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Talks resume

On Sunday night, President Joe Biden returned from the G-7 Summit, Speaker Kevin McCarthy and Biden connected, and by Monday morning talks resumed.

Potential turbulence

We could see market turbulence in the coming days as the details are hammered out and the X-date draws near.

Three scenarios

I discuss three scenarios for resolving the debt ceiling debates, including a last-minute compromise to a controversial interpretation of the US Constitution.

US debt ceiling negotiations are occupying an increasing amount of investor attention as we get closer to the “X-date” — the date that the US government is expected to run out of money to fully meet its financial obligations. Currently, the X-date is estimated to be June 1.

Late last week, the stock market moved from complacency to fervor around the debt ceiling situation – reports that the parties were getting closer to an agreement sent stocks higher. I was skeptical because there seemed to be such a significant gap between the Biden administration’s position and House Republicans’ position. Yes, Democrats and Republicans had agreed to a clawback of COVID-related stimulus that has not been spent yet. And yes, the Democrats had eased their position on work requirements for welfare-related benefits, saying they were open to some requirements. But that was the easy part. The far bigger issue is discretionary spending cuts, where the chasm between Democrats and Republicans is wide.

Both parties agreed to ringfence Social Security and Medicare with no cuts or even caps applied, and only focus on other types of discretionary spending. The Republicans’ bill, passed in April, would reduce discretionary spending to fiscal year (FY) 2022 levels and limit the growth of future spending to 1% annually over the next 10 years. The White House has proposed keeping spending at FY2023 levels into FY2024, but they want the defense discretionary spending to share in some of those cuts. And so my skepticism comes from the wide gap in bargaining positions: Republicans want 10 years of cuts on discretionary spending while Democrats want two years of caps.

And so it is no surprise to me that, in the last several days as the tough decisions on spending get hammered out, the negotiating parties have gotten more pessimistic. It’s just more realistic, in my opinion. And it suggests to me that we’ll see more market turbulence in coming days.

So where do we go from here?

Three scenarios for resolving the debt ceiling debate

Compromise.

The most likely scenario is that the two parties arrive at a compromise. That probably wouldn’t happen until the 11th hour, as we have seen in past debt ceiling negotiations. And it will not be easy. In order to meet the X-date deadline, Speaker Kevin McCarthy says a negotiated draft bill must be received by the House Rules Committee by Wednesday the 24th, as it will not be able to receive a vote for 72 hours. After a Saturday vote, the Senate would then have four days to process the bill by regular order. There is a path in the which Senate can process the bill in a condensed timeframe, but that is a narrow strategy and less reliable.

One of the concessions McCarthy made in order to win enough votes to be elected Speaker of the House was restoring the ability for any single member to call for a “no confidence” vote on him. Such a vote would be unlikely to ever unseat McCarthy, but it injects one more possible headache into the negotiating process because there is no cooling off period after a “motion to vacate” vote, so another one can be called the following day, and so on. Suffice it to say it would be very disruptive.

Discharge petition.

A second possible scenario is that Democrats utilize a discharge petition to raise the debt ceiling. This is not a layup, however. A discharge petition is a parliamentary procedure to bring a bill out of committee and to the floor for a vote without the committee’s approval to do so. This forces the House to take action on a bill even if the Speaker or the committee it originates from objects. On May 17, House Democratic leadership filed a discharge petition to move a bill for a clean debt ceiling increase out of committee, and 210 Democratic House members signed it. However, Democrats need 218 signatures to force a vote on the floor, which would require some Republicans to sign the petition — and thus far all Republican members of Congress have remained aligned with Speaker McCarthy. And even if Democrats could force a vote, the earliest date that could occur would be June 12 – almost two weeks after estimated X-date.

The 14th amendment.

The third possible scenario is that the Biden administration invokes the 14th Amendment — an option they’ve been reluctant to use. The 14th Amendment of the US Constitution states that “the validity of the public debt of the United States, authorized by law...shall not be questioned,” which is widely interpreted to require the US government to meet its financial obligations. The idea here is that the White House and Treasury could decide to keep issuing debt in order to honor past obligations, no matter what happens with the debt ceiling. However, the US Constitution also allocates budgetary power to Congress, not the Executive Branch. Thus, using the 14th Amendment to keep issuing debt would certainly face a legal challenge from Republicans and could get caught in the courts for years. And so it seems the Biden administration is not interested in utilizing this to resolve the debt crisis unless the US arrives at the X-date without the debt ceiling being raised. Another interpretation of the 14th Amendment is that it rules out default, and since it’s part of the Constitution, it stands above the budget law — and this together with the need to maintain financial stability means that the Treasury would have to prioritize debt payments.

News around the world

While the US debt ceiling debate has captivated market observers, there have been plenty of notable developments around the world:

- **China.**

April economic data for China came in below expectations. For example, China retail sales rose 18.4% year over year, which was well below consensus.¹ And manufacturing-related activity has been disappointing, although that is likely a reflection of the global economic slowdown. It seems that the Chinese economy is continuing to experience significant growth in services activity, but it is not generally as strong as expected. I continue to believe the China re-opening has very long legs – it’s just taking a breather.

- **Canada.**

Canada's Consumer Price Index (CPI) print for April was higher than expected, and modestly higher than March. While it's moving in the wrong direction, some of that increase can be attributed to the Bank of Canada's rate hikes, which have driven up mortgage rates and increased the cost of shelter. More importantly, I continue to believe one print does not change the narrative. Canada is in a disinflationary trend; however, it is imperfect and lumpy. I don't think it should force the Bank of Canada to abandon its conditional pause.

- **Japan.**

Japan also saw significant inflation in its most recent CPI print. The good news is that Japan is also experiencing strong growth, as first quarter gross domestic product came in well above expectations. It does beg the question of when the Bank of Japan will get less dovish.

Looking ahead

In terms of investment implications, we are getting conflicting reactions from the stock and bond market. The bond market is pricing in the risk of a technical default, with yields on T-bills maturing in early June rising dramatically. However, the stock market seems far more optimistic, and is not pricing in that risk; even the VIX is relatively low. My read is that the bond market usually errs on the side of greater pessimism while the stock market is often irrepressibly optimistic.

I think the bond market is the more accurate measure of risk right now, and that a brief technical default is a real possibility. Stock markets are likely to reflect that greater risk as we get closer to the X-date without an agreement in place. I just believe a technical default would likely be very brief, as it would provide the impetus for the parties to finally reach an agreement and end the standoff.

And so I have to say that I'm looking forward to reaching mid-June, a time when I feel confident that the debt ceiling impasse should be behind us, one way or another. Perhaps we should think of this spring's debt ceiling crisis as just a financial form of allergy season: It's going to get worse before it gets better, and we just need to ride it out until pollen counts go down and we can get back to normalcy. I think we'll all be able to exhale by mid-June, although it will likely be an increasingly volatile market environment between now and then.

Once that drama recedes, I think all eyes will be back on central banks. I'm optimistic that the US Federal Reserve and the Bank of Canada will maintain conditional pauses, and that other Western developed central banks will draw closer to the end of their respective tightening cycles. I think markets will soon begin to discount an economic recovery, even though sentiment is very pessimistic right now.

With contributions from Jennifer Flitton

Notes

¹Source: China National Bureau of Statistics, as of May 16, 2023

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

An investment cannot be made directly in an index.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

The Consumer Price Index (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics. Core CPI excludes food and energy prices while headline CPI includes them.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

Tightening is a monetary policy used by central banks to normalize balance sheets.

The opinions referenced above are those of the author as of May 22, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.