Meet the Manager:
PIMCO & the Debt Ceiling Debate

Pathstone's "Meet the Manager" interview series features some of the passionate and committed asset managers with whom we have developed strong relationships. Our goal is to share the depth and breadth of expertise and collaboration that goes into our investment process.

This installment features Libby Cantrill, Managing Director, Public Policy, and Jerry Woytash, Vice President and Portfolio Manager, of fixed income asset manager PIMCO. PIMCO has been focused on active management in fixed income for more than 50 years. Pathstone uses the PIMCO Income Fund (PIMIX) as a core part of our credit risk alternatives asset class, aiming to generate attractive risk-adjusted returns for clients across a variety of fixed income asset classes.

In a discussion with Chris Martin, Director in Pathstone's Investment Research team, Libby and Jerry provide their take on the current debt ceiling debate and how it might affect the market for Treasuries and other short-term instruments. Their dialogue builds upon Pathstone's recently published analysis, Debt Ceiling Debate 2023: Our Assessment.

Please note, this interview has been edited for length.

Chris Martin, Pathstone: *Let's dive right in. What are the chances that a debt ceiling agreement is reached before the real economic impact is felt?*

Libby Cantrill, PIMCO: I would say high to very high.

To take a step back, Congress will have to raise the debt ceiling by the so-called X date, which is when the Treasury exhausts their extraordinary measures -- basically, the accounting maneuvers that give them some room to avoid hitting the debt ceiling. It looks like the X date will fall between June at the earliest and maybe September at the latest. We are confident that Congress will come to a resolution before that X date.

There's been a lot in the press comparing this time with other debt ceiling fights, particularly 2011, when the US government did come close to breaching the debt ceiling and S&P downgraded the creditworthiness of US debt. We don't think 2023 is a new 2011, for a variety of reasons.

CM: *How might the debt ceiling debate affect Fed policies through 2023?*

LC: This is the last thing the Fed wants right now, in an uncertain economic and market environment where they are almost singularly focused on getting inflation under control. We do know that, even from the minutes that were released today [*February 23*], this is top of mind for the Fed, that they are concerned that this could have an impact on liquidity in the Treasury market, that it could have an impact, if it is taken to the breach, on the economy.

If we were to default -- and again, that's not our base case at all -- but if we were to see even a technical default, the Fed could be put in a position like they were in March of 2020 or other times of market volatility, where they actually have to step in and begin quantitative easing.

That is exactly the opposite of what they want to be doing right now, which is quantitative tightening. They want to be reducing the balance sheet. They want to be taking liquidity out of the system.

CM: *Shifting gears to market impact, how is PIMCO managing this debt ceiling risk, whether it's volatility risk or default risk?*

Jerry Woytash, PIMCO: I think it's a balance between being prepared and not overreacting to one specific risk. In terms of preparation, that's making sure we're managing appropriately to avoid getting stuck with Treasury bills that might mature at a disadvantageous time relative to the X date. At the same time, because the X date is so uncertain, we're trying to avoid too much exposure on any given date.

In 2021, for example, the X date was in October. A week before the deadline, Congress came to a short-term deal that pushed the deadline out two months. Anyone that was trying to avoid the October deadline by being clever and buying December bills ended up being stuck in the exact same position a couple of weeks later. With that said, we believe in being prudent and making sure our exposure to both Treasury bills and US Treasuries is allocated correctly, without too much exposure on any given date.

In terms of other preparations, we think about the worst-case scenario. What if we do get to that point? How would we be able to preserve liquidity for our clients and how might the other functions of US Treasury debt be able to be met? For example, US Treasury debt is often used as collateral under repos and other instruments. To that end, the Fed has a playbook that outlines how they would extend the maturity on a given security that might be exposed to the X date. So between being operationally ready and being prudently positioned, that's how PIMCO is managing through the uncertainty.

CM: *How might you take advantage of volatility being created by this uncertainty for clients?*

JW: As the debt ceiling X date approaches, the Treasury spends down its cash, which (kind of paradoxically) provides liquidity to the market. That liquidity can sometimes richen short-dated bills or other assets. As we think about how we're positioning our Treasury portfolio and our Treasury bills in particular, we're not going to be exposed to reinvestment risk. Then, as the date passes or as the date gets closer and volatility rises, it's about preserving liquidity to take advantage of those opportunities where appropriate.

One area that most likely won't be impacted, at least until the X date is reached, is the repo market. The repo market allows you to invest cash overnight, safely and securely. If you temporarily invest in repos, then when market disruption occurs you can reinvest into whatever might be dislocated at the time.

Then, as you get past the debt ceiling issue and once Congress agrees to a long-term solution, the Treasury's going to have to rebuild its cash balance. When that occurs, it's actually going to be similar to a very fast quantitative tightening. That's because rebuilding their cash balance means issuing more debt, which in turn requires that the market is prepared to invest in that debt. Historically, when the Treasury is raising cash rapidly, investors receive a premium for their investment.

CM: *Let's say a default were to occur. Would Treasuries be the most impacted or would riskier assets really bear the brunt of that impact, given the kind of stress and uncertainty such an event would cause?*

JW: This falls into that "known unknown" category, where we know that this is a risk, but there is no precedent for how the risk would play out. Some ideas people have floated as alternatives to Treasuries are commercial paper or non-US government issued treasury bills, such as Japanese T-bills or Canadian T-bills. Historically, though, if there's a liquidity crunch these vehicles would also be impacted. So I don't think there's a really great way to hide out and avoid any of this.

One thing that could be helpful to investors is to think about other low-risk alternatives. For instance, federal home loan banks issue short-term debt, and that's highly rated, and implicitly guaranteed by the US government. And at the same time, it's not subject to the debt limit, so you're not going to be caught out when you invest in that.

CM: *Along a similar vein, what are the systemic risks to a default? I'm assuming those are primarily going to be liquidity related, but maybe you can touch on that angle.*

JW: It's a very burdensome operational process to extend the maturity on securities day by day and to not know what's going to occur. Also, money market funds invest mostly in US Treasuries. However, Fitch came out and said they don't expect to have to downgrade money market funds that are Treasury based, as long as those funds manage prudently around the debt limit, because even if they hold only US Treasury bills, they will not have, say, 100% of the fund maturing on a given day or even in a given week or month.

By laddering them out, money market funds can raise liquidity on T-bills that might not be impacted by the debt ceiling – though there is still the risk that it could be a fire sale. If a default actually does occur and either the securities get downgraded or moved to default status, there is the possibility that money market funds would be required to sell them. One bit of good news is that the money market funds do have some discretion as to whether they're forced to sell. So they can keep holding Treasuries if they think it's in the best interest of their clients.

But again, this is all very, very messy. Presumably if we get to this point, there will be other problems as well. We've seen how one disruption plays out in the financial system, where one problem leads to another, which leads to another unforeseen consequence, and then you end up with a liquidity problem.

There are no guarantees, but people have given this some thought. That's the comforting thing -- when you compare today to 2011, for example, where it was kind of unprecedented. The Fed's given a lot of thought to this. The Treasury Market Practices Group has given thought to this. SIFMA and the buy-side firms and sell-side firms all have as well. So hopefully they'd be able to help provide and cushion the system from a temporary shock. But the longer it goes, the harder it gets.

LC: And may I just add to that? Chairman Bernanke is one of PIMCO's global advisory board members. He was, of course, at the Fed during both 2011 and 2013 when the two major debt ceiling episodes happened. They did quite a lot of contingency planning and thinking about all of this, and also coordinating with the Treasury. Ben said two interesting things about the current situation. One is that Secretary Yellen's position that the Treasury cannot prioritize payments may not be completely true, that they may have more discretion than that, but in practice it would mean not paying Social Security benefits, because that's the easiest to switch on and off. And of course, that is not politically tenable.

The other thing he said that sort of mirrors what Jerry was saying is that the Fed could likely buy defaulted Treasury securities. So if they were doing quantitative easing just to stabilize the market, they also could target these defaulted securities.

CM: *Do you expect more significant volatility than experienced thus far and if so, in what assets and when?*

JW: Right now the X date is so far away that it's hard for the market to focus on it. But as we get within a week or two of the X date, that's where you do see collateral start to cheapen. You'd probably see repo rates go higher because liquidity premiums go higher. You'd probably also see Treasury bill rates go higher. Depending on what's going on and what the portfolio specifically is invested in, you could see premiums get to a disconnected 100 basis points, maybe, from where you think fair value is or where you think other comparable securities are. And that's when people start to have conversations about whether or not to step in and provide liquidity for those, in specific accounts, of course. It depends on both the account mandate and also how dislocated the market gets.

One of the challenges that you see in front-end markets when things get dislocated is that they are very balance sheet intensive. So you may be earning an extra 100 or 200 basis points in annualized yield, but if you're only earning it for a week, the actual amount is not that large. And that's often why when markets freeze up and the money markets stop, in particular, the Fed has to roll out programs to help offload securities from dealers' balance sheets. Those kinds of actions allow the market to continue to function and the Fed can use its balance sheet to offset those large notional amounts that might not actually be that big in terms of absolute returns.

CM: *Last question: It's pretty well understood that international investors are decent buyers of US Treasuries. Have either of you seen any change to their buying patterns or to the rhetoric from the international investment community on how they might approach a potential default scenario?*

JW: If you look back at over last year in particular, it illustrates how international investors think about US debt in a variety of ways. And so you saw, especially in Q3 and Q4 of last year as the Fed tightened rates, international investment in US bonds tapered off a little bit. This highlights that there's a multitude of risks in the financial markets and that it's hard to say with any degree of confidence how international investors as a group would react to one specific area of default or potential default. And I think there are other considerations in terms of their balance sheets and income statements and how they think about matching their cash flows and liabilities as well.

CM: Thank you both very much, we really appreciate it. This has been great.

***

Disclosures