PENDLETON STREET
BUSINESS ADVISORS

Client Bulletin
Interim 2nd Quarter
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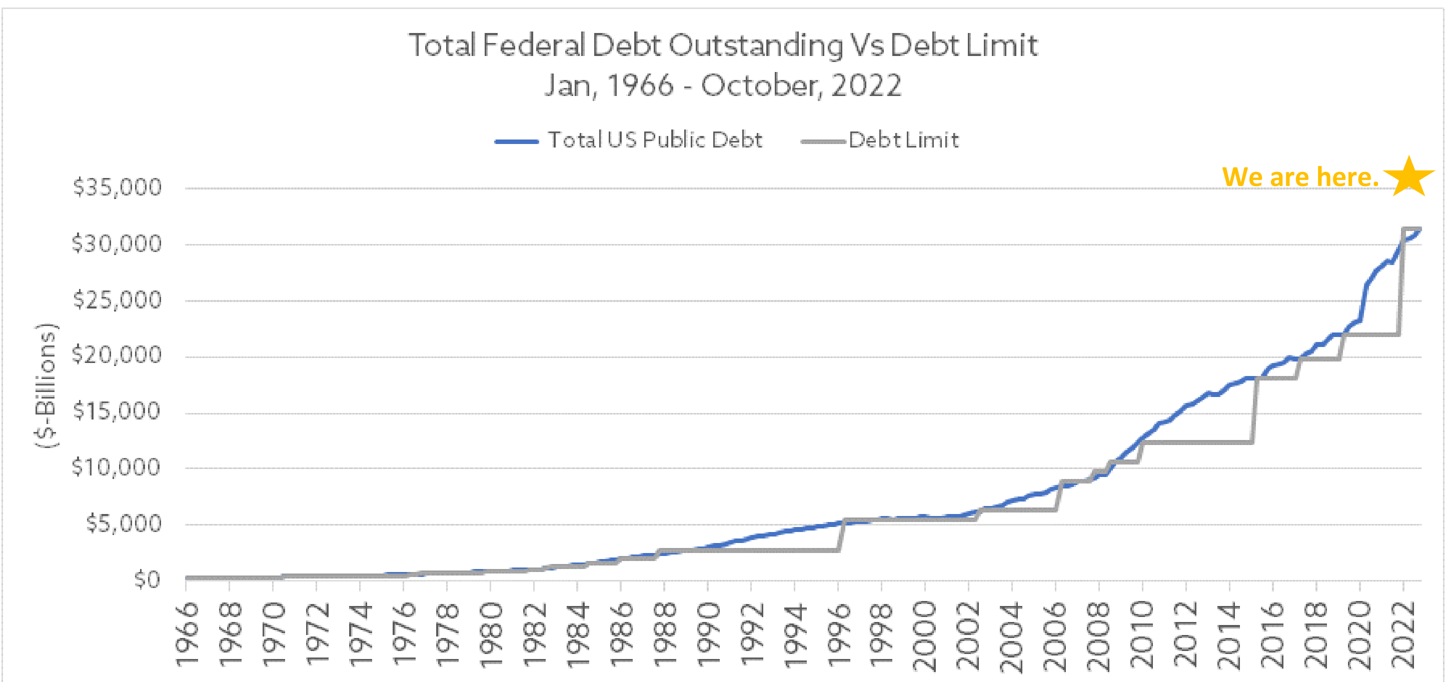
At our monthly Investment Committee meeting yesterday, most of our team's discussion revolved around the current debt ceiling debate in Congress. While we believe the likelihood of the issue going unresolved for much longer is low, there is growing concern in the markets that Congress will fail to reach agreement on the debt ceiling, which would lead to negative consequences including a default on US government bond interest payments for the first time in history. Below, we discuss why the debt ceiling matters to markets, where the situation currently stands, and how we are preparing for the worst in client portfolios. But first we cover what the debt ceiling is, and its purpose.

The Debt Ceiling – What is it and why does it matter?:



What is the debt ceiling?: The debt ceiling is a limit set by Congress on how much money the government is allowed to borrow – **currently, $31.4 Trillion**. It is important to remember that the debt ceiling applies to money that Congress has already voted to spend. **Raising the debt ceiling does not authorize new spending; it pays for spending that has already been authorized by Congress.**

While US debt has reached and exceeded the debt ceiling several times in the past, **the government has never failed to make an interest payment or raise the debt ceiling when required**.

How did we get here?: Simple. **The government spends more than it makes.** The only way to pay for spending over and above tax receipts and other forms of income is to borrow money in the form of US Treasury bonds. If the government reaches the debt ceiling, it means it has borrowed the maximum amount allowed. Until Congress raises the debt ceiling, the government cannot borrow any more money to pay its bills or meet its financial obligations.

What is the problem?: When the debt ceiling is reached, it creates a problem because the government still has to pay its bills, like salaries for government employees, interest on Treasury bonds, and other

expenses. **If it can't borrow more money, it may face a situation where it doesn't have enough money to cover all its obligations**.

What can be done?: To avoid defaulting on its debts and causing significant financial problems, the government has historically taken measures to keep functioning. These measures might include using existing funds from other areas or delaying payments. But, ultimately only Congress can provide a long-term solution.

Why haven't politicians fixed it yet?: The debt ceiling is a topic of debate and discussion among politicians because they need to decide whether to raise the limit or keep it the same. Some argue that raising the debt ceiling allows the government to pay its bills and avoid a financial crisis, while others are concerned about the long-term impact of too much borrowing on the economy.

But, worries about the debt ceiling extend beyond the government's inability to pay its employees and vendors. The impacts reach into the broader financial markets, too...

Why are financial markets worried about a default on US Treasury Bonds?:

- **Direct risk of default:** If the government reaches the debt ceiling and is unable to borrow more money to pay its bills, it faces the risk of defaulting on its financial obligations. This includes missing payments on Treasury bonds, which are considered safe investments. In fact, **US Treasury bonds are the benchmark risk-free rate across most of the financial markets**. Defaulting on these bonds would shake investor confidence and potentially disrupt financial markets. Investors may become hesitant to invest in government securities, leading to increased borrowing costs for the government and higher interest rates for consumers and businesses.
- **Credit rating and investor confidence:** The debt ceiling debate and the possibility of default can influence credit rating agencies' assessments of the government's creditworthiness. **A downgrade in the government's credit rating** would indicate higher risk, making it more expensive for the government to borrow money.
- **Impact on borrowing costs:** If the government faces difficulties in raising the debt ceiling, it may have to resort to extraordinary measures or temporary funding solutions, as mentioned earlier. These measures can disrupt financial markets and increase borrowing costs for the government. Higher borrowing costs can have a ripple effect on other borrowers, including businesses and individuals, as interest rates for various loans may rise.

Why are financial markets worried about investments other than US Treasury Bonds?

- **Systemic risk:** The debt ceiling debate and the potential for a government default can create systemic risk in the financial system. The US government plays a crucial role in providing stability to the economy, and any disruptions to its functioning can have far-reaching consequences. Financial institutions, including banks and investment firms, have interconnected relationships and exposures to government securities and other assets. A default or significant market turbulence triggered by the debt ceiling could impact the overall stability of the financial system.

- **Investor sentiment and risk aversion:** Financial markets are driven by investor sentiment and risk appetite. The uncertainty surrounding the debt ceiling can create anxiety and risk aversion among investors. In times of uncertainty, investors tend to become more cautious, potentially reducing their investments and reallocating their portfolios to safer assets. This shift in investor sentiment can lead to market volatility, impacting not only Treasury bonds but also other investments such as stocks, corporate bonds, and commodities.

- **Economic impact:** The debt ceiling and the potential for default or disruptions in government operations can have significant economic consequences. A government default or prolonged uncertainty can undermine consumer and business confidence, affecting spending, investment, and overall economic activity. Financial markets take into account these potential macroeconomic effects when assessing the risks and returns of various investments beyond Treasury bonds.

What is the situation, currently?

- **Debt Ceiling Negotiations:**

  - Treasury Secretary Yellen has revised her "deadline" for a deal to raise the debt ceiling to as early as **June 1st.** If no deal is reached then, it is assumed that the United States will not have funds available to pay obligations due at that time. This could also trigger a Treasury debt default if Treasury bill interest is due on that date.

  - Congressional negotiations and the President are locked in talks. President Biden is on a trip to Japan, but due back at the White House on Sunday, May 21st. Both sides' remarks over the past week have been constructive. **We believe that plodding progress is being made.**

  - **It's our view that any "default" would be technical in nature, very short lived**—yet damaging to the United States' standing on the world stage, and its pristine record of zero defaults in the modern era. Remember, **all of this would be caused by politics, NOT structural reasons in the way a business might default on a loan.**

- **Market Environment:**

  - We believe that if a Congressional resolution is reached prior to a deadline, markets will react very positively—and resume a trend that is beginning to form now that inflation seems to be abating, albeit not as quickly as desired. **Markets (stock & bond) are continuing to signal a belief that a resolution will be reached, and default avoided.**

  - As of this writing (Friday, May 19th) we still think there's a 65% chance that some type of Congressional compromise is reached before the deadline. Count on Congress to milk every ounce of drama out of this that they can. The next two weeks will be "sound bite heaven" for both parties. **Expect Oscar worthy grandstanding---rather than governing, aka, business as usual.**

- We're in the middle of 2nd quarter earnings season. CEOs are taking full advantage of the stomach acid inducing backdrop to lower expectations on earnings for the rest of 2023, which the markets seem to be taking in stride. Experience tells us this is one of the oldest tricks in the Fortune 500 C-suite bag of tricks: sandbagging on guidance for the future. We expect that earnings for US companies will continue to climb, maybe at a slower rate, but they will climb in this challenging interest rate/inflationary environment.
- As we meet with clients, some are expressing concerns about a looming economic recession. There's a lot of mixed data out there that makes it especially challenging to confirm objectively. The inverted Treasury yield curve is a reliable indicator, yet it's often "early"—by as much as 12 months. We've been in "inverted" territory since July of last year. But a red-hot employment market tells us that businesses are NOT slowing down on adding jobs—often the largest expense for a business.

What have we been doing in portfolios, and how are we preparing for a potential default on interest by the US government?

So far this year, actions in client portfolios have been related to initiating or cutting positions in individual stocks, along with our regular monthly rebalances. Additionally, earlier in the year we moved most cash balances into money market mutual funds yielding close to 5% on an annualized basis, rather than keeping them in regular sweep money market accounts that yield less than 1%.

As we head into the government funding deadline on or around June 1st, **cash in portfolios remains high relative to our target**. We think having some excess cash in portfolios is prudent heading into a period of increased uncertainty and potentially materially higher volatility. That said, portfolios remain invested, and we believe – barring a prolonged period of disagreement - any disruption caused by the debt ceiling situation will be short-lived and could provide great opportunities to pick up securities of high quality companies at low-quality prices.

Our primary concern has been understanding the risks to client cash investments in money market mutual funds. After researching the underlying mechanics of the funds and the securities they hold, we remain confident that money market mutual funds are a better place for short-term liquidity sitting in cash that yields relatively little. That said, we are monitoring developments very closely and we will communicate with you if and as soon as our view on cash and money market mutual funds changes.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. We appreciate your patience and we do not take your choice to be a client of the firm lightly. If you would like to discuss anything or schedule an in-person meeting, please contact us at your convenience. We look forward to hearing from you.

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