Special Report

Debt ceiling update

Wealth Management

May 26, 2023 Global Portfolio Advisory Committee

The U.S. reached its statutory debt limit in January. Since then, the government has relied largely on existing cash and accounting measures to continue normal operations while keeping within congressional mandates. Those resources will soon be exhausted—potentially as soon as June 1—and without legislative action to raise the debt ceiling, the U.S. could be forced to default on its obligations early next month.

As we have previously discussed, this year's negotiations were always likely to be fraught, and therefore we are not surprised by headlines indicating walkouts, setbacks, and negotiating impasses. These events—while anxiety-inducing—are normal for the type of brinkmanship-driven negotiations currently underway in Washington.

We think it is important not to lose sight of the forest for the trees. We feel confident that Treasury investors will not suffer a permanent capital loss on their holdings this year, and that U.S. financial markets will continue to function through the summer. For many if not most investors, ignoring debt-ceiling volatility to focus on the bigger macroeconomic picture is still the optimal use of time and investment resources, in our opinion.

Recent events

As of May 25, the Treasury Department projects that without additional borrowing capacity it will be unable to fulfill all congressionally mandated payments by early June. Negotiations between House Speaker Kevin McCarthy and President Joe Biden have made significant progress towards a debt ceiling bill, according to statements from both sides, but significant obstacles remain. Public comments have tended to focus on the positive—particularly both sides' unwillingness to contemplate default—but unsubstantiated reporting of private remarks has emphasized the significant distance separating the two parties.

We believe the distance will be closed eventually, but we think the process will almost certainly come down to the wire. Achieving a deal will require at least one side, and presumably both, to make concessions. It will likely be nearly impossible for political leaders to justify those concessions while there is still time left on the clock; the natural pushback from lower-level supporters in such situations is for leadership to get back in the room and get a better deal. Only when time has run out will it be possible to sell a deal to Congress, in our view. Again, this is not ideal, to say the least, but it is typical for high-stakes political dealmaking.

This approach is not without risk, of course. The closer we get to default, the greater the chances that a miscalculation by one or both sides could push us past the event horizon. Financial markets, which operate largely on probability evaluation, increasingly reflect this risk as we approach the Treasury's deadline, and we would not be surprised to see a short, sharp equity market correction as the days go by without a deal. To some extent, such a selloff could be helpful in reaching a deal by providing politicians with political cover as well as a salutary reminder of what is at stake.

No deal, no default

Failure to reach a deal in time for the Treasury Department to meet all of its obligations would push the U.S. into uncharted territory. We are not privy to the Treasury's contingency planning, but we see a series of levers the U.S could pull to continue operations even beyond the so-called X-date.

The first would be to delay certain payments. While this arguably could constitute a default in some metaphysical sense, for bond investors it would not. Timely payment on bills, notes, and bonds is what financial markets are focused on, and we think that level of performance would

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likely be sufficient to avoid potentially catastrophic disruptions to financial markets. We are less convinced that rating agencies and equity markets would shrug off this move, and would therefore expect the U.S. to lose its AAA status and stock prices to move meaningfully lower. Fitch Ratings, for instance, has put the U.S. on negative watch, a precursor status to a potential downgrade.

In our view, the equity market reaction to payment delays would likely be enough to get a deal across the finish line. But if that were not sufficient, we do not believe the Treasury could stick with payment prioritization for more than a few days. The legality is questionable, the politics are horrible, and practically speaking, the sheer scale of U.S. payments requires a more systematic solution.

In the unlikely event that there was still no deal, we believe that the Federal Reserve would step in to facilitate payments. The actual mechanics of Fed intervention are uncertain; the central bank could simply buy maturing Treasury bills at par, or provide zero-rate financing for maturing bills. No matter the form, the key is that investors would receive cash in the amount and on the day the U.S. government promised. To make sure its actions did not increase inflationary pressures, we would expect the Fed to sell some of its existing bond holdings to offset any emergency purchases.

End game

If those measures were exhausted, or if the Fed were unwilling to act in the place of the Treasury, then we believe the Biden administration would likely take unilateral action to ensure the government could continue to operate. Once again, we view this as a remote possibility. We believe the market reaction by this point would force politicians to reach a deal. But if it didn't, we believe the administration would sell bonds in reliance on the 14th Amendment. This outcome would likely have meaningful negative global repercussions, as it would create significant uncertainty about the validity of at least some Treasuries.

Focus on investing, not trading

One of the problems with discussing the debt ceiling and its attendant negotiations is that we are forced to examine extreme outcomes that we believe to be extremely unlikely. In a more rational world, we would not even be thinking about the possibility of the U.S. central bank redeeming Treasury obligations. The fact that we are forced to think about it, however, does not mean that such an outcome is either inevitable or even probable. In our view, the most likely outcome by far is that a deal is reached, and the debt ceiling is raised, as it has been 78 times before.

Instead of looking to trade around politically induced volatility, we think investors' time and attention would be better spent looking at the broader macroeconomic context. We continue to believe that in times of heightened economic and political uncertainty, a holistic wealth plan with a well-diversified, regularly rebalanced investment portfolio is among the best alternatives for individual investors.

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