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COMMENTARY

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Another Market Risk Potentially Avoided

- An in-principal agreement to raise the debt ceiling has been reached.
- Though there is optimism, the deal faces a tortuous process before Wednesday's vote.
- One market headwind has been potentially averted, but others persist.

This weekend, President Biden and House Speaker Kevin McCarthy reached an in-principal agreement to raise the debt ceiling until January 2025. Failure to reach an agreement before the Treasury Department's June 5th deadline could have triggered an unprecedented default on U.S. government debt and cascaded problems throughout global markets. Though the deal is not official until it moves to Congress for a likely Wednesday vote, one significant headwind to global financial markets has seemingly been averted. With that said, other worries such as an aggressive Federal Reserve (Fed), the looming threat of a recession, and a likely slowdown in corporate earnings remain of concern.

As a reminder, the debt ceiling is simply the maximum amount of debt the U.S. government is authorized to borrow by law. While Congress already authorized spending commitments, the U.S. government is spending more than it receives in tax revenues, creating a budget deficit. The government needs to issue more debt (Treasury bonds), to pay for this deficit, but the maximum amount of debt written into law had been reached. If approved by Congress, the debt ceiling agreement raises this borrowing limit. As with all of Washington, this deal needed compromise from both parties. Though final details will likely change a bit, the agreement holds non-military discretionary spending flat for fiscal 2024 and sets a 1% cap on spending increases in fiscal 2025, IRS funding would be cut by around $20 billion, possibly clawing back unspent COVID-19 aid, and tightening work requirements for federal aid. While optimism persists that both chambers of Congress will ratify this agreement at the expected Wednesday vote, it is not official and faces a tortuous process that may see opposition from special interest groups or non-centrist members in both political parties. With that said, we expect financial markets to perform well as one near-term market headline seems to have been lessened, though other ones that we have been concerned about remain.

Coming into 2023, we laid out a market scenario that investor concerns would lead to a possibly weak first half in equities followed by a better second half. Headwinds that we pointed to, and still persist today, include an aggressive Fed that has raised interest rates at an unprecedented pace and has a resultant impact on the domestic economy. Because it generally takes about 12-15 months to feel the full effect of a Fed rate hike, it is likely our economy is still headed toward a recession. Keep in mind that the expected decrease in government spending from the in-principal agreement could further slow the economy already burdened by higher interest rates and reduced access to credit. Another concern is the fallout of these higher rates and potential recession on corporate profit margins and overall profits. Since peaking in June of 2022, both have declined on slower sales volumes and higher borrowing costs, with earnings growth of the S&P 500 down about 13%. Since a recession usually sees an average earnings decline closer to 20%, the impact on earnings has likely not been fully felt. Given this uncertainty around the Fed, a potential recession, and weaker corporate earnings, current valuations do not reflect properly. With the price-earnings ratio (P/E) of 18.4 on 12-month forward earnings for the S&P 500, well above the 20-year average of close to 16, valuations are too optimistic in our opinion. Valuations are elevated since investors are too optimistic that inflation is slowing quickly, but we are concerned that investors are not pessimistic about the causes – aggressive Fed, slowing economic growth, and weakening corporate profits.

Equity markets have ignored the headwinds that they have faced in 2023. Over the weekend, with an in-principal debt agreement between democrats and republicans reached, equity markets have seemingly dodged another potential headwind. Despite positive news, we remain cautious towards equities as we enter a potentially volatile financial market period. Increased Fed uncertainty combined with below-trend economic growth will likely lead to sharp market fluctuations. To mitigate the risk of volatility, we remain committed to increased diversification. Please continue working with your financial professional to help you align your portfolio with your long-term investment objectives. It is easy to get distracted by the noise and sensational headlines. Creating a financial plan that you can monitor and follow helps to avoid the distractions and to stay focused on what you can control.

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