Why the Current U.S. Debt Ceiling Impasse Matters to Investors

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On January 19, 2023, the U.S. hit its debt ceiling, launching a significant policy debate for investors. U.S. Treasury Secretary Janet Yellen then began using "extraordinary measures" to continue paying the government's obligations and indicated that those emergency measures are due to expire on June 5. If the debt ceiling is not raised by that date, the U.S. Treasury would be unable to issue more Treasury securities and the nation could default on its debt. What does all this mean and why does it matter to investors? What possible impact could a lingering, down-to-the-wire political clash have on different asset classes? What lessons might we learn from similar moments in history? And what should investors do now?

Debt Ceiling Defined. The federal debt ceiling is a limit set by Congress on the total amount of money the U.S. Treasury is authorized to borrow via U.S. Treasury securities to fulfill its existing financial obligations. There is a limit on U.S. borrowing because according to the Constitution, Congress must authorize borrowing. The debt ceiling was first enacted in 1917, originally set at $11.5 billion, so the U.S. Treasury would not need to ask for permission each time it had to issue debt to pay bills. In 1939, Congress created the first aggregate debt limit, covering nearly all government debt and set it at $45 billion.[1]

It is important to note that raising the debt ceiling does not increase the amount the government is authorized to spend. It keeps the government from defaulting on bills and obligations it has already committed to pay.

Potential Default Consequences. A U.S. debt default matters. Virtually all financial assets around the world are priced in relation to U.S. Treasuries. So, if the U.S. Treasury defaulted, the entire global financial system would be undermined and suddenly riskier.

For individual Americans, the U.S. Treasury pays Social Security, Medicare benefits, veterans' benefits, military salaries, unemployment benefits, and tax refunds, among other obligations. Already deferring new investments in government employees' retirement plans as part of its "extraordinary measures," a default potentially means a suspension of all those payments.

Battle Context Provided. Today's debt ceiling battle is nothing new. Congress has raised, extended, amended or suspended the limit 78 times since 1960 alone. Congress has never lowered the debt limit. Sometimes Congress has raised the debt limit to a specific dollar amount; sometimes Congress has suspended the debt ceiling for a specific period of time. What makes today's debt ceiling debate different is two-fold. First, what was once a routine vote has become especially contentious politically given the atmosphere of deep divisiveness that dominates today's Congress. Second, the current national debt is larger than ever, standing at $31.4 trillion. The U.S. debt to Gross Domestic Product (GDP) ratio, a bellwether metric for a country's ability to pay down its debt, grew to 124% in 2022, according to the U.S. Office of Management and Budget.

> *"A potential default is of real concern, and short-term market volatility is expected to accompany a barrage of dire 'what if' media stories while posturing continues. If history is a guide, rational actors should reach a late agreement to avoid a self-imposed default."*
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> *Chuck Kiraly, President of Oak Associates Funds*

Historical Example Illustrative. The most similar impasse to that being faced today occurred in the summer of 2011. The Republicans controlled the House of Representatives; the Democrats held a slim majority in the Senate; a Democrat President was in the White House. About a month before the August 2nd default deadline approached, the U.S. equity market experienced a downturn, and market volatility spiked as that deadline drew closer. More specifically, the S&P 500 Index fell by more than 16% in just five weeks in July and early August 2011.[2]

Congress finally reached a compromise, with the Senate approving the measure to raise the debt limit and the President signing it just hours before the U.S. would have defaulted. It took the S&P 500 Index almost six months to recover.[3]

Having already placed the U.S. credit rating on review for a possible downgrade earlier in the summer, Standard & Poor's downgraded the U.S. credit rating on August 5, 2011 for the first time since 1917—from AAA to AA+, removing the U.S. from its list of lowest-risk countries. The ratings agency specifically cited the growing deficit and dysfunctional policy debate in Washington D.C. as factors in the downgrade. Contrary to what one might think, U.S. Treasury prices rallied and yields plummeted immediately after the downgrade, as investors still considered U.S. government bonds safe-haven assets in an uncertain economy. The 10-year U.S. Treasury yield declined from 2.57% on August 5, 2011, when the Standard & Poor's announcement was made, to 2.48% by August 8.[4] (Remember, there is usually an inverse relationship between bond prices and yield movements, so that bond prices fall when yields increase and vice versa.) Despite the U.S. government's credit rating being downgraded, U.S. Treasuries continued to be perceived as less risky than stocks and corporate bonds.

The U.S. debt ceiling was raised by nearly $17 trillion, or $1.416 trillion per year, from 2011 to 2023.[5]

Possible Market Impacts. Interestingly, studies indicate there is a lack of direct relation between a country's debt and equity market returns. Even large increases in debt/GDP do not hurt equity market performance.[6] However, Congress' gridlock around raising the government debt ceiling is likely to increase market volatility—both in the equity and fixed income markets—during the next several months. If the U.S. Treasury is compelled to prioritize its payments to individuals, states, federal workers and military personnel, capital markets could be further unsettled. The debt ceiling fight could also make individuals and businesses reluctant to spend, increasing the effects of slowed economic growth and exacerbating the Federal Reserve's challenges in navigating a soft landing as it tries to bring down inflation—particularly impactful this year. Uncertainty —about asset prices, borrowing costs and economic activity—is a factor financial markets simply do not like, causing possible disruption as Congress wrangles a deal.

In a scenario where a deal is not reached in advance of early June and does not get settled until the third quarter of 2023, it may be more likely to see a significant sell-off in both equity markets and U.S. Treasuries. Credit markets globally would face reverberations. The U.S. dollar could lose value.

"We do not recommend making changes to your investment portfolio strategy before the debt ceiling deliberations are resolved because heightened market volatility may distort asset prices, including those of equities and the perceived safe haven of long-term U.S. Treasuries. Further, we do not believe that such near-term volatility changes the longer-term underlying fundamental analysis upon which we make investment decisions."

Robert Stimpson, Co-Chief Investment Officer and Portfolio Manager of Oak Associates Funds

Interest rates in the U.S. could rise sharply. Gold and commodities could rally. The threat alone of such financial market turbulence driving politically damaging economic fallout—including what many might well perceive as an avoidable and self-inflicted recession—has spurred Congress oft-times in the past to take action to avoid default, even if at the eleventh hour.

If a debt default actually occurs, then we are in uncharted waters in terms of market and economic impact.

What Investors Should Consider Doing Ahead of the Debt Ceiling Resolution

In the months leading up to resolution of the current debt ceiling brinksmanship, it is most important, as always, for investors to maintain a long-term perspective. Consider: • Consulting with your financial advisor to see if near-term volatility might be a good buying or portfolio rebalancing opportunity for you. • Maintaining a level of cash reserves with short-term CDs that are now offering attractive interest rates and trying to save a little extra in case there are any major, albeit temporary, changes to your government benefits. • Remaining diversified, spreading your risk among different asset classes and different sectors within the equity market. • Sticking with your overall investment strategy, not giving in to the temptation to let emotions and reactions to media headlines determine your actions, regardless of market or politicians' behavior. • Staying informed.

Oak Associates Funds has been specializing in U.S. equity investing for more than 35 years based on an investment philosophy centered on the core tenets of investing for the long term, concentrating in our best ideas and remaining fully invested. We view our emphasis on quality as a cushion against the uncertainties of the debt ceiling debate, though, of course, past performance is no guarantee of future results.

[1]https://finance.yahoo.com/news/u-officially-hit-debt-ceiling
[2]https://www.schwab.com/learn/story/us-hits-debt-ceiling-will-it-impact-investors
[3]https://moneywise.com/news/economy/us-hits-debt-ceiling-what-now
[4]https://www.forbes.com/advisor/personal-finance/debt-ceiling-hurt-your-finances/
[5]https://seekingalpha.com/article/4571400-an-investor-roadmap-for-2023-us-debt-ceiling-crisis
[6]https://www.squire.com/resources/blog/us-reaching-debt-ceiling-impact-stock-markets/

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16673299-UFD-3/28/2023