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SKY Harbor Weekly Briefing

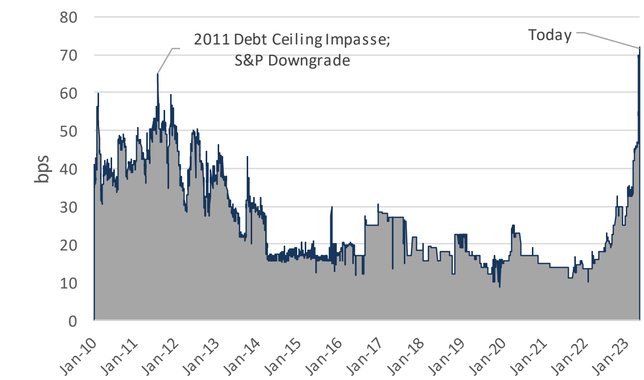
Debt Ceiling Deadlock

With the May FOMC meeting now in the rear view mirror, investors have begun to shift their attention away from a pause in the hiking cycle and toward the looming debt ceiling debate. So far, key figures on both sides of the political aisle remain entrenched in opposition, setting the stage for increased market volatility in the coming weeks. In this *Weekly Briefing*, we find that most debt ceiling showdowns fail to derail the trajectory of high yield market returns, all while acknowledging that downside could be steep if compromise proves elusive.

Markets Are Signaling Stress

Created by Congress via the Second Liberty Bond Act of 1917, the purpose of the debt ceiling was to enable the US Treasury to issue bonds (in the original case, it was to finance military spending during World War 1) on an as-needed basis up to a pre-determined maximum set by legislators. The most recent limit, or approximately $31.4 trillion, was reached in January of this year. According to Treasury Secretary Yellen, **extraordinary measures will be exhausted in the coming month, placing the US at risk of not being able to meet its debt obligations as soon as June 1** (the "X-date"). Since its original implementation, augmentation has come with little debate – Congress has increased the debt ceiling 78 times since 1960 – regardless of which political parties led the executive and legislative branches. However, political polarization in the US has accelerated in recent years, leaving many to fear that resolution may be far more difficult to achieve this time around. Credit default swaps on US sovereign debt reflect this risk, with levels now surpassing contentious debates in both 2011 and 2013.

US Sovereign Credit Default Swaps Signaling Stress
5-year CDS spread, daily data



Key Figures Urge Resolution; Politicians Remain at Odds
select commentary

"This is something that could produce financial chaos..."
-Treasury Secretary Janet Yellen

"No one should assume that the Fed can really protect the economy and the financial system and our reputation globally from the damage that such an event might inflict."
-Federal Reserve Chair Powell

"Now that we've introduced a clear plan for a responsible debt limit increase, they have no excuse to refuse to negotiate" and "...sit down, neogiate and address this crisis!" (comments after passing his Limit, Save, Grow Act of 2023 in the House)
-Speaker of the House McCarthy

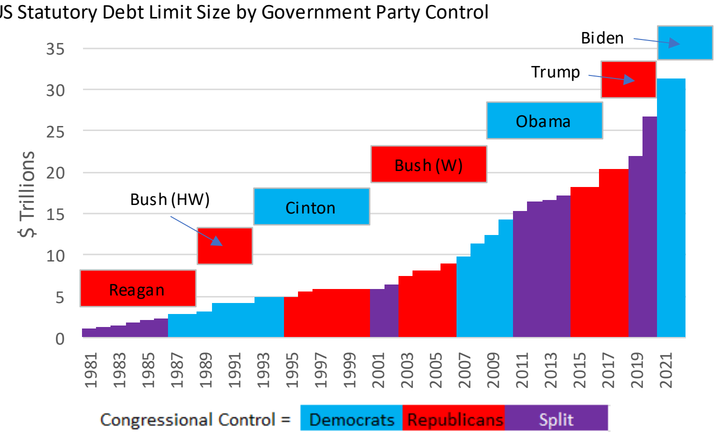
"We can debate where to cut, how much to spend, how to finally move the tax system...but not under the threat of default."
- President Biden

Source: SKY Harbor, Bloomberg

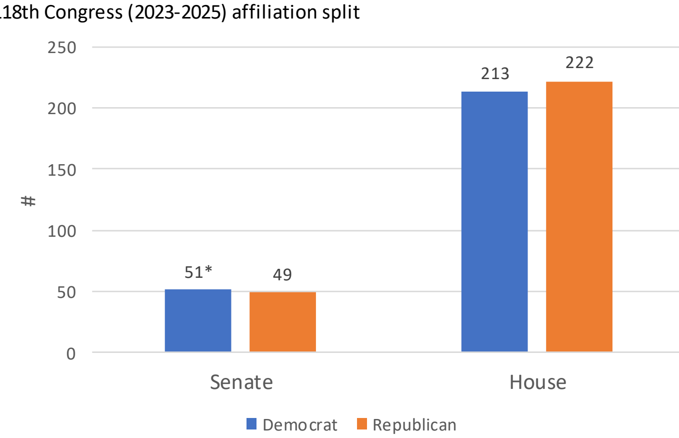
Little Margin for Error

In late April, Speaker Kevin McCarthy (R-CA) was able to pass a plan to address the nation's debt ceiling despite a razor-thin majority in the House of Representatives. **The plan offered to raise the current debt ceiling by $1.5 trillion, allowing the nation to avoid default in exchange for a rollback in discretionary spending to 2022 levels.** Though characterized as "dead-on-arrival" by counterparts in the Democrat-led Senate, passage demonstrated a modicum of unity among Congressional Republicans, and placed pressure on the Biden administration to commence negotiations. The President, for his part, has continued to insist that spending cuts remain a debate separate from the debt ceiling, insisting on a "clean" raise that would be more closely aligned with normal procedures prior to 2011.

Debt Limit Has Risen Substantially Under Both Parties Since '00
US Statutory Debt Limit Size by Government Party Control



Current Backdrop is Closely Split and Contentious
118th Congress (2023-2025) affiliation split



Source: SKY Harbor, United States House of Representatives Archives, United States Senate Archives

Much Ado About Nothing?

All debt ceiling backdrops are different, including varying levels of political discourse, majority party cushion, and economic backdrop. Additionally, some Congresses are more proactive in addressing concerns, while others wait until the last minute. With those issues in mind, we took a look at high yield market returns in the two months leading up to debt ceiling resolution dates since 2011, all of which occurred within weeks (in some cases days) before the estimated "X-date." As demonstrated below, **median returns in both the lead-up to and aftermath of debt ceiling resolution dates tend to be in-line with normal high yield performance across all periods**. Additionally, we find that returns in the two months leading up to resolution have been directionally consistent with the market trajectory in the two months that precede that period. Note, however, that though index returns have been relatively consistent, **higher-quality has tended to outperform historical norms during times of uncertainty in the lead-up to resolution, while lower-quality tends to outperform following resolution**. Further note that depressed returns that followed debt ceiling resolution in 2011, 2014, and 2021 were perhaps more influenced by macroeconomic developments not necessarily tied directly to the ceiling debate.

Return in 2 Months Leading Up To Debt Ceiling Resolution

if resolution occurred over a weekend, the prior trading day is used

Date Resolution Reached	HY Index	BB Index	B Index	CCC Index
02-Aug-11	0.2%	0.9%	0.3%	-1.6%
04-Feb-13	2.6%	1.6%	2.5%	5.3%
17-Oct-13	2.7%	2.9%	2.7%	2.3%
15-Feb-14	1.9%	1.8%	1.8%	2.3%
02-Nov-15	0.1%	1.2%	-0.4%	-2.2%
08-Sep-17	1.2%	1.5%	1.0%	1.0%
09-Feb-18	-1.1%	-1.7%	-0.9%	0.1%
02-Aug-19	1.9%	2.5%	1.7%	0.2%
16-Dec-21	0.2%	0.3%	0.1%	-0.5%
Debt Limit Median	1.2%	1.5%	1.0%	0.2%
All Period Median*	1.1%	1.1%	1.1%	1.5%

Return in 2 Months Following Debt Ceiling Resolution

if resolution occurred over a weekend, the prior trading day is used

Date Resolution Reached	HY Index	BB Index	B Index	CCC Index	
02-Aug-11	-6.5%	-5.0%	-6.1%	-12.3%	<--- US downgrade, European sovereign debt crisis
04-Feb-13	1.7%	1.3%	1.8%	2.6%	
17-Oct-13	1.7%	1.3%	1.7%	2.4%	
15-Feb-14	1.8%	2.0%	1.5%	1.7%	
02-Nov-15	-4.9%	-3.5%	-5.0%	-9.5%	<--- Commodity crisis in US
08-Sep-17	1.1%	1.0%	1.1%	1.5%	
09-Feb-18	1.1%	0.6%	1.4%	1.5%	
02-Aug-19	1.1%	1.6%	1.2%	-1.5%	
16-Dec-21	-3.7%	-4.5%	-2.8%	-2.5%	<--- Omicron, worries of Fed policy misstep
Debt Limit Median	1.1%	1.0%	1.2%	1.5%	
All Period Median*	1.1%	1.1%	1.1%	1.5%	

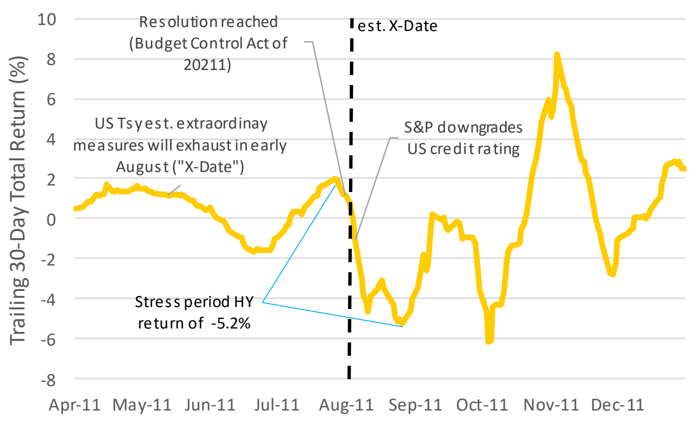
Source: SKY Harbor, ICE Data Indices, Deutsche Bank

But Maybe This Time is Different

Though median market returns during debt ceiling debates don't typically deviate much from historical norms, it's tail risk investors must worry about. In fact, one needs to look no further than the election of Kevin McCarthy as Speaker this January – which took 15 rounds of voting, the most since the US Civil War – to get a sense of the level of disfunction and disagreement in Washington. For these and other reasons, **we find the current showdown is perhaps most reminiscent of 2011 and 2013 in terms of both contentiousness and root cause**. As demonstrated below, those periods of political brinkmanship did produce several compressed periods of market weakness (last minute resolution and a subsequent sovereign downgrade by S&P resulted in high yield returns of -5.2% from late July to late August 2011, a period in which equity returns were twice as bad; high yield returns were -1.8% in the month preceding an announcement of the 2013 impasse "X-date" in late August 2013). However, markets would go on to stage rallies following both initial downturns.

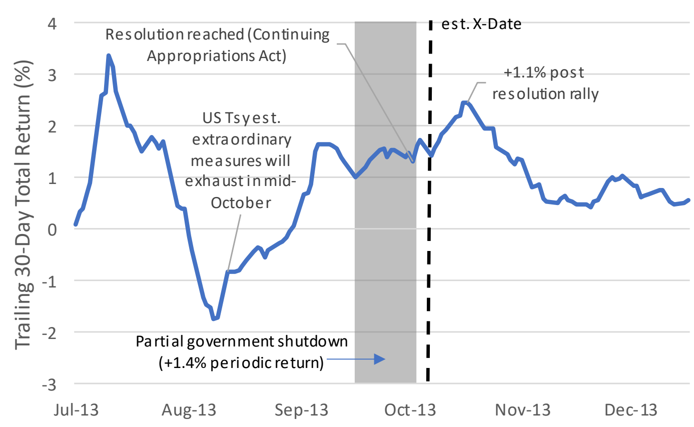
2011 Debt Ceiling Impasse Most Relevant to Current Situation

daily data



2013 Debt Ceiling Impasse Triggered Government Shutdown

daily data



Source: SKY Harbor, ICE Data Indices

A Waiting Game

Markets have historically operated in a composed manner in the lead-up to debt ceiling deadlines, primarily because policymakers have numerous tools at their disposal to avoid catastrophe, and also because some resolution has always been reached. But, as the saying goes, there's a first time for everything. The non-zero chance of failure (particularly given slim majorities in Congress and rising political polarization) in the context of significant downside should the US default on debt obligations, in our view, supports our more defensive portfolio setup. With that said, we could reduce our underweight to credit risk should a steep selloff materialize in the run-up to the early June "X-date," largely in anticipation of an eventual relief rally historically consistent with what has been triggered in the past.

Important Disclosures and Disclaimers