Invesco

Investment Insights | Invesco Global Liquidity

The U.S. Debt Ceiling, The Next Episode

Justin Mandeville
Senior Portfolio Manager
Invesco Global Liquidity

Overview

- The US debt ceiling is back in the news as limit reached on January 19
- Extraordinary measures in place likely to last into June according to the US Treasury
- In this paper, we address potential implications for the market, options available to Congress and the most likely outcome
- We remain optimistic that the US Congress will pass legislation to raise the debt ceiling

Key takeaways

- The US Congress is again being asked to raise the federal borrowing limit, or debt ceiling.
- On January 19, US Treasury Secretary Janet Yellen notified Congress that the debt ceiling had been reached and should be raised by June 5, or the government risks running out of funds to pay its obligations.
- Since then, the US Treasury has utilized "extraordinary measures" to meet its obligations. We estimate that these measures could last beyond June 5 and into the third quarter.
- We are optimistic the US Congress will pass legislation to raise the debt ceiling (or temporarily suspend it), although the decision will likely go down to the wire and the process could be contentious.
- We expect US Treasury bills (T-bills) that mature in the third quarter to be the most affected and yields to rise significantly on a relative basis.
- However, yields on T-bills that mature after the third quarter could be pressured downward in the near-term as the US Treasury cuts T-bill supply to comply with the current debt limit constraints.

The US debt ceiling has taken center stage once again, as media coverage has increased in recent weeks. On January 19, US Treasury Secretary Janet Yellen notified Congress that the federal borrowing limit of USD31.4 trillion had been reached, meaning that the debt ceiling must be raised or the US government risks running out of funds to pay its obligations[1]. While the Treasury can employ certain tactics to bridge the gap in the short term, Congress must agree on legislation in the coming months to avoid default[2].

The US Treasury market is regarded as one of the largest and most important markets in the US financial system, with around USD24 trillion of outstanding marketable securities.[3] This sector is considered the "backbone" of the US fixed income market because it is systemically important to the economy. It enables the US government to borrow to meet its legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds and other payments. A default could trigger unprecedented economic and financial disruption that could reverberate beyond the US domestic market.

What is the debt ceiling, and what happens if it's reached?

The debt ceiling is the legal limit on the borrowing authority of the US federal government, as set by Congress. In December 2021, Congress enacted a law limiting the total public debt to USD31.4 trillion. Because the federal government typically spends more than it collects in tax revenues, the debt ceiling has been periodically raised to allow additional borrowing through the issuance of new Treasury securities. It is important to note that setting the debt limit is separate from setting the federal budget and spending limits. The debt ceiling does not authorize new spending but prescribes how much the government can borrow to cover its existing obligations.

After the Secretary Yellen informed Congress that the statutory debt limit had been reached, the US Treasury began employing extraordinary measures to fund the US government to avoid defaulting on its obligations until Congress can raise the debt ceiling.

(1) Source: US Department of the Treasury, 01/19/2023, https://home.treasury.gov/news/press-releases/
(2) A default would delay principal and interest payments on US Treasury securities until a resolution is reached.
(3) Source: Bloomberg LP, US Department of the Treasury, as of 12/31/2022

> Extraordinary measures are a series of accounting techniques that give the Treasury temporary leeway to meet its obligations

What are extraordinary measures, and how long will they last?

Extraordinary measures are a series of accounting techniques, including halting contributions to specific government pension funds, suspending certain securities issued by state and local governments and borrowing money that has been set aside to manage exchange rate fluctuations. These temporary measures give the Treasury leeway to meet its obligations before the debt ceiling can be raised.

The Treasury estimates that cash and extraordinary measures will last at least until June 5. Given the propensity of Congress to wait until the eleventh hour to reach resolutions, we believe, the Treasury has likely given a conservative estimate for how long extraordinary measures might last. But the biggest challenge for the US Treasury and market analysts is determining exactly when the hard debt limit or “X-date” will be reached. This uncertainty is due to the unpredictability of tax receipts.

As the Treasury collects personal income taxes through the April 18 deadline, the US Treasury will be able to replenish its cash balances and pay down debt. If T-bill supply follows its typical seasonal pattern in the second quarter the Treasury could meet its obligations until sometime in the third quarter. Unfortunately, until the level of 2022 tax receipts is clearer, determining the exact timing of the X-date is extremely difficult. Analysts have noted that the growth in tax collection has slowed in recent months, and because of higher coupon payments and a lack of Federal Reserve remittances, there is a risk that the X-date will occur sooner than expected.

What are the market implications?

It is challenging to predict how this episode of the debt ceiling debate will play out, but we believe T-bill supply could be constrained until the debt ceiling issue is resolved. Once market analysts narrow down when the Treasury’s extraordinary measures will likely be exhausted, demand for Treasury securities that mature near the X-date should fall, as the perceived risk of a default increases, especially if Congress is at a standoff in its negotiations. Demand for Treasuries that matured near previous debt ceiling X-dates were shunned and traded more cheaply on the T-bill curve, since they were viewed as being at risk of delayed payment.

Once the debt ceiling is resolved, the Treasury should be able to increase T-bill issuance and focus on replenishing its balances drawn down by extraordinary measures, which will increase the Treasury General Account to its typical levels of around USD600 to USD700 billion[4]. Thus, we expect a sharp increase in T-bill supply in the fourth quarter. Although market participants will likely be able to absorb this influx of supply, the heavy pace of T-bill issuance over a short timeframe is likely to put upward pressure on T-bill yields, providing a potentially attractive opportunity for investors. It is important to note that the T-bill curve is currently inverted from six months to one year, as the market is currently pricing in a Federal Reserve rate cut in late 2023[5].

What makes this episode of this debt ceiling debate interesting is the economic backdrop. The Federal Reserve increased interest rates aggressively in 2022 to bring inflation under control, but the full effect of these rate hikes is still filtering its way through the economy as we wait for Congress to resolve the debt ceiling issue. The confluence of factors - the potential for a slowdown in economic growth, heightened political discord over the debt ceiling and the perceived risk of default - could cause investor risk sentiment to deteriorate. The possibility that one or more of the rating agencies could downgrade the US has also increased, similar to when Standard and Poor’s downgraded the US in 2011 from AAA to AA+.

(4) Source: Bloomberg LP, Federal Reserve
(5) Source: Bloomberg LP, as of 01/31/2023

What options are available to Congress to resolve the debt ceiling issue?

Congress has two options to resolve the current debt ceiling issue. First, it can decide to increase the debt limit to a new dollar amount, which would remain in place for an indefinite period of time. This option makes it difficult to predict exactly when a debt ceiling resolution would be reached and how long the US Treasury would be able to meet its obligations. (In the last debt ceiling fight in December 2021, Congress opted to increase the debt limit by USD2.5 trillion, breaking a long cycle of suspensions agreed in lieu of increases). The second option is to temporarily suspend the debt limit, which would allow the Treasury to issue an undetermined amount of debt within a specified timeframe but would ultimately require a debt ceiling adjustment to meet or exceed the amount of debt outstanding when the suspension is lifted. (In 2019, Congress suspended the debt ceiling for two years and later reinstated it at the amount of debt outstanding on the day the suspension ended, necessitating a debt ceiling increase in December 2021.)

What is the most likely outcome?

While recent debt ceiling battles have been contentious, market analysts expect it to be particularly challenging to reach a resolution this time, pointing to recent political discord over choosing the new Speaker of the House. What's more, the Speaker ultimately determines if a "clean" debt ceiling bill (i.e., one with no major spending cuts or other conditions) can even be brought to the House floor.

This debt ceiling "game of chicken" presents heightened risks to the financial markets as they hope for a quick resolution and brace for a potential default. It brings back memories of 2011, when Congress refused to pass a debt ceiling bill until the last possible minute. While it was ultimately resolved after Congress agreed to a multi-year set of spending cuts, financial markets experienced significant volatility as a potential Treasury market default loomed.

Invesco Fixed Income believes that Congress will ultimately raise or suspend the debt ceiling, allowing the US government to resume normal debt issuance and financing activities. But this resolution will likely go down to the wire, as the Biden administration is asking for a clean, no-strings-attached debt ceiling bill. However, some members of Congress are seeking spending cuts before they agree to any increase, which will likely raise the negotiating stakes and make a quick resolution unlikely.

References and useful resources:

US Department of the Treasury @ https://home.treasury.gov/

US Department of the Treasury, Debt Limit
https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit

SIMFA @ https://www.sifma.org/

Committee for a Responsible Federal Budget (CRFB) @ https://www.crfb.org/

CRFB Q&A: Everything You Should Know About the Debt Ceiling
https://www.crfb.org/papers/qa-everything-you-should-know-about-debt-ceiling

Learn more

For additional liquidity insights or to learn more about Invesco Global Liquidity solutions, please call (800) 659-1005.

Invesco Global Liquidity

The Invesco Global Liquidity team manages over $200 billion in liquidity assets across the money market and low-duration risk spectrum. For more than 40 years, Invesco Global Liquidity has been a core business for Invesco, providing extensive insights and experience that span multiple decades, business cycles and credit events. Today, we offer a wide range of high-quality money market, ultra-short, short-term and customized liquidity solutions to help meet the specific needs of cash management investors, through a proven, research-driven investment approach and deep commitment to delivering industry-leading client service.

Invesco Global Liquidity Team

Robert Corner
Senior Client Portfolio Manager
Atlanta, GA
404-439-4871

Natalie Cross
Senior Client Portfolio Manager
London, England
+44 20 3219 2718

Ana Buckley
Product Manager
Atlanta, GA
404-439-4687

Celia Soares
Client Portfolio Manager
London, England
+44 20 7959 1631

Contributors

Justin Mandeville
Senior Portfolio Manager
Atlanta, GA

Ann Ginsburg
Head of Thought Leadership
Atlanta, GA

All data as of 01/31/23, unless otherwise stated.

All data provided by Invesco unless otherwise noted.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.