WASHINGTON INSIGHTS

Debt Ceiling Déjà Vu: Will 2023 Repeat 2011 Market Volatility?

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Welcome to the May issue of the Investments & Wealth Institute's Washington Insights. *This month's column reviews the last time Congress deadlocked on the debt ceiling in 2011, and what the implications are for today's impasse.* Washington Insights *also provides a brief wrap-up of other public policy topics of interest to wealth and institutional managers.*

2011 Deadlock Over the Debt Ceiling a Reminder of Policy Risks Facing Markets Today

On April 26, the GOP-controlled House of Representatives passed H.R. 2811, the "Limit, Save, Grow Act," legislation designed to jumpstart talks between President Joe Biden and House Speaker Kevin McCarthy (R-CA) over raising the federal government's debt limit and cutting deficit spending. A day after the vote, the White House responded that Congress should act on the potential default without preconditions.

To longtime political observers, it was a reminder of how perilously close the U.S. government came to default in 2011. On April 18, 2011, for the first time since 1860, credit rating agency S&P Global Ratings (S&P) issued a "negative outlook" on the U.S. government's AAA sovereign debt rating as Congress remained gridlocked and talks between the two parties collapsed. As in 2011, Democrats controlled the Senate and White House, and Republicans had just taken control of the House.

Like the GOP's Tea Party first-year class that in 2010 ushered in a bare-knuckles approach to cutting taxes and federal spending, today's three-dozen-member Freedom Caucus, a powerful voting bloc in the House GOP, has been eager to employ the same leverage.

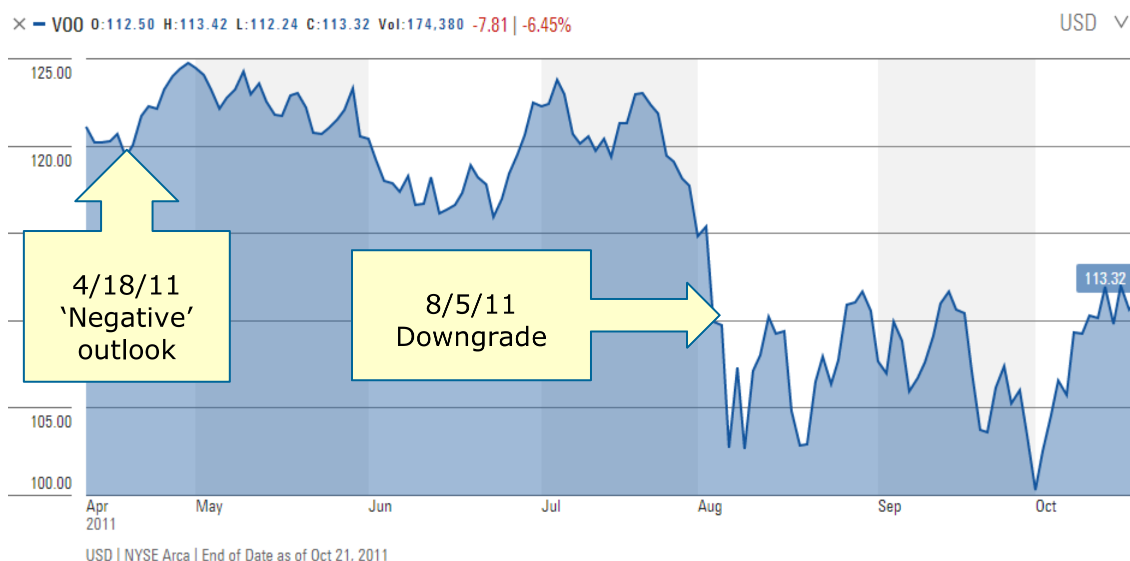
On that spring day in 2011, though, markets seemed to have ignored the S&P warning. Five days after S&P's announcement of a potential downgrade, the S&P 500 Index was up 1.7 percent.

However, 2011 wasn't the first time Congress was unable to reach an easy consensus. According to the Congressional Research Service (CRS), the nonpartisan research arm of the Library of Congress, debt policy "has been a divisive issue since the beginning of American government and has often been linked with other policy decisions." The process often has been contentious. The debt ceiling has been raised in some form at least 74 times between 1962 and 2011, some with "clean" bills that simply raised the debt limit, others with conditions attached.

In some ways, though, 2011 was different from previous negotiations between the two parties. Despite Congress eventually reaching a compromise on August 2, 2011, for the first time in history S&P went further than a negative outlook by downgrading the U.S. credit rating to AA+, the next highest debt rating. By August, the market was watching, having begun a steep decline in late July that was followed with abrupt swings lasting through early October (see figure 1).

At its lowest point from the year's peak on April 29, 2011, the S&P 500 dropped 19.6 percent on October 3. The market did not fully recover these losses until mid-February 2012.

FIGURE 1: S&P 500—APRIL 8 TO OCTOBER 21, 2011



Source: Morningstar database for VOO, an exchange-traded fund approximating the S&P 500 index. Graphic by Potomac Strategies.

Fast forward to spring 2023. Is today's political impasse any different? Are the stakes higher this time? In 2009 the S&P 500 gained 23 percent, followed by a 13-percent gain in 2010. Today's market, for lack of a technical term, is moving sideways. Given a turbulent U.S. market that lost nearly 21 percent last year and with investors coping with a regional bank panic in March and ongoing Federal Reserve interest rate increases to combat stubborn inflation, market expectations appear to be much lower than in spring 2011.

Comparisons with 2011 also differ significantly in terms of the political dynamics. The House GOP then was coming off a major midterm election victory during President Barack Obama's first term, with a net gain of 63 new Republican seats, the highest single gain for either party since 1948. The 2010 landslide stands in stark contrast to last year's midterms in which Republicans, confidently expecting to see a "red wave" and gaining control of both chambers, and after averaging gains of nearly 30 House seats in recent midterm elections, fell short of taking the Senate back, and barely taking control of the House with a slim four-seat majority.

As a result, the election mandate that Republicans hoped to achieve—compared to 2011—has left the GOP-controlled House with little room to maneuver and eventually compromise.

Could we see another "negative" outlook issued soon by S&P, or by Moody's or Fitch Group—the "big three" credit rating agencies? With Wall Street firms forecasting the so-called "X-Day"—the date that the Department of Treasury sets as the day the United States is unable to pay its bills—it's certainly possible volatility could suddenly increase.

Meanwhile, *Bloomberg News* reports that the Securities and Exchange Commission (SEC) wants public companies to start providing details in their corporate filings of risk factors involving the impact of the current gridlock on their businesses.

At a recent meeting of the American Bar Association, Erik Gerding, director of the SEC's Division of Corporation Finance, said the agency is "not looking for boilerplate disclosure," adding "for example, some issuers are heavily reliant on government contracts. That might be some of the disclosure that you all are already thinking about right now."

The Government Accountability Office estimated the delay in raising the debt ceiling in 2011 cost taxpayers $1.3 billion. Some economists are predicting a more dire outcome this time if Congress and President Biden are unable to arrive at a new agreement, even as far as sinking the U.S. economy and impacting other countries because about a third of U.S. debt is owned by governments abroad.

Nonetheless, *Forbes* suggests the odds of a default remain "very low" while conceding "the dynamics this year are particularly dramatic" given that no one believes the House bill has a chance of becoming law and President Biden has refused to negotiate. *Barron's* suggests in a blaring headline that "A Stock-Market Plunge Will Resolve the Debt-Ceiling Standoff." Whether—as the *Barron's* column elaborates—that "Sell in May" could be more than a cliché this year, it could also be the catalyst needed in order to get Congress and the White House to make a deal.

THE WRAP-UP

SEC Regulation

T+1 trading date effective May 5; compliance deadline is May 28, 2024. If you see a headline that the new deadline for settling securities transactions in one day is May 5, 2023, don't expect to see trades settled as speedily as promised. As initially proposed by the SEC, markets would have had until March 31, 2024, to meet the new compliance deadline. After industry protests, however, the SEC pushed the compliance deadline back until Tuesday, May 28, 2024—the day after the Memorial Day holiday. The SEC cited a need to allow more time for planning and operational changes at firms.

Broker–dealers and RIAs need to consider reasonable alternative strategies "early in the process" for clients. In a SEC staff bulletin released April 20, 2023, and styled as an FAQ, staff expanded its guidance on the care obligation for broker–dealer firms and the fiduciary duty of care for registered investment adviser (RIA) firms by stating both should consider "reasonably available alternatives" early in the process "rather than as a retroactive exercise undertaken after the firm or financial professional has already decided what to recommend or what advice to provide."

Some of the factors the 24-page staff bulletin said should be considered as part of evaluating the risks, rewards, and costs include:

- Time horizon;
- Investment objectives (such as providing income, principal protection, growth, or exposure to a specific market sector);
- Initial and ongoing costs, including potential costs such as redemption fees;
- The product or strategy's key characteristics and risks, such as liquidity and volatility; and
- Any special or unusual features such as tax advantages or guaranteed payments.

The bulletin also noted financial professionals should not rely "solely" on the firm's list of approved investments but also share responsibility "for personally understanding an investment or investment strategy before they recommend or provide advice …"

With regard to a firm with a limited menu of investments, the short answer was, "It depends." Staff added that if the limited menu is inconsistent with the investor's investment profile, the firm and its advisors may not "satisfy the obligation to act in a retail investor's best interest."

Research and Surveys

New poll shows bipartisan support for ESG, sort of. A recent poll by Penn State and political consulting group Rokk Solutions indicates voters across the political spectrum support their investment managers considering long-term environmental, social, and governance (ESG) investments.

The poll of 602 registered voters taken in March 2023, showed 53 percent of Republicans and 80 percent of Democrats see climate efforts as "relevant to their financial futures," such as conservation and resource management.

However, when nuances are raised, such as support for net-zero emission goals, Republican support drops to 42 percent while Democratic voters are more supportive. The report recommends, among other things, clearly defining ESG investing and proving to lawmakers that ESG returns are beneficial to investors.

Americans have a net worth problem, survey shows. Credit Karma recently sponsored a study that shows 51 percent of Americans do not know how to calculate their net worth, despite their fascination with the wealth of a random celebrity or the richest person in the world.

That said, 31 percent of those surveyed say their net worth is zero or negative, particularly among Gen Z and millennials. However, a significant population of Americans age 59 and older, 21 percent, also report having a negative net worth.

According to the survey, nearly one in five respondents age 59 and older don't have a retirement account, the highest percentage of any generation.

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If you have questions after reading this update, please contact the Institute's general counsel, Robert (Rob) Frankel at rfrankel@i-w.org.