PRIVATE CLIENT SOLUTIONS

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Insights & Strategies

The Debt Ceiling: Tempest in a Teapot?

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The Debt Ceiling: Tempest in a Teapot?

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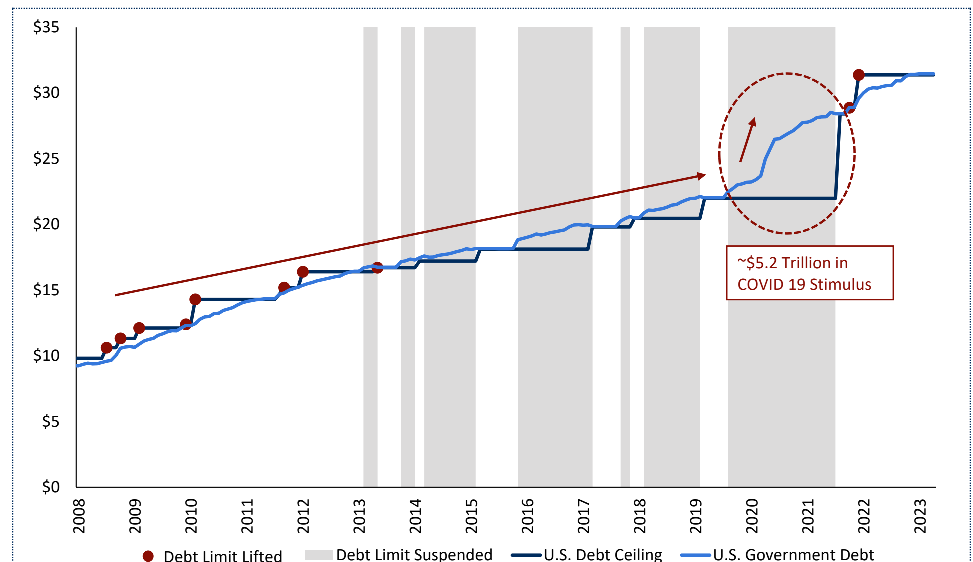
It's difficult to get through an hour of business (or political) news lately without hearing about the U.S. debt ceiling. While the prospect of the U.S. government running out of cash to repay lenders and make other payments would obviously be a dire and globally impactful event, it would also be an entirely self-inflicted wound. Negotiations are not about if the debt ceiling should be raised, but rather what type of spending constraints the government should be subject to over the next few years and revisions to some previous programs and initiatives. As such, we expect the two sides of the House to reach a compromise and raise the debt ceiling before any significant harm falls on the U.S. (and the global) economy, and importantly, before voters endure any material hardship that might impact their support for their respective elected representatives.

The most recent comments from Treasury Secretary Janet Yellen suggest June 5 as the deadline to effect the ceiling increase. With a tentative deal seemingly moving to both houses of Congresses for approval, by the time this report is published on June 1, the deal may be reached or there may be a temporary solution to continue paying bills for a short period while details on a more permanent deal are hammered out. Irrespective of these outcomes, it is worth noting why the U.S. seems to be going through this process on an almost annual basis and why investors should try to cut through this type of noise and remain committed to well-established long-term investment plans.

How Did We Get Here?

Perhaps a quick history lesson could be useful at this point. In 1917, Congress enacted the Second Liberty Bond Act, which set a limit on how much the U.S. Treasury could borrow. Prior to that, each bond issuance had to be approved with a legislative act. Since then, the debt limit has been increased over 90 times, including 78 times since 1960, or roughly once a year or so, as the country's borrowing needs grew. Most occurred without much fanfare, but with remarkable flair a few times in the recent past.

U.S. Government Debt Is About to Hit Its Limit for the 79th Time Since 1960



Source: Bipartisan Policy Centre; FactSet; Raymond James Ltd.; Data as of April 30, 2023, in trillions of U.S. dollars.

What Is the Comparison to 2011 and 2013?

In 2011, similarly to 2023, Republicans refused to approve a debt limit increase without concessions on government spending. A bitter bipartisan negotiation ensued, with an agreement coming only hours before the deadline. In 2013, a deal was struck with just one day to spare. The 2011 event was so dramatic that it prompted S&P, one of the top rating agencies, to lower the credit rating of the United States from AAA to AA+. Now, in 2023, another agency, Fitch Ratings, has warned of a potentially similar move.

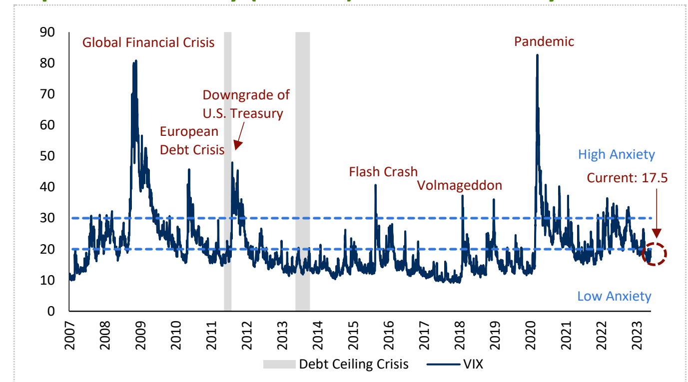
What Would Happen Without a Deal?

The question has not really been if they would reach a deal, but rather how close to the wire negotiations run. Even if discussions run past the dreaded x-date, the Treasury can still employ "extraordinary measures" to keep cash flowing for the short term. Suspending the ceiling, functionally allowing the Treasury to exceed its debt limit, has actually been invoked seven times in the last 10 years.

How Have Markets Reacted So Far?

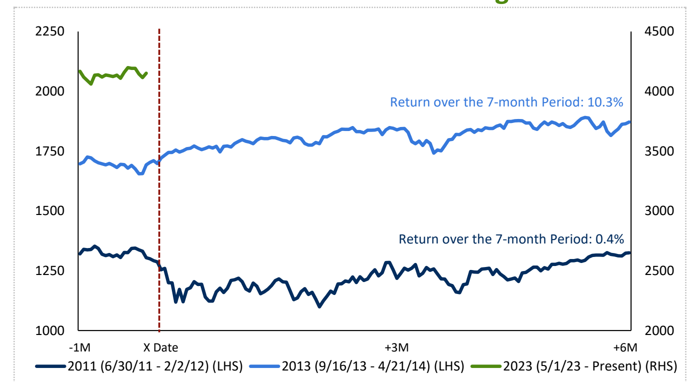
As we saw in 2011 and 2013, the primary assets impacted by these near misses are short-term treasury bills, as investors worry about how repayments could be impacted. For the most part, equity markets have been shrugging off the potential dire consequences of a default, as evidenced in the VIX, which we can use to gauge expectations of anticipated volatility or negative reactions. We are currently sitting below 20, which is generally a level of low anxiety, versus the high anxiety benchmark of 30 expected during periods of more serious concern. If politicians stay true to form, expect negotiations to run right down to the wire. There is always the potential for a short-term negative reaction in times of uncertainty, but we would expect any ensuing recovery to be relatively swift.

Expected Volatility (the VIX) Is Still Relatively Low



Source: FactSet; Raymond James Ltd. Data as of May 30, 2023.

S&P 500 Has Shown Resilience Following the "X-Date"



Source: FactSet; Raymond James Ltd. Data as of May 25, 2023. "X-Date (2011)": August 2, 2011. "X-Date (2013)": October 17, 2013. "X-Date (2023)": June 5, 2023.

The Final Word

Despite the headline-grabbing noise around the debt ceiling, remember that there are multiple and more fundamental issues that support/impact asset valuations. Investors should remain committed to their well-established long-term plans.

Neil Linsdell, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

For Long-Term Oriented Investors: Stay Invested and Well Diversified

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	YTD
Em.Mkt Equities 43.5%	Canadian Equities 17.6%	US Bonds 10.4%	Em.Mkt Equities 16.5%	US Equities 41.3%	US Equities 23.9%	US Equities 21.6%	Commodities 23.0%	Em.Mkt Equities 28.3%	US Bonds 9.1%	US Equities 24.8%	US Equities 16.3%	Commodities 36.1%	Commodities 16.5%	Int'l Equities 11.8%
Canadian Equities 35.1%	Commodities 14.5%	Canadian Bonds 9.3%	Int'l Equities 16.2%	Int'l Equities 29.5%	US Bonds 15.5%	US Bonds 20.5%	Canadian Equities 21.1%	Int'l Equities 16.9%	US Equities 4.2%	Canadian Equities 22.9%	Em.Mkt Equities 15.0%	US Equities 27.6%	Cash 1.7%	US Equities 7.9%
Commodities 29.0%	Em.Mkt Equities 10.4%	US Equities 4.6%	US Equities 13.4%	Balanced Portfolio 14.7%	Balanced Portfolio 12.4%	Int'l Equities 18.7%	US Equities 8.1%	US Equities 13.8%	Cash 1.3%	Int'l Equities 15.9%	Balanced Portfolio 9.3%	Canadian Equities 25.1%	Canadian Equities -5.8%	Canadian Equities 7.2%
Balanced Portfolio 12.1%	US Equities 9.1%	Commodities 4.6%	Balanced Portfolio 8.4%	Canadian Equities 13.0%	Canadian Equities 10.6%	Balanced Portfolio 9.3%	Em.Mkt Equities 7.0%	Canadian Equities 9.1%	Canadian Bonds 1.0%	Balanced Portfolio 14.4%	Canadian Bonds 8.6%	Int'l Equities 10.5%	US Bonds -6.7%	Balanced Portfolio 5.8%
Int'l Equities 7.8%	Balanced Portfolio 8.0%	Cash 0.8%	Canadian Equities 7.2%	US Bonds 4.6%	Canadian Bonds 8.3%	Canadian Bonds 3.3%	Balanced Portfolio 6.4%	Balanced Portfolio 8.9%	Balanced Portfolio -0.3%	Em.Mkt Equities 12.2%	Int'l Equities 5.7%	Balanced Portfolio 10.1%	Int'l Equities -8.1%	Canadian Bonds 3.4%
US Equities 7.4%	Canadian Bonds 6.1%	Balanced Portfolio 0.4%	Canadian Bonds 3.4%	Commodities 4.2%	Em.Mkt Equities 4.7%	Em.Mkt Equities 0.5%	Canadian Bonds 1.3%	Commodities 3.8%	Int'l Equities -6.0%	Commodities 10.3%	Canadian Equities 5.6%	Cash 0.0%	Balanced Portfolio -9.6%	Em.Mkt Equities 3.1%
Canadian Bonds 5.2%	Int'l Equities 2.5%	Canadian Equities -8.7%	US Bonds 1.5%	Em.Mkt Equities 2.8%	Int'l Equities 2.3%	Cash 0.5%	Cash 0.5%	Canadian Bonds 2.4%	Commodities -7.4%	Canadian Bonds 7.3%	US Bonds 5.6%	US Bonds -2.6%	Canadian Bonds -11.7%	US Bonds 2.8%
Cash 0.4%	US Bonds 0.8%	Int'l Equities -10.1%	Cash 0.8%	Cash 0.8%	Cash 0.8%	Canadian Equities -8.3%	US Bonds -1.1%	Cash 0.6%	Em.Mkt Equities -7.7%	US Bonds 3.0%	Cash 0.5%	Canadian Bonds -2.8%	US Equities -12.2%	Cash 1.6%
US Bonds -12.6%	Cash 0.4%	Em.Mkt Equities -16.8%	Commodities -2.0%	Canadian Bonds -1.3%	Commodities -27.8%	Commodities -10.7%	Int'l Equities -2.1%	US Bonds -3.2%	Canadian Equities -8.9%	Cash 1.6%	Commodities -7.8%	Em.Mkt Equities -4.4%	Em.Mkt Equities -14.8%	Commodities -11.6%

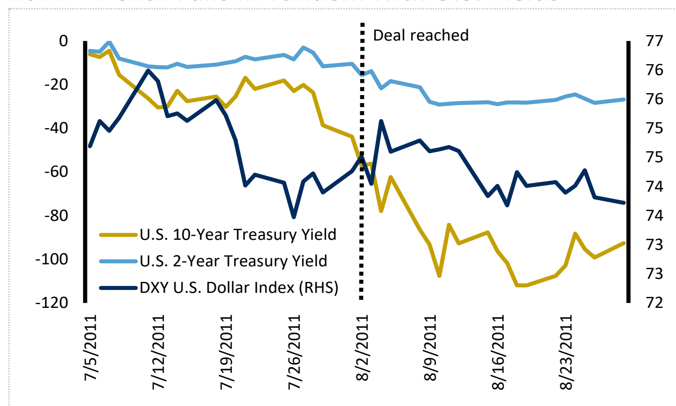
Source: FactSet, Raymond James Ltd. Data as of May 15, 2023. All returns are in CAD. Asset classes are represented by: S&P/TSX Composite TR Index (Canadian Equities); iShares Core Canadian Universe Bond Index ETF (Canadian Bonds); S&P 500 TR Index (US Equities); iShares Core U.S. Aggregate Bond ETF (US Bonds); iShares MSCI EAFE ETF (International Equities); iShares MSCI EM ETF (Emerging Market Equities); iShares Premium Money Market ETF (Cash); SP GSCI Commodity Futures (Commodity). The asset allocation of the Balanced Portfolio is 20% Canadian Equities + 20% US Equities + 10% International Equities + 10% Emerging Market Equities + 20% Canadian Bonds + 20% US Bonds.

Can the Debt Ceiling Drama Threaten the Power of the U.S. Dollar?

"We have been here before." This may provide some solace by looking back to the 2011 debt ceiling standoff for some hints on what to expect this time around. However, there are some stark differences to consider. In today's highly polarized political climate, protracted congressional deadlocks seem to be the norm. More importantly, this political standoff between President Joe Biden and House Speaker Kevin McCarthy runs the risk of putting more undue strain on an already vulnerable U.S. economy.

While many are hoping for a resolution to the U.S. debt ceiling and other budget resolutions to come before the eleventh hour, we can still look to the past for clues on what to possibly expect. Back in 2011, U.S. Treasury yields slid lower just before a deal was inevitably reached and proceeded to fall further afterward, taking the DXY U.S. Dollar Index down with them.

2011 – Dollar Falls in Tandem with U.S. Yields



Source: FactSet; Raymond James, Ltd.; Data as of July-August 2011.

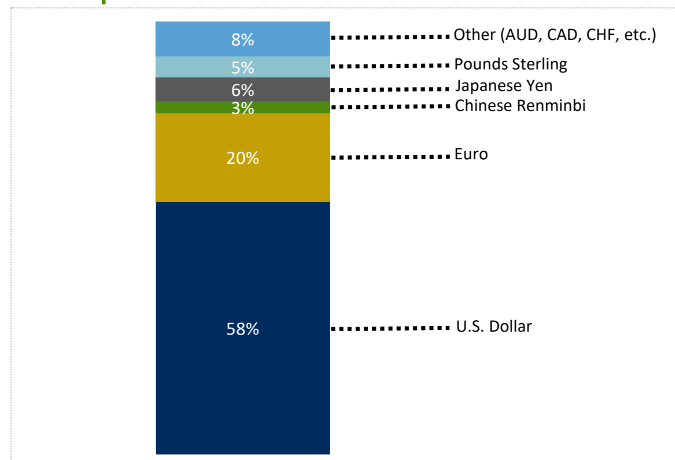
Looking ahead to the next couple of months, we are anticipating a bout of heightened volatility across markets as matters related to the debt ceiling, the ongoing banking crisis in the U.S. and a possible final quarter-point rate hike from the Fed all play out.

Consequences of a Debt Ceiling Breach or Default

It comes as no surprise that a technical default on U.S. debt would have apocalyptic global ramifications and would erode the dollar's role as the global reserve currency. While no one is expecting this scenario to come to fruition, pushing negotiations down to the wire or actually hitting the debt ceiling without a congressional deal in place may very well dampen confidence in the U.S., lead to a potential downgrade by credit rating agencies and increase borrowing costs. The uncertainty surrounding a default as negotiations continue to drag on may even push investors to sell their U.S. Treasury securities, weighing on the dollar in the process.

At the time of writing, the DXY U.S. Dollar Index is already down nearly 10 per cent from late September 2022 on the back of a weakening economic backdrop and expectations the Fed is at the cusp of pausing its rate hiking cycle. It is also important to note that over half of global central bank foreign currency reserves are held in U.S. dollars, so any sharp devaluation in the dollar would undoubtedly wreak havoc on many countries' ability to fulfill their financial obligations on their sovereign debt.

USD Represents the Lion Share of Global FX Reserves



Source: IMF.org; Raymond James Ltd.; Data as of Q4/2022.

So, Any Cause for Concern?

While markets appeared to be relatively calm, volatility across asset markets has been increasing, especially in the short-term Treasury bill market. At a time when many believe that the Fed is behind the curve on its battle with inflation, coupled with a string of bank failures and now a high-stakes political battle over the borrowing limit, there is certainly reputational risk at stake for the United States.

As countries around the world continue to promote viable alternatives to the U.S. dollar as a way to combat Washington's weaponization of the dollar via sanctions, any loss of confidence in the U.S. government and the dollar would only exacerbate this push. U.S. debt is viewed as one of the safest and most liquid assets in the world. Given the high global demand for U.S. treasuries, the U.S. has enjoyed the privilege of borrowing money at relatively low interest rates. The faith and perceived stability of U.S. Treasury assets, and the privileges that come with that belief, will therefore not be retracted overnight. However, such frequent political events, and most definitely a technical default, could diminish that position over time.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Inflation Falling, but Yields Holding In

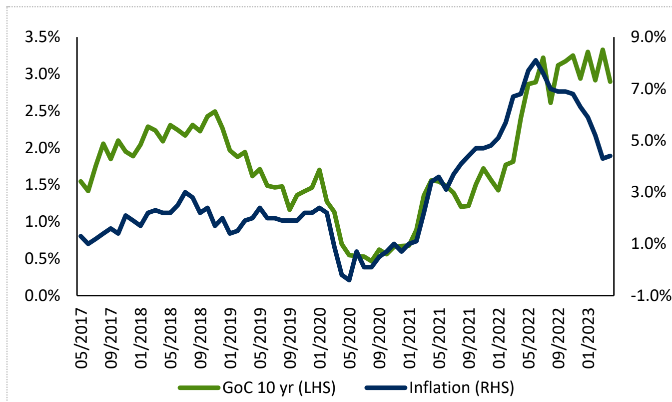
The last few years have been anything but typical. The story began with the COVID pandemic and worldwide shutdowns. But the conversation, at least from an economic standpoint, quickly focused on whether the underlying drivers of inflationary pressures were transitory.

Now, 15 months after the first Bank of Canada (BoC) rate hike of the cycle, we can say that inflation was a sustained concern. In an attempt to rein in rising prices, the BoC raised the overnight rate from 0.25 per cent to 4.50 per cent with the last hike in January 2023. We note that inflation peaked in June 2022 then began falling, with the most recent number sitting at 4.4 per cent. The BoC stated that their actions would be data driven, ultimately looking to fulfill their mandate of price stability. Although they said further increases are on hold for now, a hotter-than-expected April CPI print has markets pricing in one additional hike by the end of the calendar year.

Is the Trend Your Friend?

Bond yields, especially in the short end, tend to follow interest rates set by central banks. Further out on the curve, bonds begin to account for expectations of the future yield environment rather than focus solely on what we see today. When we compare the 10-year Government of Canada yield against inflation (see graph), we see that for the most part, the two values tend to move together. However, despite inflation falling as of late, bond yields have held in. This implies that market participants believe that inflation, or rate hikes, would remain on the horizon.

Inflation and Bond Yields Tend to Trend



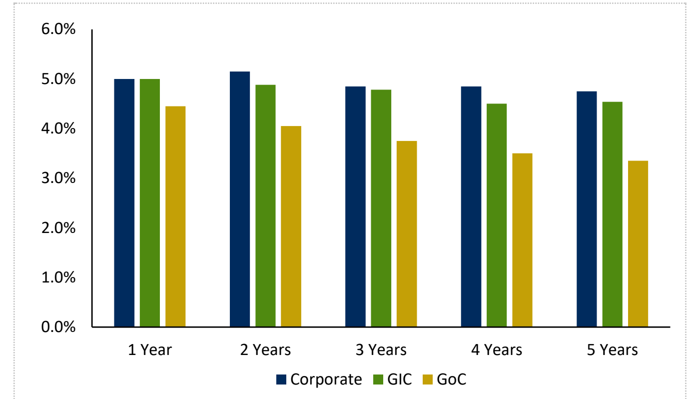
Source: FactSet; Bank of Canada Raymond James Ltd.; Data as of May 25, 2023.

However, another outcome is possible. The market may decide that higher rates are not sustainable or necessary in the eyes of the central bank, and bond yields would fall to coincide with that expectation, moving us more in line with inflation levels yet again.

How GICs Compare Today

GIC rates often take a longer period to adjust to prevailing interest rates when compared to other fixed income products. For example, Government of Canada securities and corporate bonds often anticipate future rate hikes. Thus, when a rate announcement is made, there is little to be seen in terms of market action (unless the announcement outcome is a surprise). GICs may be quiet around that time as well, but their yields may shift in the days or weeks following.

Corporate Debt and GICs Provide Similar Yields Today



Source: FactSet; Raymond James Ltd., as of March 31, 2023.

When rates were low, GICs often provided a yield advantage over corporate securities. But when we compare yields across GICs, corporate debt (bank bonds used for illustration here) and Government of Canada bonds in the one- to five-year term today, we see that corporate bonds yield the same or slightly higher every year. Each of those types carries its own pros and cons, which investors should consider before purchasing.

- *GICs:* These are guaranteed instruments, most with CDIC insurance, and are a safe investment for most individuals. However, the vast majority are not liquid, meaning your funds are locked in until the maturity date, and they cannot be sold or traded prior to that.
- *Corporate Bonds:* Such securities inherently carry bigger risks than GICs do but can be sold at any time in the open market. There are also many different options of risk and maturities.
- *Government of Canada Bonds:* These benchmark securities are often perceived to carry smaller risks than those of corporate bonds and thus have lower yields. However, for investors who are searching for high quality (low risk) with liquidity, these may be an option. In addition, provincial bonds could be explored.

Charlotte Jakubowicz, CMT, CIM
Vice President, Fixed Income and Currencies

Mining for Physical Gold ETFs

ETFs that invest in physical gold are a unique innovation within the ETF industry. The ETF vehicle provides a convenient structure that offers exposure to the price movements of gold without having to manage the headaches of insurance, shipping and storage arrangements.

Benefits of Gold ETFs

Diversification: Gold ETFs have historically offered a lower correlation to other traditional equity and fixed income securities. These ETFs are often considered a safe haven during uncertain times.
Accessibility: Unlike physical gold, gold ETFs trade on major exchanges and offer a convenient way to gain exposure to the metal without the need for direct ownership.
Liquidity: Gold ETFs can be bought and sold throughout the trading day, which allows investors to enter or exit positions quickly compared to trading physical gold investments.
Transparency: Gold ETFs offer full transparency, as their holdings are visible in the ETF's fund facts documents.

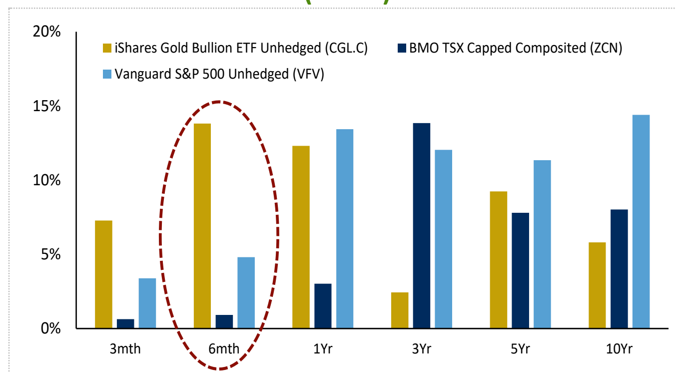
Risks of Gold ETFs

Market Volatility: Gold ETFs can be a choppy trade during uncertain market environments as the price of these ETFs can fluctuate greatly based on sentiment swings.
Opportunity Costs: The commodity is a non-income-producing asset and will not generate income unlike other securities.

Digging Up the Details

By using the **iShares Gold Bullion ETF (CGL.C-TO)**, we can compare the long-term performance and correlation of physical gold next to the **BMO TSX Capped Composite ETF (ZCN-TO)** and the **Vanguard S&P 500 ETF (VFV-TO)**. As we continue to face uncertainty in the markets, CGL.C has considerably outperformed both ZCN and VFV on a six-month basis. In addition, CGL.C has served as a great diversifier with a 10-year correlation of -0.13 next to both ZCN and VFV.

iShares Gold Bullion ETF (CGL.C) vs. Broader Index ETFs



Source: Raymond James Ltd.; Capintel; Data as of May 23, 2023.

ETF Correlation Analysis

10 Year Correlation Matrix		A	B	C
iShares Gold Bullion ETF	A	1.00	-	-
BMO S&P/TSX Capped Composite Index ETF	B	-0.13	1.00	-
Vanguard S&P 500 Index ETF	C	-0.13	0.71	1.00

Source: Raymond James Ltd.; Capintel; Data as of May 23, 2023.

Canadian-domiciled Strategies

There are three CAD-listed physical gold ETFs that provide the purest exposure to the spot price of gold. These ETFs hold physical gold that is stored in vaults via their custodians. Given the fact that these ETFs are all investing in gold bullion, using an ETF that keeps costs down can be a key differentiator. At the same time, it is also important to consider liquidity factors as low liquidity can lead to a discrepancy between the ETF's price and the underlying value of the securities it holds. As a rule of thumb, smaller ETFs tend to have lower trading volumes, which translate to higher trading costs via larger bid-ask spreads. Both are important factors to weigh when selecting a physical gold ETF strategy.

Canadian-domiciled Gold ETF Figures

ETF	Tickers	AUM ($M)*	MER†	Avg 12mth Bid-Ask Spread†
iShares Gold Bullion ETF	CGL/CGL.C	754	0.55%	0.13-0.17%
Purpose Gold Bullion Fund	KILO/KILO.B/KILO.U	326	0.23%	0.41%
CI Gold Bullion Fund ETF	VALT/VALT.B/VALT.U	57	0.17-0.18%	0.07-0.16%

ETF	Tickers	Fund Flows ($M)		
		1Mth	*YTD*	*1Yr*
iShares Gold Bullion ETF	CGL/CGL.C	(8)	13	(90)
Purpose Gold Bullion Fund	KILO/KILO.B/KILO.U	(3)	(26)	(43)
CI Gold Bullion Fund ETF	VALT/VALT.B/VALT.U	2	4	(13)

Source: Raymond James Ltd., Morningstar, FactSet; AUM data as of May 25, 2023. Fund flows data as of May 24, 2023. *AUM is the sum of all series. †MER and average bid-ask spread ranges were sourced from latest ETF Facts.

ESG Considerations

Not surprisingly, mining for gold can have environmental impacts along with negative social consequences in regions where mines are located. As a result, gold ETFs are not traditionally considered an ESG-friendly investment. However, recent progress has been made with the introduction of the **Franklin Responsibly Sourced Gold ETF (FGDL-US)**. This strategy sources gold from accredited refiners (defined by the London Bullion Market Association) that commit to implementing a set of internationally recognized standards to ensure that the gold is mined through verified supply chains. This U.S.-domiciled ETF attempts to provide a responsible style tilt to physical gold investments. At this point, there is no equivalent Canadian-domiciled option available in the Canadian ETF marketplace.

Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

Dollar Cost Averaging Simulation

Investing in the stock market is as much about strategy as it is about understanding which businesses to invest in. Two strategies often proposed are Buy and Hold (B&H) and Dollar Cost Averaging (DCA). Choosing the right approach can be influenced by many factors, with market volatility being an important consideration.

Methodology and Process

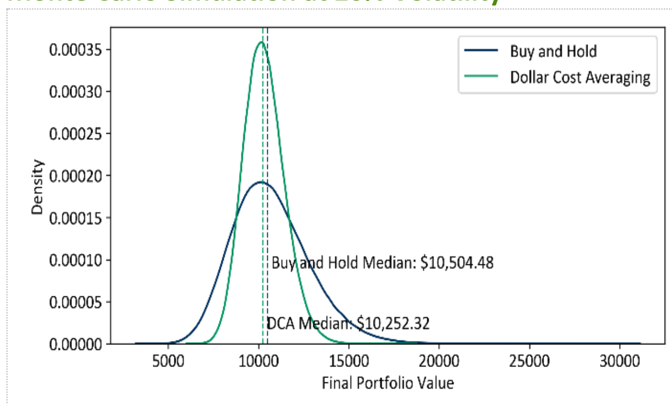
Volatility refers to the extent of price fluctuations in the market within a specified timeframe. For example, high-volatility markets exhibit significant price changes and are considered less predictable.

To analyze these investment strategies, we conducted a Monte Carlo simulation to observe their performance under varying market volatility conditions. Our simulation generated and examined 500,000 market scenarios for each level of volatility, from zero per cent (a completely stable market) to 70 per cent (a very volatile market). For each level of volatility, we computed the median, minimum and maximum portfolio values for both the B&H and DCA strategies. Our simulations also assumed a base seven per cent annual return then applied the volatility levels to generate a hypothetical series of 12-month returns.

Findings

The Monte Carlo simulation outcomes revealed interesting trends between the two strategies. In low volatility environments (close to zero per cent), the B&H and DCA strategies delivered comparable portfolio results. However, as volatility increased, the B&H strategy displayed larger swings, ranging from substantial losses to higher gains. In contrast, the DCA strategy maintained more stability, suggesting it may be used to counteract market volatility.

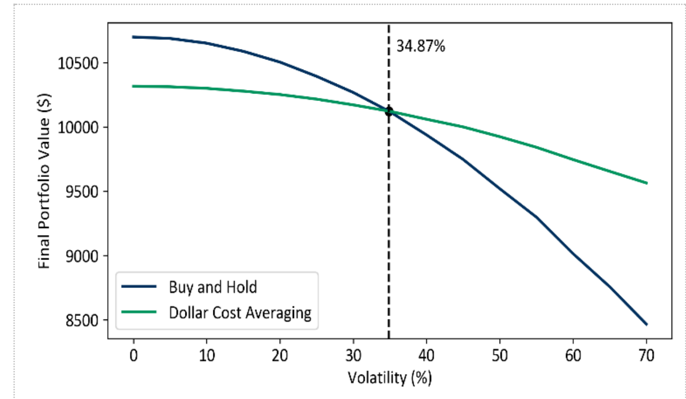
Monte Carlo Simulation at 20% Volatility



Source: Raymond James Ltd.

From the chart above, we display the results from the Monte Carlo simulation at the 20 per cent volatility level. Interestingly, we see that DCA strategies have a higher peak and narrower distribution of outcomes, meaning that using DCA strategies can help offset volatility by reducing the potential set of possible outcomes. By spreading out contributions throughout the year, you avoid being fully invested right before a market downturn. While this limits downside potential, it also limits the potential gain too.

Median Outcomes for Different Volatilities



Source: Raymond James Ltd.

B&H is still one of the simplest and most straightforward investment strategies to implement. However, if volatility or a risk for the year is expected to be high, then DCA has its advantages. A significant finding from our simulation was the identification of an "intersection point" where the median outcome of the B&H strategy equals that of the DCA strategy. Our analysis showed that when volatility is expected to be greater than ~35 per cent, DCA is the more preferable strategy for deploying new capital, while B&H is better when volatility is lower.

Final Thoughts

If you are a risk-averse investor or foresee high market volatility, DCA could be the preferable approach. Conversely, if you are open to accepting more risk for potentially higher returns and have faith in your investments' long-term growth, the B&H strategy may be better.

Regardless of the approach you take, it is important to align your investment strategy with your financial goals, risk tolerance and investment horizon. We recommend consulting a financial advisor to ensure your strategy is tailored to your individual circumstances.

Peter Tewolde
Senior Equity Specialist

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