VIEWPOINTS

# The U.S. Debt Ceiling Debate: Expecting Resolution, Appreciating the Stakes

We believe Congress will reach an agreement before the debt limit is reached, but markets could face turbulence later this year.

BY **LIBBY CANTRILL**, **JERRY WOYTASH** | JANUARY 31, 2023

The U.S. debt ceiling and fears over a potential breach have recently dominated headlines. However, the day of reckoning – the so-called x-date when the U.S. government exhausts extraordinary measures and hits the debt ceiling – is months away, and while we expect some brinkmanship, we believe the odds greatly favor a resolution before the U.S. reaches the brink.

Still, there are ramifications to the political drama, which could drag on over the next several months, and we are already seeing some impact in short-term markets. Additionally, we expect a modest recession this year, and the political posturing over the debt ceiling simply underscores our view that fiscal spending is unlikely to support growth. With the Federal Reserve focused on inflation, monetary policy is also unlikely to mitigate a contraction. (Read our *Cyclical Outlook* for more on our views for 2023.) In other words, the "fiscal put," similar to the "Fed put," is no longer available to support markets or the economy for the foreseeable future (see our recent blog post, "What to Expect From Divided Government").

## Is 2023 the next 2011?

Of course, we have seen this movie before as both parties have used the debt ceiling as leverage to try to win concessions from the opposing party over the past few decades. The only time in recent memory, however, that holding the debt ceiling hostage resulted in policy wins was in 2011, when House Republicans secured spending cuts from the Obama administration. But that only happened after the country was on the brink of default, causing volatility in the markets and precipitating a downgrade by S&P.

While parallels are being made to 2011, we think the dynamics are very different today, and we do not expect the negotiations over the next few months to result in spending cuts – or default.

The biggest difference between 2011 and 2023 is that House Republicans had much bigger majorities in 2011 (+24 seats vs. +4 today, including 18 House Republicans who won in Biden districts). With such a skinny majority, Speaker Kevin McCarthy cannot afford to lose more than a handful of members, a harder proposition as we get closer to the date when markets (and donors) may get skittish. Plus, the very small majority makes it much easier for Democrats to try to use a discharge petition, which would compel Speaker McCarthy to bring a debt ceiling bill to the floor for a vote, even if he did not bless it. To be sure, to successfully launch a discharge petition is an uphill procedural battle, but even the threat of a discharge proposition could inform ultimate behavior.

Additionally, in 2011, voters sent dozens of new Tea Party Republicans to the House with the mandate to rein in government spending. Not only was the 2022 election *not* about deficit reduction, but Medicare and Social Security, in particular, remain wildly popular across both parties, particularly among older people – who also happen to vote. (See Gallup survey results here).

Lastly, while President Barack Obama was open to negotiating government spending around the debt ceiling in 2011, President Joe Biden has reiterated that he is not open to entitlement reform; and moreover, unlike Obama, he won't discuss spending cuts in the context of a debt ceiling increase.

While it is no surprise that Republicans are using the debt ceiling to try to secure concessions, it is too early to know how the dynamics will play out and how close we will actually get to default – if at all. Political posturing and brinkmanship should be expected, but ultimately, we believe cooler heads will prevail and the debt ceiling will be raised, albeit potentially not until the eleventh hour and maybe with some choppiness in the broader financial markets. Importantly, we think *at most*, there could be a compromise to raise the debt ceiling in exchange for a commission to evaluate future spending. But regardless, we do not anticipate a debt ceiling agreement to include *any* spending cuts. After all, we do not believe 2023 is the next 2011.

# Market impact

The impact on financial markets has been limited so far given uncertainty over how negotiations will play out, and of course, the debt ceiling is just one of many risks that the global economy faces.

In prior debt ceiling showdowns, the impact on equity markets was mixed. In 2011, after the debt ceiling was raised, the S&P 500 index tumbled over 10% in the following week, mostly due to fears about the emerging eurozone debt crisis. In 2021, after it was clear that a temporary debt ceiling deal would not be filibustered, equities rallied. This suggests that while a standoff makes for good press, *as long as* the U.S. does not default, the broader market impact is temporary and limited.

However, for money market investors, the impact of the debt ceiling is already being felt because it affects how the U.S. Treasury manages its debt issuance and cash balances. Typically, the U.S. Treasury holds enough cash in its general account to meet at least five days of expenses,[1] but the debt ceiling limits its ability to raise cash by preventing it from issuing more debt.[2] Since the Treasury prioritizes maintaining a "regular and predictable" auction schedule for longer-term debt, debt issuance is ultimately reduced by cutting shorter-term Treasury bill supply, which money market funds usually purchase.

In December, the U.S. Treasury reduced the number of Treasury bills it issued and correspondingly lowered its cash balances to avoid exceeding the debt ceiling. Secretary Janet Yellen has invoked "extraordinary measures," a set of one-time accounting maneuvers that temporarily increase the amount of marketable debt the Treasury can issue. However, this increase in the bill supply will be short-lived as new coupon issuance will eventually bump up against the debt ceiling. This means that as we go through the spring and into the summer, there will be fewer Treasury bills to buy, paradoxically leading to Treasury bills richening[3] as the "x-date" approaches. A flight to safety into bills resulting from broader market risk aversion could further push down yields.

Once the debt limit is raised, we expect that the Treasury will move swiftly to rebuild its cash balances. This should cheapen Treasury bills – along with other money market products – and provide cash investors opportunities to earn extra yield.

# One other thought

A unique wrinkle in the 2023 debt ceiling standoff is that the Federal Reserve has been performing quantitative tightening (QT) as it continues to battle inflation. QT works by reducing the reserves that commercial banks hold, thereby reducing banks' ability to provide funding for other money market participants. The Fed has reiterated multiple times that a key principle for QT is its intention to reduce the Fed's securities holdings "over time in a predictable manner."[4] This is key because it takes time for market participants to adjust, and rapid change can overwhelm the money market's ability to function smoothly. Such an event occurred in 2019, when the Fed's last QT effort ended and the repo market stopped functioning due to a sudden drain in money market liquidity.

The interaction of the Fed continuing QT and the resolution of the debt ceiling could result in turbulence for money markets. As discussed above, as the Treasury runs out of room under its various accounting maneuvers, the Treasury is expected to operate with a lower level of cash holdings at the Fed, and in the past this has temporarily increased the level of reserves held by banks – providing a boost in money market liquidity. However, after the debt ceiling is raised, this liquidity could  reverse (and depending on how the Treasury chooses to rebuild its cash buffer, this liquidity drain could be quite rapid). Still, the currently elevated level of the Fed reserve repo facility makes these relationships harder to forecast[5]. This provides both a risk for those that need funding as well as an opportunity for active investors who are willing to help meet the liquidity needs of the U.S. government and other money market participants.

# Bottom line

The debt ceiling is important because it impacts the market for U.S. Treasuries, which is the deepest and most liquid market in the world. The interest rates on U.S. government debt serve as a benchmark that most other assets are priced relative to. A large part of why Treasuries have been used as the benchmark rate for other investments is that investors think of them as having the lowest risk profile and the least amount of uncertainty due to the incontrovertible full faith and credit of the U.S. government.

So although we think it's too early to say that the debt ceiling is a threat to this, if the government opted to not pay its debts – even for a brief period of time – it would be unprecedented, and the market impact – on both the Treasuries market as well as on risk assets – would be difficult to predict.

We believe investors should be prepared for multiple outcomes. At PIMCO, we are constantly reviewing liquidity management and operational procedures to ensure we are prepared for a wide variety of outcomes. Amid uncertainties, it is important for investors to stay diversified.

*For details on our outlook for the global economy and investment implications for 2023, please read our latest Cyclical Outlook, "Strained Markets, Strong Bonds."*

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[1] Generally this is approximately $500 billion. ↩

[2] The Treasury issues two primary types of debt: bills targeted at money market investors with maturities less than 12 months and coupons targeted at longer-term investors with tenors ranging from 2 years to 30 years. ↩

[3] As we discussed in 2021, bill markets are unlikely to be a good early warning signal because the timing of the x-date is highly uncertain and Congress always has the option to raise the debt limit temporarily if they are close to a deal. ↩

[4] The Fed has reiterated multiple times that a key principle for QT is its intention to reduce the Fed's securities holdings "over time in a predictable manner." https://www.federalreserve.gov/newsevents/pressreleases/monetary20220504b.htm ↩

[5] A mitigating factor for this risk is that there is a second source of liquidity for money markets on the Fed's balance sheet currently in the form of the Reverse Repo Facility (https://www.newyorkfed.org/markets/desk-operations/reverse-repo). The Fed's Reverse Repo Facility (RRP facility) is designed to help market participants (including PIMCO) invest excess cash to keep interest rates within the Fed's target range. In theory investors should reduce the amount of excess cash they invest at the Reverse Repo Facility when more favorable front-end investments are available. Therefore, when the Treasury is rebuilding its cash balance after the debt ceiling is resolved we should expect to see usage of the RRP decline, but this remains a key unknown. ↩

## DISCLOSURES

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