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SUMMARY

- RiverFront places a high probability on a debt ceiling 'solution', whether an actual deal or a temporary suspension.
- Even in a US technical default, the Fed and Treasury have measures they can take to mitigate a lasting default scenario.
- Our risk management process allows us to be nimble with regard to portfolio construction, should our probabilities of default significantly deteriorate.

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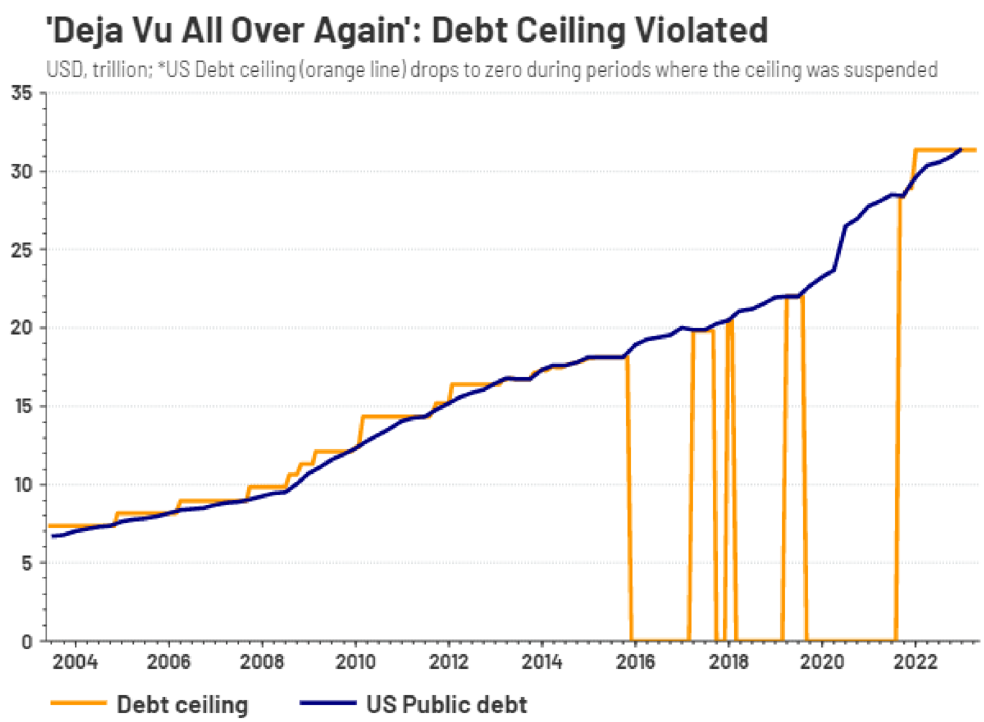
Debt Ceiling Déjà Vu:

We Anticipate Another Increase in the Debt Ceiling

"It's like déjà vu, all over again!" – baseball legend Yogi Berra

Americans find themselves at the precipice of another US government default, due to political disagreements around the self-imposed debt limit. If this scenario seems familiar, that's probably because it's happened before. A lot. According to the US Treasury, since 1960 Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the 'debt ceiling,' a limit imposed by Congress on the amount of debt that the U.S. Federal government can have outstanding. This includes seven extensions (i.e., 'kicking the can' to a later negotiation) during the Obama and Trump presidencies alone (see chart below, orange vertical lines). The most memorable recent debt 'debacle' was in 2011, when the impasse was resolved by raising the ceiling only 2 days before the 'X-Date' – the date the money runs out.



Source: Refinitiv Datastream, RiverFront. US public debt data quarterly. Data as of December 30, 2022. Chart shown for illustrative purposes.

Highest Probability Outcome: Congress 'Kicks the Can' to a Later Date

Despite all this drama, the US has never actually failed lastingly to make principal or interest payments on its debt. In our view, the highest probability outcome this time is a 'déjà vu' scenario, with our policymakers once again either squeaking out a ceiling raise compromise in the 11th hour before the X-date (which Treasury officials have said is likely to be in early June) or a 'kick the can' temporary suspension of the ceiling until at least the fall. **RiverFront's investment team places a roughly 90% probability of a near-term 'solution', whether a temporary suspension of the ceiling or an actual deal.**

At the end of day, we think politicians of all persuasions are in the self-preservation business, and for them there's little upside to being branded as the policymakers who caused a delay in Social Security or Medicare payments or caused a rating agency to downgrade US debt on their watch… especially with a Presidential election cycle starting next year.

Public Negotiation 101: Prepare for Scare Tactics and Brinksmanship

In many ways, 2011 is a useful analog for today: both feature a Democratic President with a divided Congress, combined with an uncertain economic outlook and a cyclical bear market in stocks. In 2011, the issue was resolved by an 11th-hour compromise with a $2.1T increase in the ceiling. This increase was offset by more than $900B in deficit reduction measures with a mandate to find more savings in order to avoid sequestration (automatic spending cuts via the withdrawal of certain government programs).

But will this time be different? We believe US politics are more fractured today than in 2011. **This slightly increases the probability of default, in our opinion, from tiny to merely low (<10%).** The US economy is in a different place today as well, with inflation debt-to-GDP much higher than in '11…perhaps increasing the economic fallout in a default scenario, and potentially limiting the Fed's ability to help offset it via lowering interest rates. However, some things don't change…including tactics during a highly public political negotiation. These include scare tactics and brinksmanship, with supposed 'hard lines' drawn by both sides.

While debt ceiling negotiations are likely to remain heated right up until the 11th hour, it is important to recognize that this is a negotiation, and classic public negotiation tactics should be expected. We would expect both sides to take an extreme initial position, emphasize the 'sense of urgency', magnify the consequences of not getting their way and occasionally 'walk away from the table' to make a point. The intense spotlight also presents an opportunity for those at the political extremes to have a 'soapbox' for their own agendas, which may not be reflective of either party's negotiating objectives. While some statements regarding the state of the negotiations may be accurate, we also recognize the incentives and take these with a grain of salt.

To Think the Unthinkable: What Might Happen in a Default Scenario?

First, we'd like to discuss the type of technical default we'd likely experience in a country with the size and economic prowess of America, in comparison to the historical precedent of defaults in small, less productive emerging market countries. While a US technical default would be embarrassing and costly, we find it hard to believe that a country with the world's largest economy and reserve currency will stay in technical default for very long.

But since US default has never happened before, it's hard to say definitively what it would look like. Several things would likely happen in short order…none of them positive. This likely includes immediate credit downgrades, more tightening of liquidity and monetary conditions, leading to a much higher probability of an extended economic downturn. We would expect US dollar weakness along with elevated volatility in risk assets such as stocks. In 2011, the S&P 500 had a peak-to-trough drawdown of close to 20% before rebounding relatively quickly as a solution was reached. Interestingly, US government bond yields actually fell throughout this debacle, with 10-year Treasuries ironically assuming their classic flight-to-quality characteristics despite the 'full faith and credit' of the US government theoretically at risk. We think this episode speaks volumes about the differences between an emerging market default and what the US's might look like.

Even in a technical default, the Treasury and Fed have some tools at their disposal to make sure foreign creditors, Social Security benefactors and others are not permanently impacted. For instance, according to a Wall Street Journal article, Fed Chair Jay Powell is on record back in 2013 suggesting that the Fed could buy back Treasuries at risk of default or allow banks to pledge defaulted Treasuries to the central bank to be made whole. There are other potential stop-gap measures, including possible Constitutional remedies, coin printing, delay of principal payments, and others. None of them are optimal, and some of them may have questionable legality. Treasury and Fed officials have been understandably vague about these, preferring a political solution to what in essence is a political problem.

Message of the Stock and Credit Markets Remain Constructive

Recent headlines have suggested some progress. Speaker of the House Kevin McCarthy managed to get a bill passed in the House that represents a concrete starting point for a counter by President Biden, who has cut his current trip to Asia short to focus on debt negotiations. If both parties can get close enough in principle to a compromise to agree to a temporary ceiling extension, a deal to raise the ceiling doesn't have to be immediately signed. Such an extension, perhaps until fall or early 2024, would allow some breathing room for both sides to fine-tune and then ultimately present the final resolution as a 'win' to their constituency. Over the weekend, Biden and McCarthy talked via phone and struck an optimistic tone but still appear far apart, with talks in person resuming on Monday.

The stock and corporate bond markets have remained resolute in the face of this uncertainty, with relatively tight credit spreads and the S&P 500 trading near multi-month highs, well above the psychologically important 4,000 level. We believe this is due to a Fed on the brink of pausing rate hikes, solid employment and retail spending trends, and a Q1 earnings season that highlighted the resilience of the consumer and Corporate America's pricing power. RiverFront's investment team believes in the 'message of markets', and thus views market strength as one sign that the probability of debt ceiling-induced market dislocation is low.

Conclusions:

- RiverFront's investment team places a high probability that the debt ceiling debacle will be averted at the last second, most likely with a temporary suspension to allow both sides longer to negotiate a more lasting solution.
- Even in a US 'technical' default, the Fed and Treasury have measures they can take to avoid a lasting default scenario. However, in any default situation, the US and global economies' growth prospects will be damaged, in our view.
- Given the uncertain backdrop, RiverFront's balanced portfolios are currently focused on security selection and yield generation, rather than making large allocation shifts relative to our policy benchmarks.
- Our investment team motto is 'Process Over Prediction'; our process is to reassess our views as new information comes in and act accordingly, if necessary. Should our internal view of default risks increase significantly, our risk management process allows us to be nimble with regard to portfolio construction.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

The debt ceiling is the maximum amount of money that the United States can borrow cumulatively by issuing bonds. The debt ceiling was created under the Second Liberty Bond Act of 1917 and is also known as the debt limit or statutory debt limit.

The U.S. Treasury, created in 1789, is the government department responsible for issuing all Treasury bonds, notes, and bills. Among the government departments operating under the U.S. Treasury umbrella are the Internal Revenue Service (IRS), the U.S. Mint, the Bureau of the Fiscal Service, and the Alcohol and Tobacco Tax and Trade Bureau.

The Federal Reserve System (FRS) is the central bank of the United States. Often simply called the Fed, it is arguably the most powerful financial institution in the world. It was founded to provide the country with a safe, flexible, and stable monetary and financial system. The Fed has a board that is comprised of seven members. There are also 12 Federal Reserve banks with their own presidents that represent a separate district.

A bear market is when a market experiences prolonged price declines. It typically describes a condition in which securities prices fall 20% or more from recent highs amid widespread pessimism and negative investor sentiment.

Brinkmanship is a negotiating technique where one party aggressively pursues a set of terms so that the other party must either agree or disengage. Brinkmanship (or "brinkpersonship," or less commonly, "brinksmanship") is so named because one party pushes the other to the "brink" or edge of what that party is willing to accommodate.

A technical default is a deficiency in a loan agreement that arises from a failure to uphold an aspect of the loan terms (other than the regularly scheduled payments). Technical default indicates that the borrower may be in financial trouble, and may trigger an increase in a loan's interest rate, foreclosure, or other negative events.

Treasury Bills are loans to the federal government that mature at terms ranging from a few days to 52 weeks. A Treasury Note matures in two to 10 years, while a Treasury Bond matures in 20 or 30 years. The 10-year Treasury yield is closely watched as an indicator of broader investor confidence. Because Treasury bills, notes, and bonds carry the full backing of the U.S. government, they are viewed as one of the safest investments.

Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. This type of sensitivity must be taken into account when selecting a bond or other fixed-income instrument the investor may sell in the secondary market. Interest rate sensitivity affects buying as well as selling.

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