Strategy

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The Debt Limit with Complications from Money Market Funds

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Abstract

Debt limit negotiations often go down to the wire, generating headline risk and investor uneasiness. The yield on T-bills maturing around default date may be substantially higher than those maturing in neighboring months. The exponential growth in government money market funds since the 2016 regulatory reform increases contagion risk should shareholders and portfolio managers begin to sell. We advise investors to develop additional portfolio liquidity through US agency discount notes and highly rated corporate commercial paper. Institutional cash investors should manage their government fund balances with an eye towards the funds' outsized influence on market liquidity.

Introduction

The congressional fight over the national debt limit has captured the attention of financial professionals since the limit was reached last March. While financial markets have endured at least three similar high-wire acts in the last six years, causing the federal government to nearly default on its debt obligations, this year's debt limit fight involves a new phenomenon for institutional cash investors. The money market fund reform that took effect in 2016 resulted in dramatic asset migration from prime to government funds. The substantially larger exposure to the government sector through indirect means poses new risks to the treasury community in addition to those faced in previous debt limit fights.

The just-announced deal between President Donald Trump and Democratic leaders in Congress likely will push the debt limit fight by three months to mid-December. The threat of a failed final agreement, of course, remains. In this credit commentary, we provide a refresher course on the debt limit and how investors have reacted to the threat of technical default by Treasury securities. We offer reasons for investors to take special notice of the current and future rounds of debt limit fights in light of the larger presence of government fund assets in a treasury organization's liquid balances.

What Is the Debt Limit?

The government debt limit, or debt ceiling, is a legislative limit on total federal government debt beyond which the US Treasury is not allowed to issue new debt. Under Article I Section 8 of the US Constitution, Congress must authorize all borrowings to fund the federal government. Congress authorized each debt offering until 1917, when it established an aggregate limit (ceiling) to provide more flexibility to finance the country's involvement in World War I. The debt limit legislation underwent amendments and limit increases over the decades to accommodate increases in deficit spending.

What Happens when the Debt Limit Is Reached?

Without reauthorization by Congress to raise the limit, the US Treasury faces the risk of defaulting on its outstanding debt, seeing its sovereign credit ratings downgraded, facing substantially higher borrowing costs and having its ability to borrow from the public severely curtailed.

The Treasury may engage in "extraordinary measures" by temporarily withholding payments to certain internal accounts under its control to free up some additional borrowing capacity. These measures buy some time for Congress to reach a deal to raise or re-suspend the debt limit.

How Did We Get Here?

The debt limit has been raised by Congress 78 times since 1960. Serious debt limit fights in Congress were infrequent in the past until after the financial crisis of 2008, when government borrowing was increased substantially. The fights became increasingly politicized when politicians from opposing sides used the risk of federal debt default as leverage to extract political gains.

In 2011, the debt limit fight reached a crisis point of near default on public debt, which resulted in the US government debt losing the coveted AAA credit rating from Standard & Poor's. A last minute deal increasing the limit set the stage for another debt limit fight in early 2013. The resolution of that crisis planted the seeds for yet another one in late 2015.

The re-suspension of the 2015 limit expired on March 15, 2017, at which time the limit was reset to $19.809 trillion. The Treasury has since employed "extraordinary measures" as Congress works to raise or re-suspend the limit again.

When Will the Government Run Out of Options?

After the Treasury exhausts its extraordinary measures and runs out of cash, it will face the prospect of defaulting on debt payments. The exact date is an imprecise science as it depends on the Treasury's tax receipts. In a July 28 letter to Congress, Treasury Secretary Steven Mnuchin determined that a "debt issuance suspension period" will last through September 29, implying the failure to raise the debt ceiling by then will jeopardize the Treasury's ability to service its debt. The Congressional Budget Office, in its latest update dated June 29, projects the date to be "in early to mid-October". To make matters more complicated, advance payments in support of Hurricane Harvey's recovery efforts, estimated to be around $8 billion, could potentially move forward the cash exhaustion date.

News broke on September 6 that President Donald Trump agreed with Democratic Congressional leaders on a deal to combine emergency funding for Hurricane Harvey and measures to keep the government funded and the debt limit suspended until mid-December. The proposal, if passed, sets the stage for another fight just before the end of the year.

What Happens after the Government Runs Out of Cash?

When the government runs out of cash, the Treasury may decide to prioritize payments to creditors or pay them by their due dates with collected tax revenue. The Bipartisan Policy Center, a Washington DC-based non-profit think tank, suggests a prioritization scenario wherein the Treasury would pay in this order: interest on Treasury securities, Medicare/Medicaid, social security benefits, military pay, defense vendor payments, education payments, and other miscellaneous withdrawals (Homeland Security, State Department, Centers for Disease Control and others), while delaying payments on tax refunds, federal salaries, and other spending. The difficulty of prioritization is cited by the BPC in a 2012 report from the Treasury's Inspector General that prioritization may be of questionable legality and that the sheer number of daily payments would "require a massive overhaul and reprogramming" of federal payment operations[1].

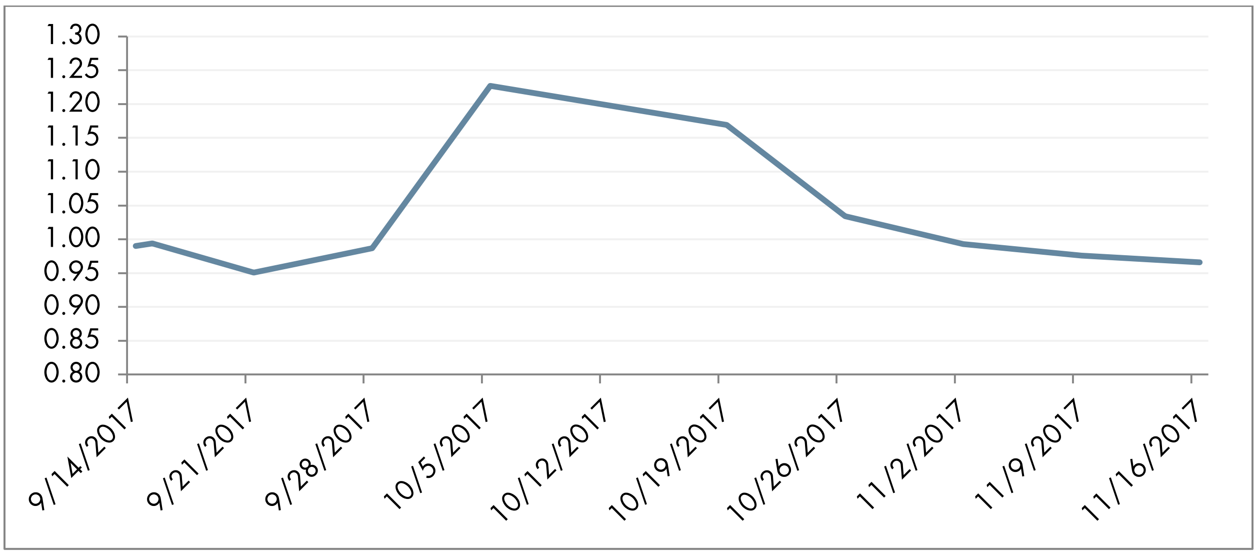
At a House Financial Services Committee hearing, Treasury Secretary Mnuchin said that he has no plans to prioritize payments. "The government should honor all of its obligations," he said[2].

How Do Markets React to the Debt Limit?

Prior to the US Treasury engaging in extraordinary measures, financial markets tend to take a sanguine view on the prospect of technical defaults, or missed payments by the government. About a month before the government is about to run out of cash, investors tend to hedge against the possibility of default by avoiding Treasury bills maturing near the estimated default date.

Figure 1 provides an illustration of this risk-averse behavior. Prior to the deal announcement to suspend until mid-December, the market expected the Treasury to run out of cash in mid-October. The yield on T-bills maturing in October was substantially higher than the yield on those coming due in both September and November. The October 5th T-bill (1.23%) was yielding 0.28% higher than the September 21st T-bill (0.95%)

Figure 1: Treasury Bills Yield Curve (As of 3 PM 9/05/2017)



Source: Bloomberg

What Is Different This Time?

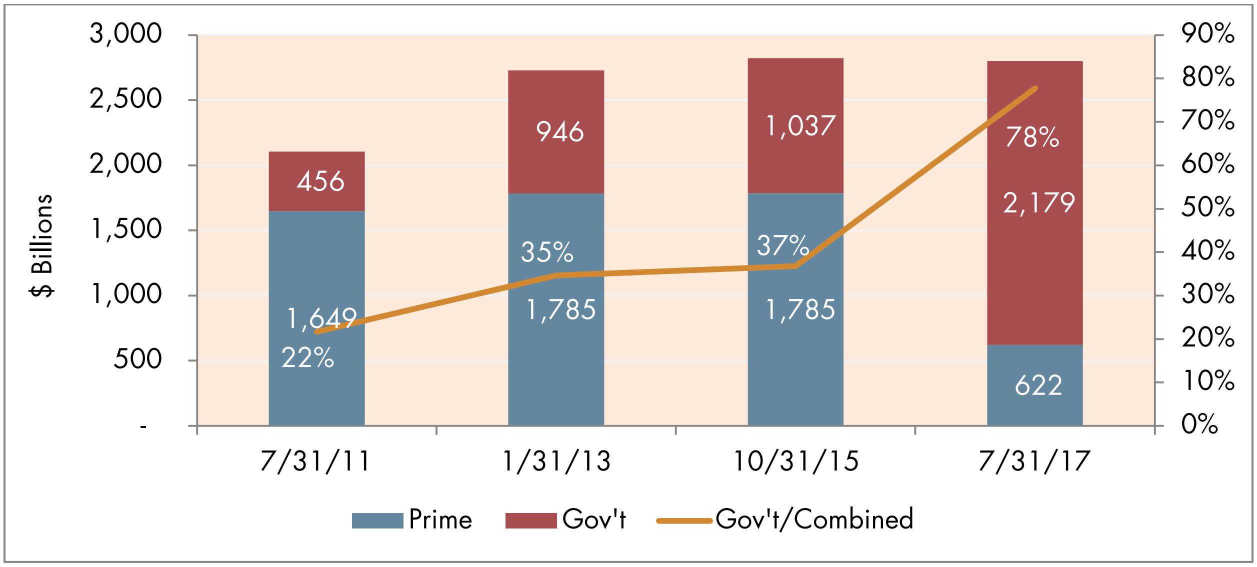
Institutional cash investors are always concerned with debt limit fights for at least three reasons: a) they may have direct investments in T-bills risking technical defaults; b) a technical default may threaten market liquidity and cause volatility in other short-term instruments; c) they may be exposed to market contagion through investments in money market funds.

While the first two risk concerns likely mirror past debt limit episodes, cash investors' involvement with money market funds has changed dramatically. A 2016 regulatory change requires institutional prime funds to adopt

[1] Bipartisan Policy Center, Debt limit analysis, August 2017, https://bipartisanpolicy.org/wp-content/uploads/2017/08/2017-Daily-Debt-Limit-Analysis.pdf
[2] Kate Davidson, Mnuchin says he has no intent to prioritize payments if debt limit isn't raised, the Wall Street Journal, July 27, 2017.

floating net asset values and redemption fees and grates. The structural changes to the popular cash management vehicle led to large asset migration from prime funds to the government fund sector.

Figure 2: Money Market Fund Assets around Debt Limit Dates



Source: Office of Financial Research Money Market Monitor and iMoneyNet

Figure 2 shows the concentration of government fund assets vs. prime fund assets as of July 31st as well as near the three previous debt limit dates. Compared to July 2011, when government fund assets represented 22% of the combined category, 78% of such fund assets are concentrated among government funds today. Note that there may be some exposure to Treasury securities in prime funds as well.

How Can Higher Concentration in Government Funds Be a Source of Risk?

In normal times, investments in government money market funds represent a source of strength, not risk. The pooled investments and inherent maturity mismatches in money market funds can be a source of concern in times of uncertainty.

In past debt limit fights, government money market funds began to experience outflows several weeks before the estimated default date. Some shareholders, unsure of the exact holdings in the funds they buy, initiated such sales. The preference to avoid at-risk Treasury securities could prompt some portfolio managers to sell such investments preemptively. These actions by the shareholders and portfolio managers influenced more selling in other funds. We should note that outflows during the 2013 and 2015 debt limit periods were not as significant as the 2011 episode, when the US debt rating was cut by S&P.

How Should Institutional Cash Investors Get Prepared?

Debt limit negotiations often go down to the wire, generating headline risk and investor uneasiness. It should be noted that a technical default, should it happen, represents a short-term delay in payments, which can be quickly cured with the creditors made whole once the situation is resolved. Investors holding T-bills maturing around December 2017 generally need not be alarmed by potential credit losses related to the technical default. The main risk is the delayed access to liquidity.

Investors with substantial balances in government money market funds should not hasten to sell their positions. Instead, they should gain an understanding on the portion of their funds maturing around mid-December. They should engage their fund managers on a course of action regarding such securities and the funds' portfolio strategies in the months in between. For example, some government funds have recently reduced T-bills and increased positions in repurchase agreements, which generally are collateralized by long-term Treasury securities and can take advantage of higher Treasury issuances once the debt limit issue is resolved.

In addition to fund investments, we advise investors to hold T-bills maturing one or two months outside of the mid-December timeframe. We think additional portfolio liquidity in other highly liquid instruments such as US agency discount notes and highly rated corporate commercial paper is also advisable.

In the long run, recurring debt limit fights will erode foreign investors' confidence in US government securities. Institutional cash investors should manage their government fund balances with an eye towards the funds' outsized influence on market liquidity, especially around debt limit time.

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