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Institute Alert

FIRST ANALYSIS

News or events that may affect your investments **May 24, 2023**

Global Investment Strategy Committee

10 questions on the debt ceiling and markets

Key takeaways

- To be clear, our base case is still for a near-term agreement in Congress to raise the debt ceiling.
- We believe the debt ceiling matters most as one more near-term uncertainty and a likely source of austerity measures that add to a moderate recession and remove cash available for markets.

What it may mean for investors

- In turn, we expect that recession and reduced liquidity will make for volatile markets, reinforcing our preference for a defensive portfolio stance.

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1. Is there any flexibility in the U.S. Treasury's X-date?

On May 22, Treasury Secretary Janet Yellen continued to warn policymakers that it is very likely that the U.S. Treasury will run out of sufficient cash in early June and that this X-date could still come as soon as June 1.

Disappointing tax revenues and rising interest costs have combined to move the X-date forward from earlier Treasury estimates of July and even August. Capital gains revenues have been weaker than the Treasury's earlier forecasts. Accelerated filings for unexpectedly large refunds also have undercut revenues, as have weather-delayed tax deadlines in California, Alabama, and Georgia (moved back to mid-October 2023).

2. Once a deal in principle is in hand, how much time does Congress need to pass an increase in the debt ceiling, and what are the issues?

In 2011, congressional leaders agreed in principle to a deal over a weekend, and it became law two days later. Since then, the House has adopted a rule that requires a 72-hour reading period between a bill's presentation to the House and a vote. The Senate also has procedures that could take several days. Fortunately, each chamber has procedures that could expedite the process significantly. We do not believe that a deal and presidential signature are impossible for an early June deadline.

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Principally, the president wants a debt ceiling extension that has room to take the Treasury into 2025. The House is willing to raise the debt ceiling but wants a dollar-for-dollar decrease in spending. Two prominent issues already on the table could become the basis for a compromise. First, rescinding unspent federal COVID funding could count against spending. Second, the two sides may compromise over work requirements for some types of federal aid. A third item, the reform of procedures to grant permits for fossil fuel extraction, seems further away from compromise.

3. How might Congress extend the time to work out a debt ceiling agreement?

A short-term debt extension is the most obvious way of buying time for the government to extend the debate over the debt ceiling. This extension could last for a few weeks to allow any raise to get through the legislative process, if a near term agreement is reached, or it could be to align longer, more in-depth discussions with the government's fiscal year end on September 30.

Invoking the 14th Amendment (effectively saying that validity of government debt, authorized by law, should not be questioned) to resume government borrowing seems far less feasible because this interpretation raises constitutional issues likely to trigger a drawn-out legal challenge. However, the government could find more solid legal ground if it uses the amendment to prioritize government interest payments, perhaps one course of action if Congress cannot forge an agreement before Treasury funding runs out.

Several other alternatives we view as very unlikely alternatives, including Treasury minting a $1 trillion platinum coin or using premium Treasury bonds with interest rates high enough to boost government revenues as prices are bid higher at Treasury auctions.

4. Would interest be paid on existing debt even during a technical default?

The U.S. Treasury could potentially prioritize paying principal and interest on existing debt over other outlays in order to avoid a technical default. If there is a delay in the interest payment, the Securities Industry and Financial Markets Association (SIFMA) believes that "*interest will not accrue in the delayed interest payment. However, there may be a rate announced for compensation, but it will most likely not be the same as the one stated in the coupon*."[1] Although the exact form of compensation is unclear, it is our belief that there will be some form of interest compensation for the delayed payment.

There is some precedent to this type of scenario. In 1979, there was a blip in payment processing that caused some delays in the interest payment of some specific T-bills.[2] After some legal battles and new legislation, the Treasury made investors whole for the additional interest.

5. What are the potential market implications of a technical default?

As the negotiations in Congress stretch out and investors worry more about a technical default, volatility could increase. We believe most Treasury yields likely would decline, although those maturing in the coming weeks (around the X-date) could rise sharply. We also would expect credit spreads to widen, credit defaults swaps to rise, and the U.S. dollar to potentially depreciate. Equity markets likely would view any technical default as a risk-off event and could decline until a clear resolution is achieved.

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1. SIFMA, May 2023. Delay in Treasury Payments: Discussion of Scenarios & Playbook. Page 7.
2. "The Day the United States Defaulted on Treasury Bills," Terry Zivney and Richard Marcus, The Financial Review, vol 24, 3, August 1989.

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Since the Treasury moved the X-date forward, some of the Treasury securities maturing in June have lost some of their value. In our opinion, as long as there is a debt ceiling impasse, most investors may consider holding their Treasury securities that mature between now and July. We believe that investors eventually will be made whole and will receive back their principal and interest once the debt ceiling is raised. Nevertheless, investors with a near-term liquidity need should evaluate whether they can tolerate a delay in payment. Investors who need access to the funds by a specific date may need to explore selling securities.

As for equities, after the debt ceiling agreement that year, the S&P 500 Index dropped roughly 18% between July 20, 2011 and October 3, 2011. What is interesting about that decline is that the vast majority of the damage occurred *after* the 2011 deal was reached. The deal came with greater austerity than the market had anticipated, and investors revised growth estimates lower. The main influence on markets is likely not to be *if* a deal is reached — as we expect a deal at some point to emerge — but whether the details of the deal materially impact market expectations.

6. What type of impact could money market funds experience if the danger of default grows?

The implications of a technical default are complicated for money market mutual funds (MMFs), especially on the operational side, but we do not believe that MMFs will be forced to liquidate their Treasury holdings in case of a technical default. Current rules do not force MMFs to liquidate the securities that have defaulted, and fund ratings criteria also include provisions giving fund managers reasonable time to deal with defaulted securities.[3]

MMFs could experience increasing risks of outflows as investors' worries increase, but we believe that most of them are well prepared to deal with redemptions. MMFs with access to the Federal Reserve's liquidity facility are able to invest in overnight repos and could liquidate positions in order to meet redemption needs. Treasury MMFs that do not have access to invest in repurchase agreements may need to hold more cash with their custodian or avoid bills that mature near the X-date.

7. Is another downgrade of the U.S. sovereign credit rating likely? What would that mean for fixed income pricing?

If a technical default were to occur, we believe credit rating agencies will most likely move to change their rating downward. Near-term implications would not be as evident, as U.S. Treasuries are still regarded as a safe haven. During these periods of risk aversion, we believe Treasury securities would most likely rally (yields decline and prices increase). However, there could be issues eventually if investors demand higher interest to hold U.S. Treasuries and a potential change in demand from foreign investors that could become apparent in upcoming auctions. In sum, the implication would be net negative for fixed-income pricing, as U.S. Treasuries securities are considered risk-free and hence are the base building block for fixed-income pricing.

8. What should equity investors do?

We favor looking through near-term volatility to focus on the longer-term factors impacting relative performance, such as the economic cycle, Federal Reserve policy, or interest rates. Even in 2011, after the 18% drop mentioned in question 5, it only took until February 22, 2012 for the S&P 500 Index to reach a new high. Investors had reoriented their attention to the economic recovery and the broadly positive earnings backdrop.

Since early 2022, we have maintained defensive equity positioning while risk appears to exceed potential return by an ever-widening margin. Even though the S&P 500 Index is up 9.64% year-to-date (through May 22), the gains are

3. In the Code of Federal Regulations, Title 17, Chapter II, Part 270, Rule 2a-7, pertaining to money market funds, requires the fund to hold a minimum of 10% of its total assets in daily liquid assets and at least 30% in weekly liquid assets. See "The Electronic Code of Federal Regulations".

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narrowly centered on a few, large technology companies. The equal-weighted S&P 500 Index is up only 1.23% over the same period. While stock prices hover near the top end of the recent range on a debt ceiling deal, we favor trimming exposure, especially in lower quality areas, ahead of the recession we anticipate.

9. How might different debt ceiling solutions aggravate or ameliorate the economic slowdown that is developing?

Austerity connected to the compromises suggested above would contribute to the moderate recession we expect this year. Even without a near-term debt ceiling deal, the deficit is already above 12% of projected revenue, and rising. As we recently pointed out, interest expense above 14% previously has triggered austerity.[4] Even if Congress does not cut spending as part of a debt ceiling deal, a rising interest burden could pressure bond yields higher and push Congress into spending cuts or tax increases, potentially cuts similar to those now being negotiated.

Beyond the direct economic impact of spending cuts and tax increases is the effect of higher interest rates on government spending, and on housing and other interest-sensitive economic sectors. The increases can come from a higher risk premium on government debt, tied to a technical default, or even the sort of chaotic negotiations prompting Standard & Poor's to downgrade government debt in August 2011. The government could mitigate aftershocks from a debt-ceiling agreement by delaying tax and spending changes, essentially extending the adjustment period to lower deficits.

10. We think of the debt ceiling as a U.S. issue, but some leaders have warned of global impact. What are the potential global implications if fears intensify that the U.S. could default on its debt?

Even a short-lived disruption of Treasury interest and debt payments would have an impact on the smooth flow of global financing and the pricing of other securities in the U.S. and abroad. U.S. government debt's role as the risk-free benchmark means that distortions to U.S. Treasury debt pricing caused by the interruption of debt payments would ripple through other parts of the global bond market, potentially disrupting issuance and trading of seasoned securities.

Disruptions in the market for U.S. Treasury securities also would have a more direct effect on market liquidity, in our view, through their use as collateral in repurchase agreements and other funding transactions globally.

A debt default also could lift spread-sector interest rates by establishing a risk premium on government debt, adding to the base rate on other securities built on the Treasury benchmark. That added Treasury risk premium could be cemented by a downgrade of Treasury debt by a second legacy credit-rating agency (Moody's or Fitch), making the AA+ rating on Treasury debt the commonly accepted rating in the global bond market.

Longer-term, the precedent of a debt default and its fallout adds to the case for diversification away from the dollar as the dominant currency in world trade and finance.

4. Please see *Investment Strategy* report, "Navigating volatility around the debt ceiling debate", May 15, 2023.

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