Our Thoughts on the Debt Ceiling

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Once again, the U.S. debt ceiling is in the news. The debt ceiling or limit is the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations. This total includes Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds, and other payments.

While the debt limit has been a source of great debate in recent years, its origins are rooted in compromise and efficiency. The debt limit was established by statute in 1917 as the U.S. government issued bonds to help finance the nation's participation in the first World War. Prior to its establishment, each new bond issue required a bill to be passed in Congress; the debt limit was an effort to streamline this process. Congress instituted the first aggregate limit on the total accumulated debt of all kinds with the passage of the Public Debt Act of 1939. The current limit, last increased in December 2021, was $31.381 trillion.

Reaching the Debt Limit

When the Treasury Department has both reached the debt limit and depleted its available cash on hand, it will be unable to fulfill the nation's financial obligations. This, most notably, includes the timely payment of principal and interest to holders of U.S. Treasury debt, which would result in a default. The U.S. Treasury is the world's largest issuer of bonds and U.S. Treasuries are widely considered to be the safest and most liquid fixed-income instrument. A default, while extremely disruptive for the global economy, would also diminish the longstanding credibility of the "full faith and credit of the United States Government."

This outcome can, most simply, be avoided if Congress acts to either lift or suspend the debt limit. Lifting the debt limit would raise it by a defined amount; suspending the limit essentially removes the limit for an interval of time. When the suspension ends, the debt limit is automatically reset to the total amount of outstanding debt at that time.

On January 19, 2023, Treasury Secretary Janet Yellen informed Congress that the outstanding debt of the U.S. had reached its statutory limit and that the Treasury Department began implementing certain "extraordinary measures" to prevent the U.S. from defaulting on its obligations. Secretary Yellen indicated that the period of time these measures may be deployed is subject to considerable uncertainty, but it is unlikely that cash and extraordinary measures will be exhausted before early June. Private forecasters put the so called "X-date" (a term used to reference the expected date that the U.S. Treasury Department would no longer be able to meet all of its financial obligations) sometime in the third quarter. Timing is important for strategic planning around the potential date of default.

Political Negotiations

Similar to recent debt ceiling episodes, it is widely believed that Congress will act to avoid a default on U.S. Treasury debt. However, the partisan brinksmanship seems much greater this time, given the tenuous relationships between and within the major political parties. While negotiations frequently come down to the wire, there has been little progress to date and both sides seem firmly committed to their positions, which heightens the risk of default. Addressing the debt ceiling requires action by both houses of Congress – the Senate cannot do it alone and President Biden cannot veto the debt ceiling.

As a reminder, Standard and Poor's downgraded the credit rating of the U.S. from AAA to AA+ in 2011, citing dysfunctional policymaking in Washington as a key factor and noting at the time, "The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed." The rating has remained at that level ever since, and it should be noted that the U.S. maintains a rating that is lower than Canada, Germany, Australia, Switzerland, and several other nations.

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Market Expectations

Based on our research, current expectations are that with the extraordinary measures currently in place and related cash inflows from April's personal income tax payment deadline, the Treasury Department will be able to meet its financial obligations until mid or late summer. As we approach this timeline and expectations for the Treasury Department's cash flow solidify, we are preparing for heightened volatility, negative price action, and impaired market liquidity in Treasury obligations that mature near the "X-date."

We expect the direct impact to be largely limited to the short-duration part of the yield curve. It is difficult to assess the potential impact on the balance of the yield curve, and even more difficult to isolate the impact of the debt ceiling from the list of factors currently at play (i.e., high inflation, moderating economic growth, Federal Reserve policy tightening, etc.). As a reference point, when the U.S. Treasury was downgraded in 2011, the market reaction was a "flight-to-quality" which, counterintuitively, resulted in strong demand for Treasuries and pushed yields lower. However, this time could be different, and it is impossible to predict a market reaction to an unprecedented event.

Our Strategy Response

As estimates of an "X-date" become more reliable, we would typically avoid or reduce holdings of certain U.S. Treasury securities that mature around or just after the expected date to mitigate the potential adverse effects that related market volatility may have, particularly as it pertains to liquidity. This would also result in a preference for a federal agency, high-quality credit instruments or other permitted investment options. It is also challenging to target dates precisely as Congress could pass a short-term Continuing Resolution (CR), which pushes the "X-date" out a few weeks or months, starting the process all over again.

In the unlikely event of a default, we believe the situation would be short-lived, particularly if the impact were severe. However, in any case, it is likely that there would be great uncertainty and volatility. In the unforeseen event of a technical default, it is possible that a strong negative reaction from markets would push Congress to quickly resolve the debt ceiling while ensuring that all holders of Treasury debt are quickly paid, though delays of certain payments and tremendous market volatility could emerge in the interim. The Treasury could also choose a more radical and untested option of prioritization of payments, but the market might view that as dysfunctional.

PFMAM will continue to monitor developments associated with negotiations to address the debt limit and will carefully consider the timing of maturities to mitigate the impact of a prolonged period of uncertainty.

To learn more or discuss in greater detail, please contact your PFMAM relationship manager.

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