



The debt ceiling: now what?



Melissa Ochoa Cárdenas
Investment Strategist
Insigneo

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Lately, much has been written and discussed about the looming debt ceiling and the implications of a US default for the current macro and investment backdrop. Even if there is much uncertainty and speculation around the issue, let us do our best to highlight the upcoming timeline, the potential scenarios that could unfold if we breach it, and gauge any market or investment implications.

First, let us define the debt ceiling. As per the Congressional Budget Office – CBO – the debt ceiling is the “maximum amount of debt that the Department of the Treasury can issue to the public or to other federal agencies.” This limit is determined by law, and over the past years, it has been either increased or suspended to allow the government to finance its operations by granting it access to additional borrowing.

The most recent increase to the debt ceiling was performed on December 16, 2022 when lawmakers set the cap to a new total of USD 31.4 trillion. However, that USD 2.5 trillion increase completed in December was insufficient to keep the government running, and on January 19 of this year, the limit was reached. This led the Treasury to announce what is known as a “debt issuance suspension period,” during which it could take extraordinary measures to borrow funds without breaching the ceiling.

According to the CBO’s own projections, *ceteris paribus*, the government will run out of cash at some point between July and September of this year. If the ceiling is not increased or suspended before that “X date”, the government will be unable to fully pay its obligations and will have to decide whether to delay making payments for some activities, default on its obligations, or both.

Here, it is relevant to highlight that projecting the X date – namely, the day that the government will run out of

cash – is complicated due to the pandemic-related stimuli and tax revenue that still need to be determined. These two factors could either bring the X date closer to early June, which would be more aligned with what Treasury Secretary Janet Yellen last stated, or would leave it closer to the CBO’s July estimate.

Moreover, since the debt ceiling discussions were reignited, the White House’s position has been one of not negotiating over the debt limit and telling Congress, or more specifically, the Republican party, that they need to vote to raise it with no strings attached. In contrast, Speaker Kevin McCarthy has stated that he and his party would “seek to use the current debt ceiling standoff to enact spending cuts and reduce the national debt.” On March 1st, House Republicans unveiled a new debt ceiling bill that aims to match spending cuts with any potential debt limit increase. The bill, known as the Dollar-For-Dollar Reduction Act, is spearheaded by Rep. Randy Feenstra from Iowa in coordination with Sen. John Barrasso, chair of the Senate Republican Conference. This bill is still under discussion at the time of this writing, but it seems to be the first approach of the Republican Party to state

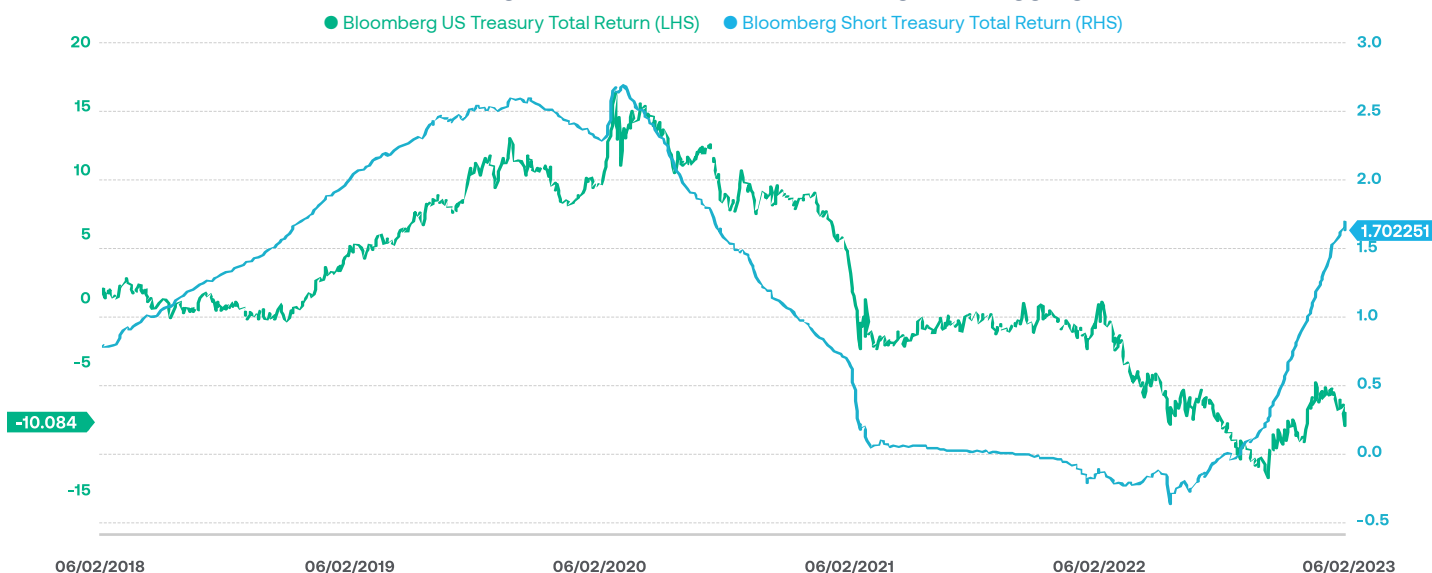
what they would like to reduce or how they would carry out such reduction.

Hence, the question remains: What scenarios could play out considering the current impasse, and what investment opportunities could arise from it?

According to some market specialists, the two most plausible outcomes are that: **a)** the Treasury decides to implement a strategy known as “prioritization” or **b)** the government falls into a “general default”. In our opinion, the general default, in which the US government does not perform any payments until the debt ceiling is lifted is highly unlikely. This view is currently reflected in the price of most financial assets.

As a result, investors have increased their exposure to the shorter end of the Treasury curve. According to the Bloomberg US Short Treasury Index, this part of the Treasury curve has gained over the previous 12 months, a stark contrast to the negatively performing longer-dated parts of the US Treasury market. These have been falling steadily since the early days of the pandemic.

12-Month Total Return of Bloomberg’s UST Indices – short-term vs general aggregate



Source: Bloomberg (as of March 3rd)

On another note, the prioritization plan that was first introduced during the Obama administration allows the Treasury to prioritize payments if the government reaches its debt limit. The Treasury Department started employing extraordinary measures in January to preserve cash, which led to its estimations that payments can be extended at least until early June. Once these extraordinary measures run out, the Treasury could continue paying some of the country's obligations, albeit not all. The idea is that this prioritization of payments is done with the rationale of mitigating financial and economic fallout. It emphasized performing government debt payments while delaying other government bills, if no deal was reached on the debt ceiling.

However, this stance has not been met favorably by some of the financial authorities: for example, Secretary Yellen back in January stated that “failure on the part of the United States to meet any obligation — whether its debt holders, to members of our military or to Social Security recipients — is effectively a default,” while further adding that Congress cannot “negotiate over whether or not we’re going to honor our obligations.”

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Meanwhile, Chair Powell – in what seems a flashback of his discussions and briefings during the 2011 debt ceiling discussion – stated in the latest Fed conference that the only way forward is the one where Congress raises the debt ceiling while annotating that deviating from that stance would be highly risky. This statement further dents the notion that either the Treasury or the Fed can facilitate the prioritization program that Republicans would prefer instead of a debt ceiling negotiation.

Investment Implications

If history serves as a guide, the Biden Administration should bear the 2011 debt ceiling standoff in mind. Even if that impasse was resolved just in time to avoid hitting the debt limit, the brinksmanship that occurred did have consequences for investors, consumers, and business owners.

Back then, the equity market plunged amid the volatility that surrounded a potential ceiling breach: from May until September, the S&P 500 posted negative percentage variations, with the steepest decline (~17% drop) occurring between July 21st and August 8, a couple of days after Standard & Poor’s downgraded the US from its AAA rating after the Treasury came within days of being unable to pay certain benefits. Then, after hitting its lowest level for the year in October, the index gained some ground and recovered, but it didn’t get back to its pre-debt ceiling levels until March 2012.

In contrast, in the fixed income realm and considering that the macroeconomic conditions then were starkly different from what we are witnessing today, the UST curve displayed a generalized yield tightening move in 2011, even during the most complicated points of the negotiation. However, the fixed income market did experience volatility that was best portrayed by the Move Index. This index, created by Bank of America, is “a yield curve weighted index of the normalized implied volatility on 1-month Treasury options.” At the beginning of August 2011, amid the US credit downgrade, the Move Index jumped 40%.

Furthermore, both measures of consumer confidence in the US deteriorated sharply in 2011, in tandem with the NFIB Small Business Optimism survey figures. Specifically speaking about consumer confidence, this measure fell by 22% between June and August 2011, and months had to pass by before consumers recov-

ered some lost confidence in the US economy, even if the debt ceiling standoff had been resolved. Albeit at a milder rate, businesses' optimism fell during that same period by 3%, with the gauge reaching its February 2011 levels almost a year later.

As stated before – if history serves as a guide, let the 2011 episode remind the Biden Administration that the debt ceiling discussions tend to have sharp consequences for household wealth. This measure has been struggling since mid-2022. According to the latest available figures from the Fed on households and non-profit net worth nominal dollar value, this household net worth has lost nearly USD 6.8 trillion from its high recorded in 4Q21 until 3Q22.

From an investment perspective, our main conclusions are as follows:

As previously stated, and even if the current negotiation outlook seems grim, we believe the US will not default on its debt. Still, the uncertainty surrounding the negotiations and a higher-for-longer rates environment have increased investors' appetite for short-term Treasury bills. It is worth highlighting that this investment thesis provides the possibility of locking in higher rates for a brief window while minimizing duration risk and ignoring the credit risk element. Hence, having a segment of the portfolio in T-bills seems like a reasonable alternative to weather the current turmoil surrounding Washington, at least until the debt ceiling discussion comes to an end. ■

House Views Matrix

| | TACTICAL (UP TO 3 MONTHS) | CYCLICAL (UP TO 12 MONTHS) |
|--------------------------------------|------------------------------|-------------------------------|
| US Equities¹ | UNDERWEIGHT | UNDERWEIGHT |
| European Equities | OVERWEIGHT | OVERWEIGHT |
| Japanese Equities | OVERWEIGHT | OVERWEIGHT |
| Emerging Market Equities | OVERWEIGHT | OVERWEIGHT |
| Chinese Equities | OVERWEIGHT | OVERWEIGHT |
| US Treasuries² | NEUTRAL | NEUTRAL |
| Investment Grade Fixed Income | NEUTRAL | NEUTRAL |
| High Yield Fixed Income | NEUTRAL | NEUTRAL |
| Emerging Market Sovereign | OVERWEIGHT | OVERWEIGHT |
| US Dollar | NEUTRAL | UNDERWEIGHT |
| Energy³ | OVERWEIGHT | OVERWEIGHT |
| Precious Metals | NEUTRAL | NEUTRAL |
| Cash | OVERWEIGHT | NEUTRAL |

¹ Relative to global equities in USD

² Relative to aggregate fixed income markets in USD

³ Relative to an overall commodity allocation

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