eventual agreement and the length of time it takes to arrive are key factors. Meanwhile, the media will continue to focus intensely on the drama of the situation and to outline worst-case scenarios, however unlikely. The combination of media coverage and political posturing by both parties could create uncertainty and potentially lead to market volatility as the deadline approaches.

A review of the debt ceiling debate in 2011 sheds some light on the stakes involved. The debate that year pitted the House, which wanted restraints on spending, against President Obama, who wanted a no-strings-attached increase. (Sound familiar?) The impasse was eventually resolved when Congress passed the Budget Control Act on 8/2/2011. However, Standard and Poor's was unimpressed by the deficit reduction portion of the Act, and took the unprecedented step of lowering the credit rating for the US from AAA to AA+ on 8/5/2011. The following Monday, the S&P 500 Index fell 6.7% in response. Of course, the index recovered and went on to post significant long-term gains, but the violent short-term reaction illustrates the impact protracted and contentious political wrangling can have on financial markets. Underlying the policy debate is the fact that debt has outpaced economic growth for the past decade.

S&P 500 During 2011

The US debt/GDP ratio is now close to an all-time high and, indeed, hit an all-time high in Q2 2020. However, unlike emerging market countries where a high debt/GDP ratio and non-local currency debt could be an indicator of a default risk, the US can easily print money, and a high ratio, while not dismissible, may not be as ill-boding as some media pundits and economists make it out to be.

While the consequences of failing to reach an agreement on the debt ceiling would be dire, there is every reason to expect the parties will eventually come together to raise the debt ceiling, just as has played out each time in the past. We do not believe the worst-case scenarios will come to pass. However, the process is chaotic, and markets dislike uncertainty. If short-term market dislocations similar to 2011's episode were to occur in the coming months, they have the potential to create excellent longer-term investment opportunities.

– Mike Buck, CFA®, JAG Investment Team

Equity Investment Team

Norm Conley
CEO & Chief Investment Officer

Mike Kimbarovsky
Managing Director & Portfolio Manager

Mike Buck, CFA®
AVP, Quantitative Analyst

Roberta Maue
SVP, Director of Equity Trading & Portfolio Operations

Nico Falkinhoff
Associate Portfolio Manager & Equity Research Analyst

George Margvelashvili, CFA®
Equity Research Analyst

Tucker O'Neil
Equity Research Analyst

John Krueger
Junior Equity Research Analyst

Disclosures

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JAG CAPITAL MANAGEMENT LLC

9841 Clayton Rd
St. Louis, MO 63124

The Wrigley Building
400 North Michigan Ave
Suite 1680
Chicago, IL 60611