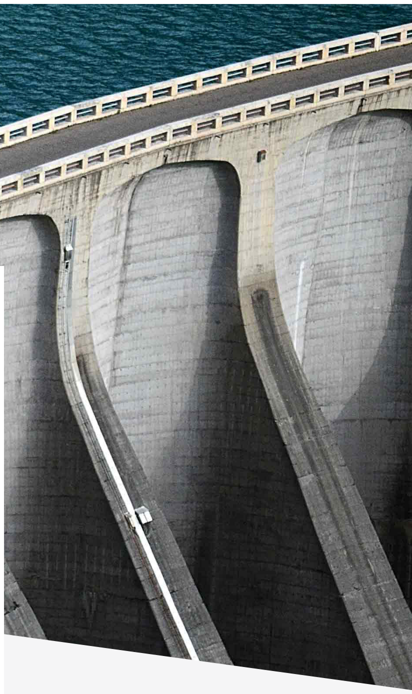


Is there anything new about this debt-ceiling showdown?

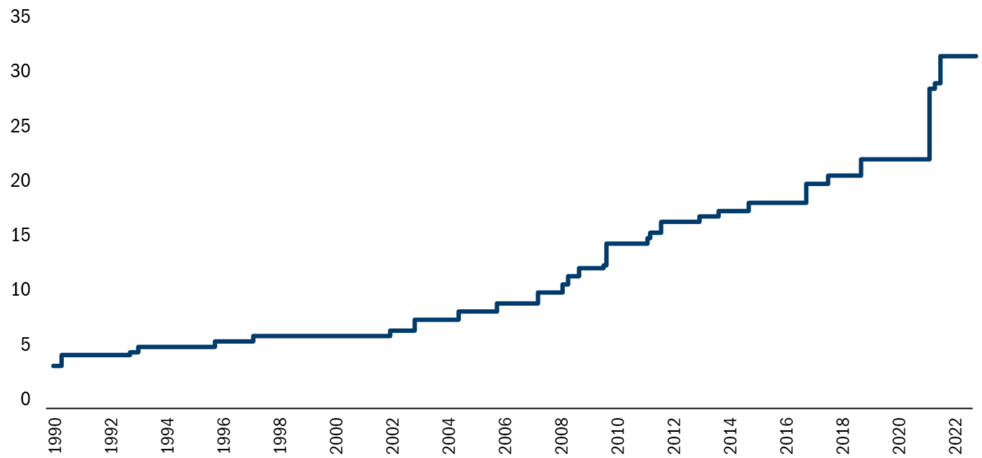
May 16, 2023

The debate over the debt limit may well drag on to the 11th hour. If it does, we're likely to see increased stress in certain parts of the market.

Raising the debt ceiling used to be a non-event. From the time the ceiling was enacted in 1917, Congress upped the borrowing limit dozens of times without incident. But more recently, notably in 2011 and 2013, we've seen battles over the debt ceiling lead to the first-ever downgrade of the U.S. credit rating. This has forced us to consider the previously unthinkable: that the world's leading economy could default on its debt.

Debt ceiling limit increases since 1990

(Dollar amounts in trillions)



Source: Whitehouse.gov. Data as of 02/28/23.

Today, we find ourselves facing the abyss once again. Since mid-January, the U.S. Department of the Treasury has been employing extraordinary measures to ensure that the government has enough money to meet its obligations, including payments to debtholders. The U.S. Department of the Treasury now estimates that the country could default on its debt as soon as June unless the debt ceiling is raised or suspended.

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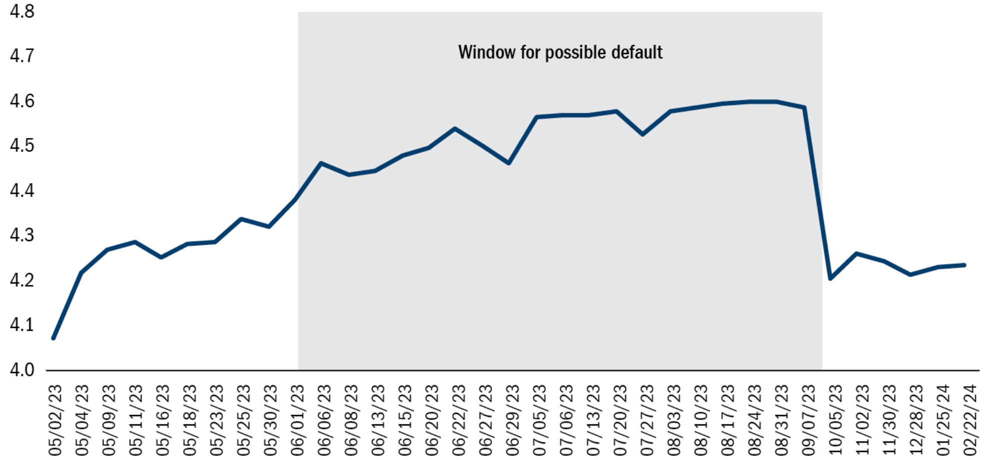
Given past history and the current state of congressional politics, we expect to see this debate dragged out until the last minute, and we're preparing for some extraordinary and unusual market dynamics.

Learning from the past. Positioning for the future.
While there is still time for Congress to raise the debt limit without taking the country to the brink of default, we're not expecting a resolution any time soon. We're already seeing distortions in the price of some short-term fixed-income government securities — notably T-bills — that mature around the time when the U.S. may default without an increase in the debt ceiling. As seen in the chart below, investors are demanding an increased risk premium to hold the six-month portion of the T-bill curve, while bills that mature just before the government could run out of cash are in high demand.

Pricing on Treasury bills reflects the impending debt ceiling showdown this summer

(Market ask price %, rolling series)



Source: Bloomberg. The window for possible default is for illustrative purposes and is subject to change.

We saw a similar dynamic in 2011. In the months before the debt ceiling was due to be breached, the markets became increasingly distorted throughout until Congress finally reached a deal to lift the debt ceiling on July 31 — just two days before the borrowing ability of the country would have been exhausted.

We'll continue to monitor developments in Washington and the markets, and we think it's quite possible that we'll see a deeper inversion of the Treasury curve and a widening of spreads as the standoff over the debt ceiling progresses. If that happens, investors may want to reevaluate certain parts of their portfolio positioning.

What's different this time
While the experience of investing through multiple crises has taught us much, we're also keenly aware that no two crises — even two debt-ceiling crises — are the same. Although 2011 offers some helpful lessons, we see two important differences with the current standoff.

First is the interest rate backdrop. In 2011, the fed funds rate was zero, and it had been for several years. Today, we're in the midst of a steep move higher that has seen fed funds rate go from 0% to 4.75% in less than a year.

Given the difference in base rates, we don't expect the percentage point swings in stressed markets will be as great as they were in 2011, but they may still be large on an absolute basis.

Another difference is the fragile nature of the Republican majority in Congress. Twelve years ago, Republicans held a solid and united majority. Today, they have a razor-thin and fractious margin in the House.

As part of the marathon process to gain the House speakership, Kevin McCarthy had to make numerous concessions to members of his party, including the stipulation that any single member of the House can demand a motion to vacate the speaker's chair at any time. With some of the same representatives that opposed McCarthy's bid to be speaker seemingly drawing a hard line over raising the debt ceiling, we can't overlook the possibility that one of them could dismiss McCarthy if they are unhappy with the way negotiations are progressing.

If this should come to pass as the government is close to exhausting its reserves, and if the House is unable to agree upon a new speaker, as it was for four days and 14 votes in January, then a speakerless House would be unable to conduct even mundane business, let alone raise the debt ceiling. So, in a worst-case scenario, the country could stumble into a default without a functioning House to prevent it.

The bottom line
We expect that our base-case scenario — a protracted battle with an 11th-hour compromise — will play out, and the government will avoid default. Because markets are likely to experience significant volatility and price dislocations in the interim, we believe financial advisors could help investors develop strategies that would help them ride out the resulting short-term market turbulence.

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