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Debt ceiling Q&A.

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Political brinksmanship is back in full force, thanks to the U.S. debt ceiling. While most observers expect some sort of deal (or series of deals) that will allow the Treasury to avoid a default, missteps are possible. While it's anyone's guess how the details of such an event would unfold, it poses multiple risks to economies and investors.

What is the debt ceiling?

The U.S. debt ceiling, which dates back to legislation passed in 1917, sets a Congressionally-determined limit on the total amount of federal debt outstanding. When the U.S. Treasury's outstanding debt approaches the current limit, it requires Congress to raise that limit in order to clear space for further debt issuance. In recent decades, what used to be a fairly mechanical exercise has become a convenient negotiating lever if not an outright political cudgel.

Why is it a concern?

While past debt ceiling episodes have ultimately been resolved, the 21st century-habit of taking them down to the wire creates unwelcome uncertainty, not just for the U.S. Treasury market but for financial markets in general, as well as economic agents that depend on payments from the federal government, such as pensioners and contractors. The actual "x date" for running into the debt ceiling is always hard to pin down, as the Treasury is able to take certain steps to postpone the day of reckoning, and quarterly tax collections can help replenish the government's available funds. Unfortunately, federal tax collections were disappointing in April 2023. This was attributable in large part to the fact that taxpayers in California have until October 2023 to pay remaining liabilities from 2022 and the first three quarters of 2023 as a result of federal weather-related disaster declarations.[1] Treasury Secretary Janet Yellen has warned that the U.S. could begin missing financial obligations in early June, while prevailing consensus holds that the x date could occur sometime between then and late summer. President Biden, House Speaker McCarthy and other Congressional leaders have begun to discuss a resolution to the impasse.

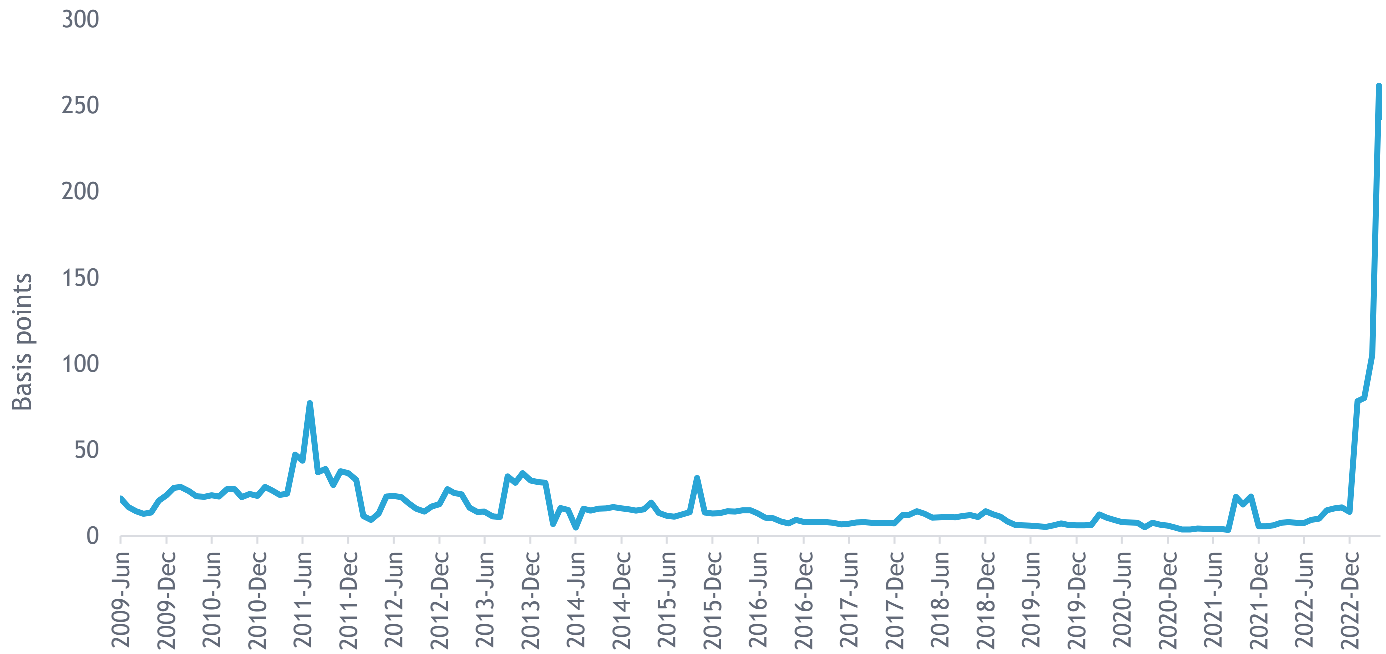
While there's some uncertainty around how a default would be managed. There's no denying that it would have significant and potentially severe effects. These range from missed payments to Social Security beneficiaries, Medicare providers, military service members and other federal employees, contractors, etc. to missed interest and principal payments to holders of Treasury securities. There's also some disagreement over how quickly the most negative effects might take hold. There is near-universal agreement that a default would constitute a severe policy error (perhaps all the more so because, unlike a typical government

[1] Goldman Sachs Economic Research, "The Debt Limit: The End of the Beginning (Phillips/Krupa)," 1 May 2023.

default, this could have been avoided). A down-to-the-wire episode or worse is also likely to aggravate concerns about the state of the U.S. government's full faith and credit and the trustworthiness of its financial obligations.

Is it different this time?

If U.S. political dysfunction seemed high in the 2011 and 2013 debt ceiling episodes, it's even worse today, and markets seem to be expressing a greater degree of concern this time around. For example, yields on Treasury securities maturing this summer have varied quite a bit by maturity, reflecting varying degrees of confidence in whether holders will be made whole on schedule. The cost to insure against a Treasury default has also risen well above levels seen in prior debt ceiling episodes, as shown in Exhibit 1.[2]



Month-end cost for six-month U.S. Credit Default Swaps (CDS) from June 2009 through April 2023 and including closing value on May 3, 2023. May 3 value of 243 implies CDS holders were paying $243 to insure each $10,000 of Treasury securities. Source: Bloomberg.

What could it mean for investors?

With only a small number of similar episodes in U.S. history, it's anyone's guess how various asset classes will perform as this ongoing drama unfolds. It's reasonable to assume a default would cause varying degrees of risk aversion across many financial markets, and that this could intensify the more remote a timely resolution appears to be. While it appears little was resolved in the May 9 meeting between Speaker McCarthy and President Biden, perhaps investors can take some comfort in the assumption that most politicians are fully aware of the gravity of the situation. As SEI's Chief Markets Strategist Jim Solloway recently quipped, "This isn't the Cuban Missile Crisis. All parties will be in constant contact with each other and everyone will be aware of each party's needs and red lines. House Speaker McCarthy could find his leadership in a tenuous position if a compromise upsets enough members of his caucus."

While it's always risky to think "this time is different," there are some other unique features to the current standoff, both positive and negative. Encouragingly, the U.S. labor market was still quite healthy as of April, whereas in 2011 and 2013 unemployment remained well above its pre-global financial crisis level. Among potential concerns, there's been persistent pressure on bank reserves since the Fed started tightening policy, due to quantitative tightening (the Fed shrinking the size of its

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[2] Higher interest rates today explain some, but not all, of the higher CDS prices observed this time around.

asset holdings) and competition from short-term, non-bank alternatives (such as money market funds) offering higher yields. If and when the debt ceiling is resolved, even temporarily, the Treasury is likely to rebuild its cash holdings, a dynamic that could cause bank reserves to fall further, potentially exacerbating the stresses that have been affecting U.S. regional banks.[3] Of course, this assumes no further policy measures are taken to ease the funding and balance sheet pressures banks have been experiencing.

While predictions about the future are often wrong, it seems safe to say the debt ceiling drama could get even more dramatic. A diversified portfolio with appropriate expected risk characteristics remains appropriate in our view.

Glossary

Alternatives: An investment that is not one of the three traditional asset types (stocks, bonds and cash). Alternative investment strategies typically operate in private, unlisted markets, or have the ability to use leverage, shorting, and active risk management in pursuit of returns that are lowly correlated with traditional asset types.

Asset classes: A group of securities that share similar characteristics and behave similarly in the marketplace. The most common asset classes are stocks, bonds and cash equivalents. Asset classes are generally governed by the same rules and regulations.

Balance sheet: A financial statement that reports assets, liabilities, equity. It provides a snapshot of an entities financials (e.g. what it owns, and what it owes).

Credit Default Swaps: A financial derivative instrument that allows an investor to swap or offset their credit risk with that of another investor.

Debt Issuance: An approach used by both the government and public companies to raise funds by selling bonds to external investors.

Treasury securities: Often simply called Treasuries, are debt obligations issued by the United States Government and secured by the full faith and credit (the power to tax and borrow) of the United States.

Quantitative tightening: Policies taken by a central bank to shrink its monetary reserves by either selling government bonds or letting them mature. This effectively removes money from financial markets.

Yield: Annual percentage rate of return on capital. The dividend or interest paid by a company expressed as a percentage of the current price.

[3] This was a point made by State Street Senior Global Strategist Marvin Loh, “Hitting the (debt) ceiling [video],” 28 April 2023.

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