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Market Commentary

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Is the Debt Ceiling a Crisis?

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Financial markets are paying closer attention to the implications of a potential U.S. government shutdown and debt ceiling crisis. In our mind, the implications of a debt ceiling-driven technical default on U.S. Treasuries are far greater than any impact from a government shutdown. With that in mind, we offer a few points on both topics with a primary focus on the debt ceiling and its possible impact on the Treasury market.

Government Shutdown vs. the Federal Debt Ceiling

A potential shutdown of the federal government is a different issue than the federal debt ceiling. While the two matters are often tied together during the political and legislative process, they are not dependent upon each other.

> Government shutdown – The government's fiscal year ends on September 30th and Congress has not yet passed any of the 12 necessary government funding bills. Complicating matters is that lawmakers return from their summer recess on September 5th, providing little time to pass annual spending appropriations. Given the tight timeline, lawmakers may choose to pass a short-term funding extension to allow breathing room to address both the debt and spending issues. If funding legislation is not passed by the end of September, the Executive Branch will be forced to shut down services and agencies subject to annual appropriations. Payments funded by law – such as Social Security – are not affected by a shortfall in annual appropriations.
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> Debt ceiling – The federal debt ceiling debate is due to the U.S. government reaching its statutory outstanding debt limit, which analysts currently expect to occur in early to mid-October. Should the debt ceiling be reached, it would restrict the ability of the federal government to issue new Treasuries to pay its debt service obligations, which could in turn lead to a technical default on certain U.S. Treasury securities.

What Is a Technical Default on U.S. Treasury Securities?

For our purposes, we'll define a technical default as a temporary delay in the payment of principal or interest on certain Treasury securities due to the inability to issue new debt to pay the government's debt and fiscal obligations. This can happen when the debt ceiling is reached and there are no additional funds available to be paid out. It is important to note the U.S. Treasury can issue new debt to replace maturing debt, as this transaction will not increase the amount of outstanding federal debt. Since the government collects more in taxes than it owes in interest payments, some debt ceiling hardliners have suggested the government could simply prioritize debt payments over other government obligations to avoid a technical default. However, in previous debates, government officials have pointed to technical and legal issues which may inhibit their ability to prioritize certain government payments over others. We cannot claim to know what is truly possible. We do know it is very late in the game to try and determine the viability of such a dubious solution, which would likely still be viewed by the markets as some form of a government default.

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Implications of a Technical Default on the Treasury Market

- It is important to note Treasury securities do not have cross-default provisions, meaning a default in one issue does not imply a default in all issues. As a result, specific Treasury bills (T-bills) and notes scheduled to mature in early to mid-October have seen their yields rise on investor wariness over a technical default. Current October T-bill yields are approximately 10 to 15 basis points higher than yields on T-bills maturing in September or November. It is interesting to note the premium yield for October T-bills over November T-bills, where the premium seemingly reflects the market's assessment that any default will be temporary in nature.

- Longer-dated Treasury notes maturing in April and October may see muted pricing pressure due to potential delays in coupon interest payments.

- The debt ceiling issue has already affected Treasury-bill supply. The Treasury strives to keep over $300B in cash on hand to manage the daily business of the federal government. The funds are normally raised through T-bill issuance. As the Treasury exhausts any extraordinary measures used to extend the debt ceiling deadline, T-bill issuance is projected to fall dramatically. Should the debt ceiling be resolved as expected, markets anticipate significant new issuance of T-bills around early November, which should put upward pressure on T-bill and repo rates.

Will U.S. Treasuries Still Be Eligible Collateral For Repurchase Agreements Under a Technical Default?

U.S. Treasuries will still be utilized as eligible collateral by money market funds and other counterparties. We do see scenarios where Treasury securities subject to delayed interest or principal payments are excluded from lists of eligible collateral.

How Does the Federal Debt Ceiling Issue Impact Government-Sponsored Entities (GSEs)?

The ability of GSEs such as the Federal Home Loan Bank, Fannie Mae, Freddie Mac and the Federal Farm Credit Bank to issue debt should not be affected by the federal debt ceiling. We expect GSE debt markets will continue to function properly in the event of a debt ceiling breach.

Our Take

Base Case – We believe a technical default on U.S. Treasury debt obligations by the federal government is highly unlikely. However, the political process will likely not be resolved until the days just before the government reaches the debt ceiling, creating potential disruptions to financial markets. Given the binary nature of the risks, we are avoiding ***new*** purchases of U.S. Treasuries maturing in October 2017 until the debt ceiling issue is resolved. That said, we do not advocate absorbing losses by selling legacy October 2017 Treasury positions at current elevated yields, as we believe these securities will mature and pay interest in a timely fashion.

The main driver of market angst lies in the difficulty of underwriting politics. With Republicans in charge of both Houses of Congress and the White House, a resolution of the debt ceiling issue would seem to be straightforward given the lack of upside for elected officials to allow a technical default. Unfortunately, the current political environment is anything but straightforward. Treasury Secretary Mnuchin has said the Trump Administration supports a "clean" bill, where the debt ceiling is increased without conditions or additional legislation. However, the President muddied the waters in an August 24th tweet suggesting he recommended to Congressional leaders that debt ceiling legislation be tied to a popular Veterans Affairs bill. For his part, Senate Majority Leader Mitch McConnell said on August 21st that there was "zero chance – no chance – we won't raise the debt ceiling." Further, in an August 24th interview, House Leader Paul Ryan expressed confidence an increase would "get done." However, some fiscally conservative Republicans – specifically the House Freedom Caucus – have suggested any debt ceiling increase be tied to spending cuts, a scenario decidedly opposed by the Democratic Party. Our sense is both parties fully understand the negative implications of a default and the debt ceiling will ultimately be raised.

Sources:

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[See next page for sources and important disclosure information.]

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Definitions

Basis Point (bps) is one one-hundredths of a percentage point. This term is often used in describing changes in interest rates. For example, if a bond yield increases from 7.50% to 7.88%, it has moved up 38 basis points.
Debt Ceiling is the maximum amount of monies the United States can borrow. The debt ceiling was created under the Second Liberty Bond Act of 1917, putting a "ceiling" on the amount of bonds the United States can issue. At the end of July 2011 the debt ceiling was set at $14.3 trillion. Over time, the debt ceiling has been raised whenever the United States comes close to hitting the limit. By hitting the limit and missing an interest payment to bondholders, the United States would be in default, lowering its credit rating and increasing the cost of its debt.
Government Sponsored Enterprise (GSE) is a privately held corporation with a public purpose, created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy. GSEs carry the implicit backing of the U.S. Government, but they are not direct obligations of the U.S. Government. Examples of GSEs include Federal Home Loan Bank, Federal Home Loan Mortgage Corporation, Federal Farm Credit Bank.
Repurchase agreement (repo) is an agreement between two parties whereby one party sells the other a security at a specified price with a commitment to buy the security back at a later date for another specified price. Most repos are overnight transactions. Treasury and agency repos are often referred to as traditional repos. Non-traditional repos can include a wide array of securities, including both investment-grade and noninvestment grade fixed income securities, municipal bonds, etc.
Treasury Bill (T-bill) is a short-term debt obligation backed by the U.S. government with a maturity of less than one year, commonly one month, three months, or six months.
Treasury Note is a fixed income debt obligation backed by the U.S. government with a maturity between one and ten years.

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