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Managing cash amid another US debt-ceiling showdown

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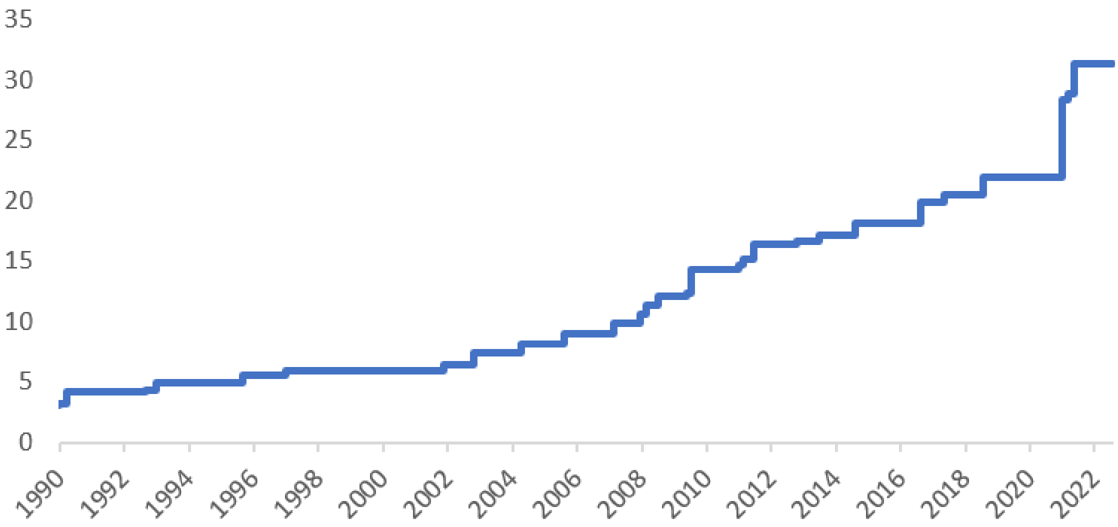
- **The showdown over the debt limit may well drag on until the 11th hour, and if so we're likely to see increased stress in certain parts of the cash markets**
- **In times of stress we think it's prudent to get shorter and more liquid, and we're already taking steps to prepare our cash portfolios for potentially tumultuous times**
- **We expect the House will come to a resolution that prevents a default, but there is a big wildcard: the possibility that a single representative could derail the House's ability to function**

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 have seen battles over the debt ceiling lead to the first-ever downgrade of the US's credit rating, and we have been forced to consider the previously unthinkable: that the world's leading economy could default on its debt.

So we find ourselves once again facing the abyss. Since mid-January the Treasury Department has been employing extraordinary measures to ensure the government has enough money to meet its obligations, including payments to debtholders. And the Congressional Budget Office estimates the country could default on its debt sometime between July and September unless the debt ceiling is raised or suspended.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 dynamics in the cash markets.

While previous debt-ceiling showdowns can offer valuable insights on how to position money-market portfolios in the coming months, we are also keenly aware that there are different factors at play this time, so we are planning accordingly.

Figure 1: debt ceiling limit increases since 1990 ($ billions)

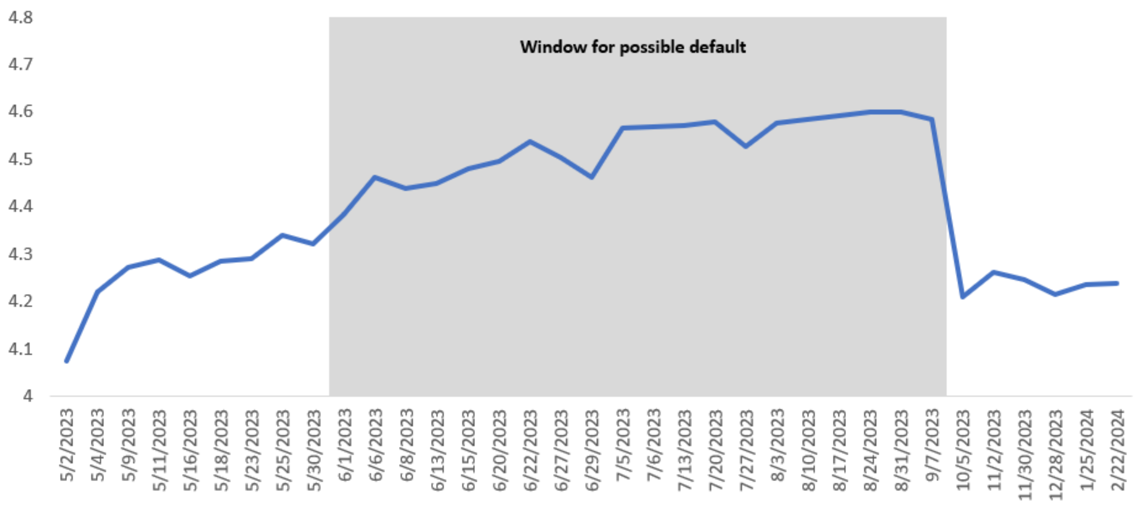


Source: Whitehouse.gov Data as at 28 February 2023

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 are not expecting a resolution any time soon – and neither are cash markets. We are already seeing distortions in the price of some securities – notably Treasury bills (T-bills) – that mature around the time when the US may default without an increase in the debt ceiling. As seen in Figure 2, 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.

Figure 2: pricing on Treasury bills reflects impending debt ceiling showdown (market ask price %, rolling series)



Source: Bloomberg, March 2023. The window for possible default is for illustrative puroses and is subject to change

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

If negotiations to raise the debt limit play out at a similar pace to 2011 cash market performance may follow suit, putting a spotlight on six-month T-bills set to mature close to the X-date of the US running out of money. A barbell strategy of three- and 12-month bills, however, could deliver similar yield and duration without exposure to bills that mature around the potential default window.

In addition, we see relatively attractive risk/reward dynamics in a number of areas including:

- Short-term Federal Home Loan Bank discount notes, which are backed by the full faith and credit of the US government, but are not subject to the same market dynamics as Treasury bonds because the issuing banks are standalone entities.
- Reverse repo transactions available through the Fed's overnight lending program.
- High-quality commercial paper from blue-chip issuers with rock-solid balance sheets.

We'll continue to monitor developments in Washington and the markets, and we think it is quite possible that we will 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 their positioning. Our overriding goal as cash investors is to preserve capital, and in times of stress experience has taught us that an appropriate way to do that can be to get shorter and more liquid.

What is different this time?

While the experience of investing through multiple crises has taught us much, we are 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 are in the midst of a steep move higher that has seen the 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 dismiss the possibility that one of them could exercise that option 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. Cash markets are likely to experience significant volatility and price dislocations, so we advocate for the recipe that we believe could be best in turbulent times: short and liquid. And given the non-zero probability that the government could default, even unwittingly, we may even double that recipe.

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