The debt ceiling is once again front and center for financial markets.

The U.S. government is expected to hit its legal $31.4 trillion debt limit soon, potentially as early as June 1. From there, the Treasury (effectively the government’s chief financial officer) is expected to use “extraordinary measures” to help the government continue to pay its obligations.

But let’s take a step back and address the fundamentals.

1) What Is the Debt Ceiling?
The debt ceiling is a legal limit on the borrowing ability of the U.S. government. At present, total public debt cannot rise above $31.4 trillion, an amount set by Congress in a bill passed in December 2021.

Everyone has bills to pay, including the U.S. government. To meet its obligations (which include paying military salaries, retirement benefits, interest on national debt, etc.), the Treasury sells bonds (i.e., issues new debt) to investors across the globe. Because the United States government generally runs budget deficits (i.e., it spends more than it collects in tax revenue), the debt ceiling needs to be periodically raised to accommodate additional borrowing, and the national debt rises.

Historically, raising the debt ceiling is a common practice. Since 1959, the debt ceiling has been raised 89 times.

2) What Happens Next?
Once the debt ceiling is hit, the Treasury will run down its cash balance at the Federal Reserve and use “extraordinary measures” to keep expenditures flowing. That runway is broadly estimated to last until early June.

3) What Are “Extraordinary Measures?”
When the amount of debt outstanding hits the debt limit, you might think it would quickly produce a hard deadline to act upon. With a binding debt ceiling in place, the Treasury would face a situation where it would not have enough funds to meet all its obligations on time.

This is where “extraordinary measures” come into play. When Congress fails to lift the debt limit, the Treasury utilizes a set of “extraordinary measures” to temporarily keep the government under the borrowing limit, primarily by halting investments in select government funds.
By halting these investments, headroom is created under the debt cap, permitting the Treasury to borrow more from the public.

4) What Happens if the Government Defaults?
If no resolution is met (i.e., Congress does not suspend or raise the limit), the Treasury would likely prioritize paying its debt obligations, while curbing discretionary expenditures. The outcome can't be handicapped with certainty, but the fallout would likely be a challenging economic environment and more volatility in financial markets. While alarming, it's worth noting a debt ceiling compromise has been reached 89 times since 1959. History would indicate a U.S. default is highly unlikely.

5) What Should Investors Do?
Many financial arguments can be distilled down to people with different time horizons talking over each other.

Does the debt ceiling matter for investors? Well, it depends.

If your time horizon is six months, the debt ceiling could represent a major event and be a swing factor in the market's direction between now and year-end.

If your time horizon is multi-year or longer, you can take solace in 89 other historical instances of debt ceilings being mere footnotes in financial market history.

Focus on your long-term investment plan, and plan accordingly for potential short-term bumpiness. III

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