Truist Advisory Services, Inc.

The Washington brief *from the Investment Advisory Group*

U.S. debt default remains unlikely, but rocky road ahead for markets

March 6, 2023

For initial commentary on the debt ceiling, please refer to our [Special Commentary] dated January 19, 2023.

Executive Summary

- We view a U.S. federal debt default as unlikely, as we expect a debt ceiling extension with modest reforms will be enacted before the August recess.
- However, we anticipate a more prolonged political debate, rattling markets at times as the debt ceiling issue fully ripens in the summer.
- Though not a perfect guide, the 2011 U.S. debt downgrade was the last similar episode. During that period, equity investors turned increasingly defensive in the months leading up to the debt ceiling deal.
- Volatility was subsequently exacerbated by the downgrade of U.S. government debt. Moreover, industries with outsized exposure to government spending experienced heavier initial selling pressure as debt ceiling negotiations stalled.
- The 2011 flight-to-quality by investors impacted 10-year U.S. Treasury yields by more than 1% in the span of two months. Given our current expectations of contentiousness, the likelihood of a negative bond market reaction is increased as the deadline nears.

Background

The debt ceiling—sometimes referred to as the debt limit—is the self-imposed maximum amount of debt that the U.S. Treasury can issue. This borrowing finances government operations including Social Security and Medicare benefits, tax refunds, military salaries, and interest payments on outstanding national debt, among other things.

Changing the debt ceiling, which can be done by increasing the total amount of allowable debt or by suspending the debt ceiling for a period, requires a bill to pass Congress and be signed into law by the President.

Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents.

Explore further

On the following pages we expand on the debt ceiling debate:

- Current political posturing
- Equity and fixed income perspective
- Timeline of key events
- Unresolved questions that will shape the debate

TRUIST Wealth

Our take

We view a default on U.S. debt as unlikely. Yet, we also foresee the likelihood that a prolonged debt ceiling debate – and the potential for fiscal austerity – would rattle financial markets. Ultimately, while it will likely be a rocky road fraught with significant political peril, we expect a debt ceiling extension with modest reforms will be enacted before the August recess.

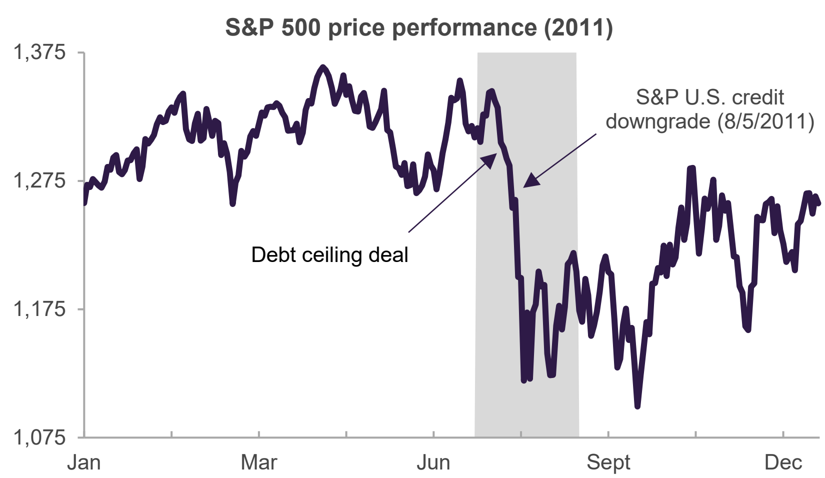
We anticipate that the debt ceiling issue fully ripens in the summer and that it will be addressed starting in the House in June. We also believe that the situation in the Senate will force the President to engage in some level of negotiations.

- In our view, moderate House Republicans don't want a default, though also want some spending reductions. For those reasons, they may not vote with Democrats in any early effort (perhaps in March/April) to pass a debt extension, instead keeping their options open in the event of timeline changes.
- Republican budget hawks will have difficulty advancing the most extreme cuts, and, while the President's budget will serve to keep parties together, will have to settle for fewer spending reductions than some Republican members would prefer.

Impact on equities from 2011 downgrade and austerity

While a U.S. debt default is unlikely in our view, we acknowledge the potential exists for more significant fiscal austerity (i.e., reduced government spending – either growth deceleration or spending cuts) should negotiations around the debt ceiling intensify.

Historically, uncertainty over future government spending has generally led to increased market volatility. In 2011, equities turned increasingly defensive in late July leading up to the announced debt ceiling deal on August 1. Market volatility was subsequently exacerbated by the August 5 downgrade of U.S. government debt by Standard & Poor's.



Data Source: Truist IAG, FactSet

Keep in mind, investor sentiment was also being weighed down by the ongoing European sovereign debt crisis. Thus, it's hard to quantify how much of the market pullback was related to the debt ceiling/government shutdown but it was certainly a significant factor.

During that period, industries with outsized exposure to government spending experienced heavier initial selling pressure as debt ceiling negotiations stalled.

- Defense, life science tools, and portions of technology with comparatively higher exposure to federally contracted services were among those industries negatively impacted.

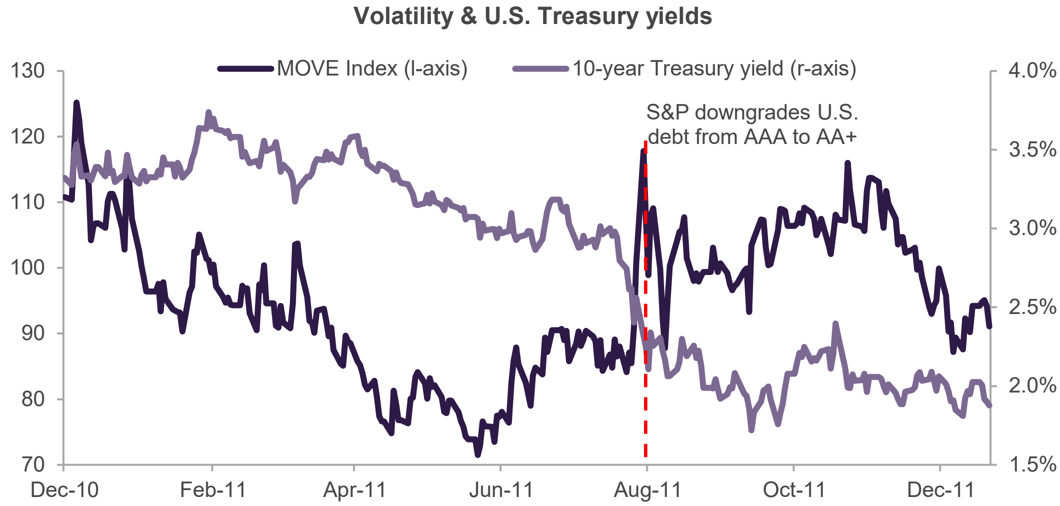
At the sector level, energy, industrials, financials, and materials experienced the heaviest selling pressure throughout the entirety of the risk-off period, while unsurprisingly, relative outperformers included consumer staples and utilities.

It should be noted that defense stocks have materially outperformed the S&P 500 over the past 12 months following Russia's initial invasion of Ukraine. Additionally, we view the current geopolitical environment as increasingly unstable relative to 2011. Military battles between Russia and Ukraine have intensified, and the potential exists for further deterioration of relations between the U.S. and China. **For these reasons, defense stocks may be comparatively better positioned relative to 2011**.

2011 impact on fixed income

As the 2011 debt ceiling deadline approached, there were heightened fears that Congress would fail to lift the limit and might default. Yet, the bond market reaction was decidedly split.

- Short-dated U.S. Treasury bill (T-Bill) yields rose by just 8 basis points (0.08%). With the Fed funds rate anchored around 0% at the time, the move in short rates was relatively muted.
- However, there was an outsized reaction in intermediate and long U.S. Treasury yields. Investors were unsettled by the evident dysfunction on Capitol Hill, casting doubt upon future government spending initiatives and economic growth.
- Additionally, the debt ceiling standoff contributed to global ratings agency S&P's decision to downgrade the U.S. federal government's credit rating from AAA to AA+ for the first time in history.
- The drama ignited a powerful flight-to-quality. Investors poured into longer-dated U.S. Treasuries, pushing the 10-year U.S. Treasury yield down by more than 1% in the span of two months. Rate volatility, as measured by the MOVE volatility index for fixed income, eased following the 11th hour agreement to raise the debt ceiling; however, U.S. Treasury yields remained low for months.
- **If the 2023 debt ceiling debate were similarly contentious, we'd expect a comparable bond market reaction as the deadline nears.**



Data Source: Truist IAG, Bloomberg. Past performance does not guarantee future results.

Timeline and unresolved questions to shape the debate

With the Republicans' slim control of the House of Representatives and President Biden and the Democrats' narrow one-seat majority in the Senate, the stage is set for the contentious debt ceiling drama. For now, the process will largely only involve House Speaker McCarthy and President Biden.

President Biden has repeatedly stated that he wants a "clean" debt ceiling extension as soon as possible, and that he will not allow the House Republicans to "take the economy hostage" via a default. Conversely, House Republicans want to address the debt and deficit together, using this as an opportunity to extract spending concessions.

Since neither side has the votes needed to achieve exactly what it wants, both parties are now in full political posturing mode in our view.

Timeline

1/19/23 – U.S. reaches debt ceiling; U.S. Treasury begins use of *extraordinary measures*, which are accounting maneuvers to continue funding operations. For instance, the Treasury can prioritize payments, such as interest payments, while temporarily deferring others, such as suspending investments in the Civil Service Retirement Fund or the Postal Service Retiree Health Benefits Fund, etc.

2/1/23 – President Joe Biden and House Speaker Kevin McCarthy hold first meeting on the debt ceiling; McCarthy announces afterwards: "no agreement, no promises, except that we will continue this conversation."

2/15/23 – A report by the Congressional Budget Office (CBO) estimates that the use of extraordinary measures will allow government to continue operations until July or September 2023 based on the CBO's projections of revenue collection and outlays.

Summer of 2023 – Extraordinary measures run out, the U.S. government no longer has capacity for short-term funding using bonds and will need to either address the debt ceiling or the United States begins missing payments on its obligations.

Key unresolved questions that will shape the debate

1. *Will the timeline hold? When does the money run out?*

   Tax receipts in April will greatly affect when extraordinary measures run out. Did 2022's stock market losses reduce the amount of tax owed by investors?

2. *Will Senate Democrats have enough votes so that President Biden does not have to negotiate concessions?*

   A couple of Democratic Senators are facing health questions that may prevent them from being able to vote. Other Senators have indicated, contrary to the President's stated wishes, that they want to negotiate with Republicans. With a one-seat majority, the balance of power can literally shift with absence or decision of a few senators.

3. *Will moderate House Republicans allow Speaker McCarthy time to negotiate, or will they support expedited legislative procedures?*

   There is a process to bring a vote on a clean debt ceiling bill as early as March. Will any Republicans choose to join with the Democrats in support of that vote?

4. *Will House Republican hard liners agree to a package that can get 218 votes?*

   The GOP has a wide variety of options with respect to spending cuts that it might advance as a part of this process. Is there a package that can win a majority of Republican votes? Will the GOP appoint a Debt Commission, use automatic spending cuts, or use some other tactic?

5. *Will Biden's budget make it harder or easier to resolve the debt ceiling?*

   Presidential budgets often include sweeping programs that appeal to the party's base. Will the size, scope and direction of President Biden's budget motivate Republicans to move forward and resolve the debt issue, or will it initiate a political fight?

6. *Can Speaker McCarthy develop/control a process that keeps his team together?*

   In the past, House leadership has closely controlled these kinds of negotiations. Yet, it was those same sorts of strategies that led to the problems that prolonged McCarthy's race to become Speaker earlier this year. He has promised that his entire caucus would participate in developing the House Republican package. Can that many cooks successfully stir the pot?

7. *Are there unexpected economic or geopolitical blips that will influence the process?*

   The current debt ceiling talks are taking place against the backdrop of an uncertain economy and heightened geopolitical tensions in Europe and Asia. An economic or geopolitical crisis could unite our country politically and force Congress toward greater bipartisanship on matters related to national security, including raising the debt ceiling, funding critical government programs, and maintaining the nation's full faith and credit.

We look forward to updating you on views as the debt ceiling debate unfolds.

Disclosures

Advisory managed account programs entail risks, including possible loss of principal and may not be suitable for all investors. Please speak to your advisor to request a firm brochure which includes program details, including risks, fees and expenses.

Truist Wealth is a name used by Truist Financial Corporation. Banking products and services, including loans, deposit accounts, trust and investment management services provided by Truist Bank, Member FDIC. Securities, brokerage accounts, insurance/annuities offered by Truist Investment Services, Inc. member FINRA, SIPC, and a licensed insurance agency where applicable. Life insurance products offered by referral to Truist Insurance Holdings, Inc. and affiliates. Investment advisory services offered by Truist Advisory Services, Inc., Sterling Capital Management, LLC, and affiliated SEC registered investment advisers. Sterling Capital Funds advised by Sterling Capital Management, LLC. While this information is believed to be accurate, Truist Financial Corporation, including its affiliates, does not guarantee the accuracy, completeness or timeliness of, or otherwise endorse these analyses or market data.

The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Truist Financial Corporation makes no representation or guarantee as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. The information contained herein does not purport to be a complete analysis of any security, company, or industry involved. This material is not to be construed as an offer to sell or a solicitation of an offer to buy any security.

Opinions and information expressed herein are subject to change without notice. TIS and/or its affiliates, including your Advisor, may have issued materials that are inconsistent with or may reach different conclusions than those represented in this commentary, and all opinions and information are believed to be reflective of judgments and opinions as of the date that material was originally published. TIS is under no obligation to ensure that other materials are brought to the attention of any recipient of this commentary.

Comments regarding tax implications are informational only. Truist and its representatives do not provide tax or legal advice. You should consult your individual tax or legal professional before taking any action that may have tax or legal consequences.

Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance.

TIS/TAS shall accept no liability for any loss arising from the use of this material, nor shall TIS/TAS treat any recipient of this material as a customer or client simply by virtue of the receipt of this material.

The information herein is for persons residing in the United States of America only and is not intended for any person in any other jurisdiction. Investors may be prohibited in certain states from purchasing some over-the-counter securities mentioned herein.

The information contained in this material is produced and copyrighted by Truist Financial Corporation and any unauthorized use, duplication, redistribution or disclosure is prohibited by law.

TIS/TAS's officers, employees, agents and/or affiliates may have positions in securities, options, rights, or warrants mentioned or discussed in this material.

Asset classes are represented by the following indexes. An investment cannot be made directly into an index.

S&P 500 Index is comprised of 500 widely held securities considered to be representative of the stock market in general.

CN 5497506.1