DEBT CEILING DRAMA: THOUGHTS AND IMPLICATIONS

MAY 23, 2023

Some Historical Perspective

The debt ceiling refers to a limitation imposed by Congress back in 1917 that caps the amount of outstanding debt that the US can offer. Currently $31 trillion, the debt ceiling relates to Treasury's ability to fund appropriations Congress has already approved, not future spending. The task faced by policymakers is hardly new – Congress has raised or extended the debt ceiling 78 times since 1960, including 3 times during the last administration. In today's highly partisan environment, lifting the debt ceiling has once again created unnerving political brinksmanship, a situation that tends to materialize when DC political power is divided.

Where Do Negotiations Stand?

We, like so many others, await news from Washington, but the outlook does not appear dire. It is said that negotiations often must fail before they succeed, and there is no lack of political grandstanding. Nonetheless, bipartisan negotiators assigned by the parties are leading the process, and the President and Speaker termed their latest meeting "productive" and "promising." A rough framework of a compromise appears to be coming together even though resolution may not occur until the 11th hour.

The House GOP has linked budget negotiations to the debt ceiling, as the need to lift the latter creates leverage to push for their spending reduction priorities. While we do not know how this will ultimately get resolved, it seems likely that a deal will involve some combination of a claw-back of unspent Covid funding, and a cap on discretionary spending at roughly 1% below current levels for a period yet to be determined (the GOP sought ten years and the White House was apparently willing to go one year). The White House has also sought to have a budget deal include tax increases on the wealthiest Americans, a proposal Speaker McCarthy has rejected.

Agreement on budget parameters for 2024 and potentially beyond would facilitate a separate vote to lift the debt ceiling. How long a debt ceiling increase extends also remains to be seen, with the White House seeking to push it beyond the 2024 election. Both sides are acutely aware that a deal must be able to achieve Congressional passage, hence the complexity of the negotiations.

A Breach is Not a Default

The word "default" has been commonly referenced although it bears emphasizing that breaching the debt ceiling is not the same thing as defaulting on outstanding Federal debt. At last report, Secretary Yellen has stated that June 1st is the date upon which "it is highly likely" that the government will be unable to pay "all of its bills." This projected date was recently pushed forward given April's disappointing capital gains tax receipts. Considerable ambiguity exists concerning this trigger date, as corporate tax payments could create more time.

The words "all of its bills" referenced above are important, as Treasury would initially only be forced to prioritize payments in the incidence of a debt ceiling breach. While certain less critical obligations might need to be deferred in this eventuality, we strongly believe that interest payments on US Treasury debt would be sacrosanct. Although a significant runway between a potential initial breach of the debt ceiling and any actual default on Treasury obligations would be anticipated, the latter is a scenario we feel is very unlikely to materialize.

Furthermore, unlike 2011 when the US credit rating was downgraded amid similar drama, S&P is being careful to define default as the failure to make payment on a security issued by the federal government, rather than the far more expansive interpretation they previously took whereby any missed obligation would be considered a default. This leaves Treasury more breathing room than twelve years ago.

Treasury Volatility Reflects Uncertainty

Treasury yields are elevated around the anticipated debt ceiling dates as market participants price perceived tail risk. For example, although markets were firming up as the morning progressed, 5/23/23 trading opened with T-Bills maturing on 6/1/23 yielding 5.82%, up nearly 40 basis points from one week ago, whereas 5/30/23 maturities yielded only 3.32%. While that yield differential is dramatic, the actual cost differential is quite small given the very short holding period.

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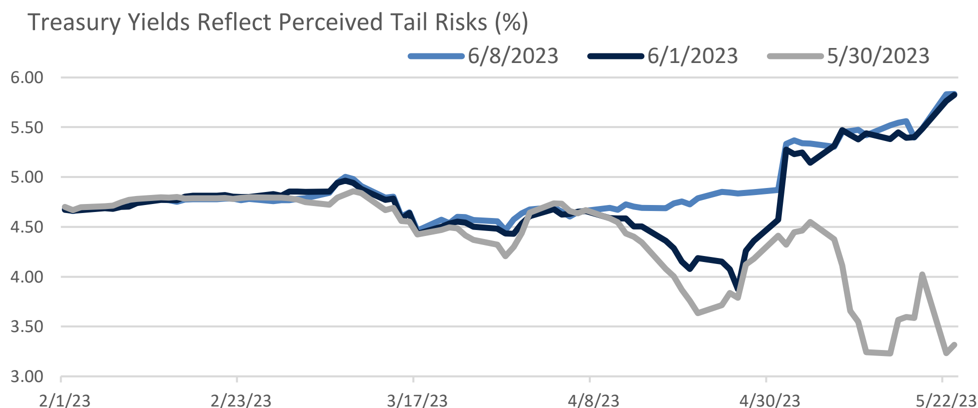
We see yield levels at the short end of the Treasury curve reflecting pricing anomalies given investors' desire to stay away from anticipated trigger dates, although an actual failure to make interest or principal payments is not a plausible scenario in our judgment. In our High-Grade Intermediate Government/Credit strategy, we do not see significantly elevated credit risk and feel the primary implications lie in pockets of liquidity strain. Our high-quality stance should position us reasonably well if a flight to quality induces spread widening.



Source: Bloomberg

Municipal Market Impact

Municipals are typically highly correlated with Treasuries and the AAA curve's inversion reflects a Fed Funds rate that has increased 500 basis points in little more than a year, as well as curtailed 2023 rate cut expectations, much more than default concerns. Baring debt ceiling induced economic chaos – an outcome we do not believe will materialize – the underlying credit standing of high-grade municipal bond issuers should not be materially affected. In our opinion, the municipal market overall remains on solid ground.

Short municipal yields spiked 36 basis points last week with the intermediate to longer end rising about 20 basis points. Debt ceiling related Treasury instability has been a factor although the tax-exempt market does not appear to be terribly concerned. Some pre-refunded issues are getting cheaper bids given their Treasury backing, yet we believe that Treasury payments would be prioritized above all else and that the risk of pre-refunded issues not being paid is remote.

Supply is still limited with YTD new issuance down more than 20%, although we are still finding opportunities to put cash to work at relatively attractive levels. The recent back-up in yields has created meaningful value in high grade municipals with tax-equivalent yields on 2-Year AAAs reaching 5.25% assuming a 42% combined tax bracket.

From a credit standpoint, we have always emphasized investment grade issuers with strong balance sheets, diversified revenue streams, and fiscal flexibility. These attributes give us a high degree of confidence in the credits we own, and we also expect a debt ceiling deal to be reached in the coming days.

Accessibility and communication are important in any environment, although these attributes are especially valuable during uncertain and volatile times. Appleton Partners is committed to sharing our market and portfolio management perspectives as developments unfold. We hope these briefs are helpful and also invite you to reach out to us directly and/or visit www.appletonpartners.com/Insights for additional commentary and insights.

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