Dear Clients and Friends:

OCEAN HEIGHTS
ADVISORS

The debt ceiling issue is in the headlines everywhere, with mentions of potentially dire consequences for the economy and financial markets should it not be resolved successfully.

Given client questions, we share below our thoughts on this matter, knowing that the facts on the ground could change substantially between this writing (Thursday, May 25th) and its receipt by readers. Rest assured that we are actively following all developments and the potential outcomes.

What is the debt-ceiling issue all about?

While virtually all countries have a process for determining government spending, the U.S. is largely unique in layering on to its budgeting process a requirement that spending not result in a debt level exceeding an authorized limit. This requirement has created an opportunity for a minority party to threaten a default on the federal debt in order to extract budget concessions from the other party which we have seen a handful of times in the past decade and half. In general, the debt ceiling contests and their implications have been much more about politics than economics.

Absent additional borrowing, U.S. federal spending will exceed the debt limit by sometime in early June, with the exact date unclear. No agreement has yet been reached despite intense negotiations. The planned Memorial Day recess for the GOP-controlled House and the time needed for drafting of any agreement and allowing legislators to approve it mean that the time available to head off potential negative consequences is short. As of this writing Thurs-day evening, it has been reported that while the House and Senate are officially on recess for Memorial Day weekend, House members have been put on notice that they should be prepared to return to Washington D.C. with 24 hours' notice.

How will this be resolved?

The U.S has gone through this drama multiple times. In every case there has been a last-minute agreement that averted a debt default. There is little question in our minds or in those of other credible observers, that such will occur this time.

The most likely path is that the Biden administration and GOP negotiators will agree to a debt expansion with a limit on forward spending, and with some additional concessions by the ad-ministration. If an agreement is close but not concluded in a timeframe consistent with dead-lines, the parties would likely agree to a short extension of the debt limit.

What is the likely impact on financial markets?

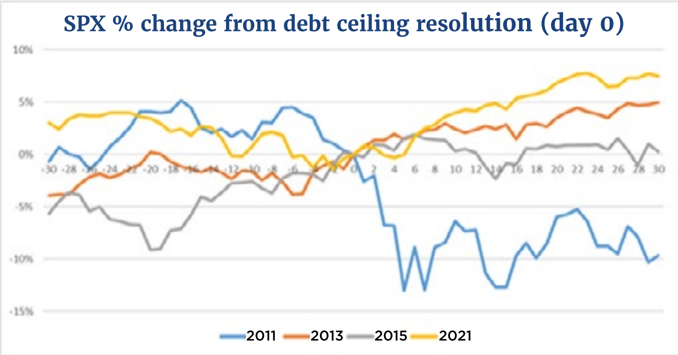
To date, equity markets have been resilient in the face of the debt ceiling drama. While mov-ing in response to data on corporate earnings, interest rates and the economy, markets have moved only negligibly in response to the ups and downs of the debt-ceiling negotiations. We would not be surprised to see some near-term wobbles in the market, followed by a retrace-ment once the situation is resolved but it is impossible to time or predict such short-term movements in equity markets. Short-term debt markets have seen more significant effects, with one-month treasury rates rising substantially in the past month.

We agree that the range of economic outcomes from no debt ceiling expansion includes the catastrophic as some observers have warned. However, the impact of the expected outcomes is much less dire as neither party would likely avoid the blame that would come their way from a "no agreement" scenario.

We expect that any spending limits to which the Administration and Congress would agree would have no more than a modest impact on the economy. After all the only spending that is really on the table is discretionary spending less entitlement spending. While there are some politically charged areas of spending in this category, there aren't enough dollars to change the economic outlook.

How should investors respond to this issue?

For long-term equity and fixed income investors we do not believe the current short-term envi-ronment warrants a shift in portfolio strategy. Using the prior debt ceiling brinkmanship agreements as an example, equity market returns following a debt ceiling agreement have been far more dependent on the overall economic environment and corporate earnings. The chart below shows how markets have responded to the previous four debt ceiling agreements, with no consistent pattern discernible.



Source : PIMCO

Conclusion:

While we expect some loud media noise in the coming days, we remain confident that the most probable outcome is a resolution before any major impact from a default, with a lower likelihood of a short-term extension. We are monitoring incoming information from our part-ner firms with contacts in Washington D.C. and our research providers. We recommend tuning out the hyperbolic rhetoric that may emit from either the political factions or the media. No agreement will make everyone happy, nor will it derail the economy.