ACG Insights: Debt Ceiling Drama

Executive Summary

- **Despite dozens of negotiated increases or suspensions of the U.S. debt limit over the past several decades, concern about the current debt ceiling is increasing (Exhibit 1)**
- **Cash available for the Treasury to pay obligations is falling which makes a technical default on some payments feel possible, although still low probability, in the absence of a deal (Exhibit 2)**
- **Historically, markets have shrugged off debt limit fears as short-term noise (Exhibit 3)**

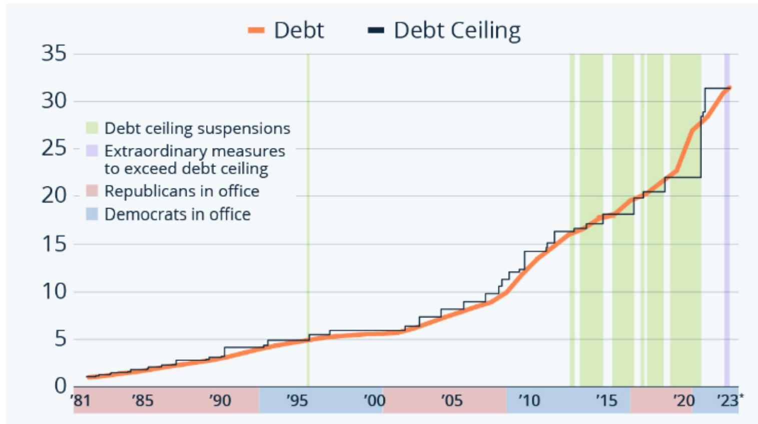
Background

The government of the United States authorizes spending (government salaries, social programs, military spending, interest payments, etc.) and revenue (taxes) policies every year as part of the budgeting process. Regardless of the political party in power, spending generally outweighs revenue and the budget runs at a deficit. Fortunately, the U.S. government is also the strongest borrower in the world, prints its own currency, and can issue debt denominated in its currency to cover spending gaps. The market for U.S. Treasury securities has become one of the bedrocks of modern finance. Congress, well-known for perfect insight into future ramifications of decisions, acted during World War I to provide flexibility to the Treasury to raise cash to cover spending while also placing limits on specific types of debt[1]. The aggregate debt limit of today was enacted during World War II to provide additional flexibility to the Treasury. It is important to note that prior to WWI, Congress had to approve each new debt issuance down to maturity and interest. As we approach another round of political posturing and market turmoil surrounding the debt ceiling in 2023, remember that progress is possible.

[1] Bipartisan Policy Center: https://bipartisanpolicy.org/debt-limit-through-the-years/

What's Happening Now, and is it Different?

Exhibit 1: Debt Ceiling Increases are Frequent [2]

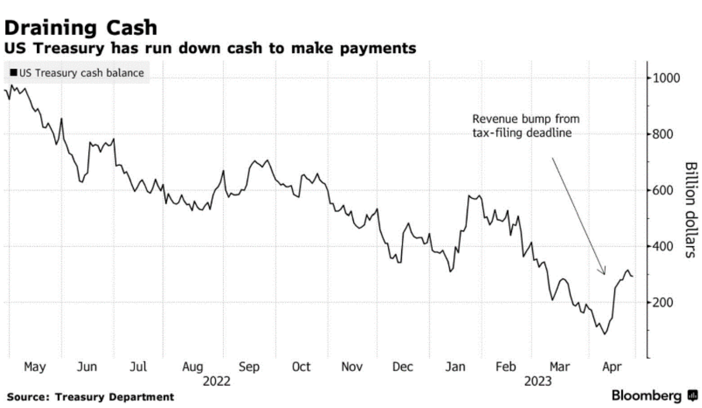


Since moving to an aggregate debt ceiling, Congress has simply raised or suspended the debt limit to allow the Treasury to finance existing spending commitments. The exercise has become routine on essentially an annual cadence, 78 times since 1960, and happens regardless of political party in power (49 times under Republican presidents and 29 times under Democrats)[3]. Exhibit 1 shows the pattern of debt and ceiling increases. The ceiling was last raised in December 2021 to $31.4 trillion and was breached in early 2023. The Treasury has measures to keep paying bills temporarily but will need to raise or suspend the ceiling by this summer to avoid defaulting on some of its obligations.

Raising or suspending the debt ceiling must pass through Congress and historically has been a routine exercise with a few exceptions. So, what feels different this time? Maybe nothing. A deal could be reached anytime to push the debate another few months or years. There is always the argument that media scrutiny has increased to a degree that everything feels more dire than even a decade ago. Political divisions and brinksmanship for show also feel worse but could just be more visible and publicly-watched. Most pundits agree that there is a high probability of an agreement before any kind of default and that the political consequences for both sides of failing to pay government debts, even temporarily, would be enough to warrant a deal.

What Happens Next?

Exhibit 2: Available Treasury Cash is Dwindling [4]



In absence of a deal, the Treasury will eventually run out of cash-on-hand (Exhibit 2) and will not be legally able to issue new debt. This scenario would likely lead to the government having to default on some of its debts given that incoming receipts would not be sufficient to cover all payments. It has been theorized that the Treasury would prioritize things like Social Security payments or interest on government bonds, but details and logistics are murky. The term "default" should be given some context in relation to the U.S. government. As an issuer of a sovereign currency the federal government always has the ability to repay debts and the chance that the government would be unable repay principal is unmentionably low. A technical default in relation to the debt ceiling *could* mean that

[2] Statista: https://www.statista.com/chart/1505/americas-debt-ceiling-dilemma/

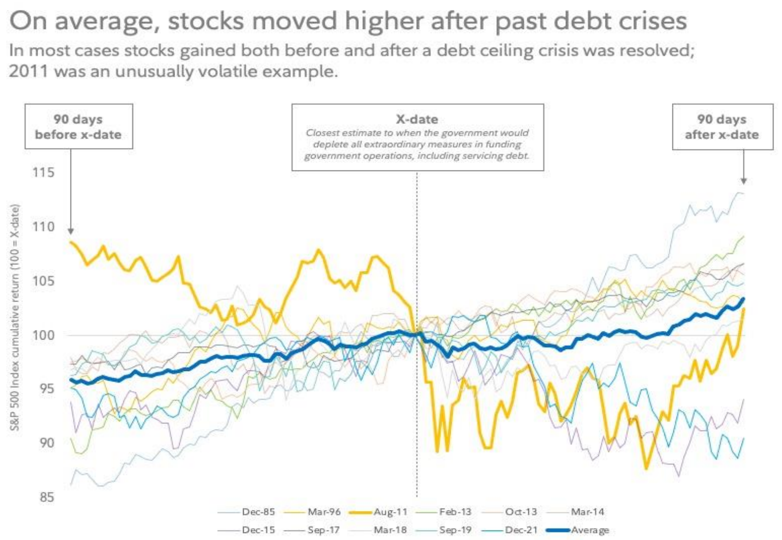
[3] U.S. Department of the Treasury: https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit

[4] Source: Bloomberg

the government would have to delay bond or other payments for a short period, but it is extremely likely that the payment would be made in full eventually.[5]

Market Implications

Exhibit 3: Stock Market Reactions Around Debt Crises [6]



Even in the event of a technical default, the short answer is that debt ceiling worries are a non-issue for longer-term, strategic investors. Tactical market action would suggest that there is some worry of a technical default for government debt. Yields on T-bills maturing near the expected default date in June have spiked and the cost to insure against default risks in the credit-default swap market have risen significantly. 2011 is the best recent proxy for what markets might experience in 2023 (Exhibit 3). Negotiations were deadlocked through the spring and summer of 2011 with an early-August default date looming. The S&P 500 fell nearly 20% from late April to October despite a last-minute deal before the X-date in August.[7] On average, the equity market has dipped slightly after a debt ceiling deal is reached and gained in price in the 90 days after the X-date. Within the broader context of the economy a default would likely have ramifications for interest rates. Expectations would be for borrowing costs to rise both for the government and for consumers via credit cards, mortgages, car loans, etc.[8] 2011 also saw U.S. credit downgraded for the first time which is a possibility again if ratings agencies see little progress towards a viable deal.

Conclusion

Virtually every base case scenario to be found assumes a high probability that a deal will be reached to either raise or temporarily extend the debt ceiling prior to the X-date and any technical default. History shows that debt limit deals are common, and the negative political ramifications of no deal are high. In the event of an impasse or a prolonged game of chicken, the cliché that “markets hate uncertainty” will likely hold true and volatility will be high. The current political climate might make an impasse more likely, but any portfolio decision based on a debt ceiling fight would be in the realm of pure speculation. There have been several creative solutions proposed to bypass the debt limit such as printing a trillion-dollar coin to deposit with the Treasury, invoking a clause of the 14th amendment, and printing above-par bonds that are outside the scope of this paper but are worth further reading for some interesting debate on the topic. These solutions have generally been dismissed by administrators. The reality is that debt ceiling fights will probably keep arising on a regular cadence but should not be a concern for markets other than some short-term turbulence.

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[5] Source: Allspring, “The Debt Ceiling: Frequently Asked Questions”

[6] Source: Fidelity: https://www.fidelity.com/learningcenter/trading-investing/debt-ceiling

[7] Source: CME Group: https://www.cmegroup.com/insights/economic-research/2023/debt-ceiling-lessons-from-the-2011-budget-debate.html

[8] Source: Committee for a Responsible Federal Budget, “Q&A: Everything You Should Know About the Debt Ceiling”

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