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Expert's opinion

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How investors should respond to the debt ceiling talks

Commentary by: Greg Davis, Vanguard Chief Investment Officer

Introduction

As Congress and the White House continue to negotiate on raising the debt ceiling, investors are asking how they should respond if lawmakers fail to reach a deal. It's best to stay the course by maintaining a long-term perspective and sticking with your investment plan.

A potential default's impact on markets and the economy

The most obvious impact of a failure to agree on raising the debt limit is that it could lead to a default. This would happen if the U.S. Treasury delayed interest or principal payments on Treasury securities. A technical default would occur if the Treasury failed to make payments when due on its non-interest obligations, such as to government contractors or to recipients of entitlements such as Social Security.

A default would be unprecedented and would likely have significant global market and economic repercussions. The greatest one would be damage to U.S. credibility. We caught a glimpse of this in 2011 during a previous debt ceiling debate when Standard and Poor's, a major ratings agency, downgraded its U.S. credit rating, citing among other things a diminished "predictability of American policymaking."

But should the United States default, it 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, could increase. And since broader borrowing costs are pegged to Treasuries, interest rates would likely also rise for businesses, homeowners, and consumers.

Stocks would probably be pressured as higher rates made companies' future cash flows less predictable. Spillover effects to 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 important.

To be clear, we don't doubt for a minute the government's ultimate ability to pay its obligations. Our assessment of the minimal credit risk posed by the United States is supported by its strong economic fundamentals, excellent market access and financing flexibility, and favorable long-term prospects, along with the dollar's status as a global reserve currency.

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How should investors prepare for a potential U.S. debt default?

Investors should be prepared for potentially significant market volatility, both as the deadline for Congress to raise the debt limit approaches and in the event of a default. They should have a plan they can stick with for the long term. Maintaining discipline can be challenging during extended periods of volatility, but that's when it's most important. Investors should consider how they might respond in the face of a market event that could cause their investments to drop in value, making sure they have the appropriate liquidity they might need to avoid having to sell securities. Such a gut check is meant to ward off any inclination to panic and sell, potentially at market lows, in such circumstances.

Having the discipline to stick to a well-considered investment plan is a hallmark of Vanguard's principles for investing success. These principles can be especially useful in times of uncertainty such as this. While it is important to stay abreast of current events, we believe investors should focus on what they can control:

- Have clear, appropriate goals.
- Have an appropriate mix of assets to achieve those goals.
- Keep investing costs low.
- Maintain discipline in a well-considered investment plan.

Investors should also consider the following:

- Costs matter more than ever. When markets are weak and investment returns are low, fees account for a larger share of those returns. Minimizing costs can contribute to stronger investment performance over the long term.
- Time in the markets is much better for a portfolio than market timing. In uncertain situations, it is important to be patient and to stick to your long-term investment strategy. A long-term perspective is critical. Market timing is incredibly challenging, as the best and worst performance days often happen close to one another. In many cases, timing the market for re-entry simply results in selling low and buying high.

The course of events will depend largely on how long any policymaking impasse may endure. We hope its resolution doesn't occur so late in the process that it inflicts damage on the U.S. economy. But what's most important for investors is to focus on what they can control and stick with their long-term investment plan.

Related resources:

- What you should know about the debt ceiling (article, issued May 2023)
- Vanguard's principles for investing success

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