PATHSTONE

Debt Ceiling Debate 2023: Our Assessment

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In mid-January the U.S. Treasury Department bumped up against the legal debt ceiling of $31.4 trillion, limiting its ability to increase debt issuance to pay the government's bills. An act of Congress will be necessary to increase or suspend that limit, something that has been done many times (78) since the practice began in 1917. The U.S. Treasury has resorted to special measures to continue paying its current obligations. These extraordinary measures are anticipated to run out some time this summer, but the timing will depend on a number of factors including tax receipts. For now, these measures do not impact payment on any currently due obligations as the Treasury is primarily saving cash by deferring payments to various government pension programs. Payments to current beneficiaries of these programs continue uninterrupted.

The details of when these measures will run out and which obligations the Treasury would prioritize is not perfectly clear (estimates suggest July or August). Regardless of the details, this development certainly raises concerns about the risk of another government shutdown — or worse, an actual default on the interest and/or principal owed to holders of U.S. Treasury obligations (Bills, Notes & Bonds), which has never previously occurred.

For investors, betting on the outcome of this political game of chicken is purely speculative. As long-term oriented investors, our primary objective is to be thoughtful about mitigating potential risks considering the various scenarios that may play out. Below we try to shed some light on common questions and provide some context for investors to put the debt ceiling debate in perspective.

Background

The Budget & the Debt Ceiling – The U.S. government's budgetary fiscal year ends September 30. Spending has already been approved by Congress, and any revenue shortfalls are made up by issuing additional debt, with the caveat that we still maintain a check on this by maintaining a formal debt ceiling that can only be changed by Congress. While many countries do not have a debt ceiling limitation, as it may be considered duplicative of the budget process, it remains in the U.S. as one more check and balance. Congress most recently increased the debt ceiling in December 2021, raising the limit by $2.5 trillion to $31.4 trillion.

When "Extraordinary Measures" Run Out – Some may think that once Treasury's extraordinary measures run out, the next day will spell default of the government's debt obligations. However, the fact is we instead move from extraordinary measures to more extraordinary measures, including shutting down different government agencies and/or not paying certain wages or bills of the government, similar to what we saw in 2018-19 and many times before that. How rare is a government shutdown? We have had more than 20 government shutdowns in the past 50 years. While shutdowns create anxiety and market volatility, and are somewhat costly in terms of economic activity, they are often the trigger necessary to force a resolution in Congress. The U.S. has never gone beyond that to the point where a default on its debt obligations was a serious risk. Should that occur, there is a wide range of contagion effects that would agitate, or perhaps even collapse, global capital markets.

Investment Considerations

Probabilities and Consequences – We see three discrete scenarios related to the debt ceiling:

1) *Hit the debt ceiling, but still have cash to cover spending –* May also defer payments that don't have an immediate impact on beneficiaries to conserve cash (aka "extraordinary measures");
2) *Run out of cash and extraordinary measures –* Must shutdown government agencies and/or stop making current payments;
3) *Default on the "Full Faith and Credit" of the federal government promise –* a default on the government's Treasury obligations could severely impact the functioning of financial markets, with a range of outcomes that could easily surpass the tumult we experienced during the 2007-08 Global Financial Crisis. Like the collapse of Lehman Brothers, the fallout would extend well beyond the U.S. Treasury market due to overlapping linkages to other financial assets.

The Big "D" - Default??? – Concerns have been raised about investments in Treasuries, particularly those that are set to mature around the time that the extraordinary measures will run out. Why those in particular? Why not longer-dated Treasuries too? The answer lies in the difference between whether you are awaiting a return of principal (a much larger amount) or whether you are only expecting interest payments (a smaller amount). While neither would be desirable, the lack of timely liquidity at maturity might be more disruptive to the bond holder.

Both of these situations (missing debt or principal payments) would be unprecedented and, we believe, very unlikely. The Treasury would have some flexibility to prioritize its payments and likely would make paying its debts the highest priority. For those who remain concerned about the government missing a debt payment, you should also be concerned about the impact that might have on other parts of your portfolio. It is not easy to predict, but a default would likely create a level of panic that might bring other financial assets tumbling down as well. Point being, we don't believe an investor can avoid the fallout of a debt default by simply avoiding Treasuries.

Market Indications of Stress - Moody's and Fitch maintain AAA ratings on U.S. Treasuries and have stated that they believe the debt ceiling will be resolved in time to avoid a downgrade. S&P has had an AA+ rating (its second highest) since it dropped from AAA in 2011. Tracking of the Bid-to-Cover ratio for 13-week and 17-week bills shows stability, with bidders regularly offering to buy 2.5x to 3.0x the offer amounts. Based on market reactions so far, it appears the consensus is that we will not experience a default.

Does the Fed Play a Part? – The Fed may be dragged into the fray if Congress does not resolve the debt ceiling debate. However, the Fed plays no role in the Treasury's ability to meet its obligations. Should economic growth deteriorate more rapidly or even push the U.S. into recession, the Fed may be forced to end this tightening cycle and pivot to lower rates sooner than anticipated, though that would likely be tied more to diminished inflationary pressures. The Fed is also an active holder of U.S. Treasury securities, with a balance sheet around $8 trillion. They are currently in the process of letting $60 billion of Treasury securities mature and roll-off their balance sheet each month. In theory that could put upward pressure on Treasury yields, as would any reasonable threat of default. While the Fed could change course and reinvest the proceeds in Treasuries or even expand its balance sheet, this would not solve the Treasury's problem of not having enough cash to fund the government's budget. In the end, the debt ceiling debate can only make the Fed's current efforts to engineer a soft-landing more difficult.

Conclusion

The probability that the U.S. government defaults on its debt is extremely low. The chances that the debt ceiling debate drags on and forces a government shutdown are meaningful. The difference in impacts to investors is night and day. In a "default" scenario, the outcomes could be long lasting and highly disruptive. In a "government shutdown" scenario, we are likely to experience some negative economic impact, but the greatest disruption is likely to be increased volatility in markets.

It is difficult to invest or alter asset allocation around political or geopolitical risk due to the inherent unpredictability. Therefore, we are primarily concerned with mitigating associated systemic risk factors. Treasuries, particularly those with maturities of 6-months to 1-year, offer a premium yield today because the yield curve remains inverted. Those attractive yields come with some perceived added risk as noted above, though we believe it is a systemic risk that is likely to impact all financial assets should it come to fruition. Therefore, our recommendation is not to avoid Treasuries, but rather to ensure that not all near-term liquidity needs are tied up in Treasury securities. Cash, municipal bonds or investment grade corporates offer reasonable alternatives.

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