Vanguard

Vanguard insights

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What the proposed debt ceiling deal means for investors

Introduction

The White House and the House speaker have reached a bipartisan agreement that would raise the government's $31.4 trillion debt ceiling for two years. The House and the Senate are expected to vote this week on legislation ratifying the deal. If approved, the legislation would go to President Biden to be signed into law prior to the June 5 deadline, which is when the U.S. Treasury Department has indicated it would no longer be able to finance all government operations.

In light of the agreement, investors may be wondering how they should respond now that lawmakers appear to be on a path to resolution. We are pleased that resolution appears likely because failure to raise the debt ceiling would increase market volatility and damage U.S. credibility. But our advice to investors is simple and hasn't changed—maintain a long-term perspective.

Avoiding the effects of a default

Coming this close to missing the deadline to raise the debt ceiling before the U.S. Treasury could no longer finance government operations is certainly not good news. Nevertheless, markets and investors can breathe a sigh of relief if a deal gets across the finish line.

The most serious impact of failing to ratify the deal would be a default by the U.S. government. This would happen if the U.S. Treasury delayed interest or principal payments on Treasury securities. A "technical defaeult" would occur if the Treasury failed to make payments when due on its noninterest obligations, such as to government contractors or to recipients of entitlements such as Social Security.

A default would damage U.S. credibility. The United States would no longer be able to fully reap the benefits—notably, financing on the best possible terms—bestowed on the most reliable debtors. The government's own financing costs, borne by taxpayers, would increase. And since broader borrowing costs are pegged to Treasuries, interest rates would also likely rise for businesses, homeowners, and consumers.

Failure to approve a deal and raise the debt ceiling would also pressure stocks because higher rates would make companies' future cash flows less predictable. Spillover effects for global markets and economies would be likely. Such developments, occurring at a time when global recessionary risks are already increasing, make averting such a scenario even more crucial.

How investors should respond to the news

Headlines about the debt ceiling and other short-term events can be unsettling for markets, the economy, and investors. But it's important to remember that volatility moves in both directions—up as well as down—and that markets are efficient at processing news. Markets don't like uncertainty, but they are also forward-looking.

A long-term perspective for investors is critical in any market environment but especially in unsettled ones. Market-timing is incredibly challenging, because the best and worst performance days often happen close to each other. In many cases, timing the market for reentry simply results in selling low and buying high.

Throughout the debt ceiling negotiations, we have reassured investors and counseled them to focus on the things they can control, such as:

- Having clear, appropriate goals.
- Having an appropriate mix of assets to achieve those goals.
- Keeping investing costs low.
- Maintaining discipline in a well-considered investment plan.

And our advice to investors has not changed because of the deal that is about to go before Congress for approval. A long-term agreement to raise the debt ceiling is welcome news for the economy and markets. Failure to resolve the impasse could cause much more uncertainty, market volatility, and damage to U.S. credibility. But the debate should have little impact on your well-structured investment plan, which should maintain a long-term perspective and ignore short-term events.

Exchange Rates

- Vanguard leaders on the possibility of a U.S. debt default (audiocast, issued May 2023)
- What investors should know about the debt ceiling (article, issued May 2023)
- Vanguard's principles for investing success (research paper, issued June 2020)

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