How to Position Corporate Cash Portfolios for the Debt Ceiling Showdown

Look past headline risk, seek out high-quality credits, and position maturities for a possible default "X-date."

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Introduction

Once again, it's time for CFOs and corporate cash investors to start focusing on another debt ceiling showdown in the United States Congress. On May 1st, 2023, Treasury Secretary Janet Yellen updated Congressional leaders that the United States would not be able to pay all its bills by June 1st, 2023.[1] Secretary Yellen had previously informed Congressional leaders on January 19th, 2023, that the U.S. government had reached its statutory debt limit of $31.381 trillion, and a "debt issuance suspension period" began during which the Treasury Department started using "extraordinary measures" to keep the U.S. government funded through June 5th, 2023. [2]

Secretary Yellen's letter was a significant development to the debt ceiling fight, as market participants had expected the U.S. government to make on time payments to all recipients until late summer or early fall 2023. The non-partisan Congressional Budget Office (CBO) had projected the so-called "X-date" to be between July and September 2023, but recently updated its view that "the Treasury will run out of funds in early June." [3] As political party leaders often appeal to their voter base by delaying serious negotiations until the final weeks or days, the updated timeline created significant market angst that leaders may not strike a deal in time to avoid a U.S. government default.

The debt limit debate is nothing new. For the last decade or so, what used to be a routine Congressional procedure turned into a high-stakes, down-to-the-wire political drama that catches the public's attention. In 2011, the drama resulted in a credit-rating downgrade by Standard & Poor's to AA+, the first time the U.S. federal government was given a rating below AAA. As in past showdowns, the unimaginable consequence of a default, even a technical one, resulted in the limit being lifted at the last minute—but not without lingering concerns that complacency and bitter politics might lead to self-inflicted wounds too grave to heal in the next round of fight.

We believe that politicians will again come to their senses and authorize spending in time. But, if they should fail to reach an agreement, the Treasury Department may work with the Federal Reserve to prioritize payments on debt obligations to avoid a default, though this would not be without operational complexity. These "extra-extraordinary measures" would most likely be temporary and politically distasteful but might create an additional incentive for Congress to authorize new spending limits. Nevertheless, given the high stakes and high degree of conflict in Congress this time around, liquidity investors are well-advised to pay attention.

[1] See the Department of Treasury's press release, Secretary of the Treasury Janet L. Yellen Sends Letter to Congressional Leadership on the Debt Limit, May 1, 2023, https://home.treasury.gov/news/press-releases/jy1454.
[2] See the Department of Treasury's press release, Secretary of the Treasury Janet L. Yellen sends letter to Congressional Leadership on the debt limit, January 19, 2023, https://home.treasury.gov/news/press-releases/jy1196.
[3] Federal Debt and The Statutory Limits, February 2023, Congressional Budget Office, https://www.cbo.gov/publication/58945. Blog: CBT Sees Greater Risk That the Treasury Will Run out of Funds in Early June, Congressional budget Office, May 1, 2023, https://www.cbo.gov/publication/59119.

Questions Confronting Institutional Cash Investors

CFOs and institutional cash investors have tools at their disposal to contend with possible consequences of the current debt limit showdown. Reviewing past playbooks and coming up to speed on the details of the situation today—especially looking past headline risk toward the possible timing of the default X-date—can help investors position their portfolios for this year's uncertainties.

The following is a primer with answers to some common questions on investors' minds, along with advice on possible strategies for cash portfolio managers.

What's the Debt Limit and Why Does It Exist?

The debt limit is the maximum amount the U.S. government can borrow to pay its bills. Because the U.S. government runs budget deficits, it must borrow money to pay these bills. Congress must authorize borrowing according to the Constitution.

The debt limit—often referred to as the debt ceiling—was first instituted in 1939 by legislation requiring the Treasury Department to ask for permission to issue debt. A simple majority in the House and Senate is required to lift it. Originally designed as a check against overspending and over-taxation, the debt limit has been raised 102 times since 1945.

Why Is Raising the Limit so Difficult?

Raising it was a routine procedure in Congress for several decades. As the political environment became more polarized, brinksmanship over the debt ceiling also increased. In recent episodes, members of Congress waited until after the limit was reached and the Treasury Department was about to exhaust the extraordinary measures before resolving the issue.

In the 2011 standoff between Democratic President Barack Obama and House Republicans, credit rating agency Standard & Poor's knocked the U.S. government debt off the coveted AAA rating.

Why Is the Market Particularly Concerned This Time?

Republicans holding a slim majority in the House are refusing to raise the limit without a guarantee from President Joe Biden's administration to cut back on spending. The White House refuses to tie raising the limit to spending cuts. This political posturing is not new.

What is new, however, is that in winning votes from members of the conservative Freedom Caucus, House Speaker Kevin McCarthy (R-CA) conceded to the rule that a single member of Congress could force a new speaker election. He also agreed to their demand of naming deficit spending as a top priority. This means that if one member forces a new speaker election, all house business including the debt limit legislation must stop until a new speaker is elected. To McCarthy's credit, on April 26th, 2023, the House passed his debt limit bill by a thin 217-215 margin, tying limit increases to future deficit reductions. Although the bill had no chance of being introduced in the Democrat-controlled Senate, McCarthy appears to have the backing of most of his fellow Republicans. Still, leadership in either party may have little control over a rogue representative who may force a speaker election at the last minute and throw Congress into limbo.

As in past debt-limit showdowns, heated rhetoric of political maneuvering has created daily news-cycle headline risk that drives significant fluctuations in market averages. Our advice to cash investors then and now is to look past the daily headlines and focus on likely scenarios for an ultimate resolution. We believe that given the

potential economic catastrophe resulting from actual default, Congress will ultimately come to an agreement to lift the debt limit as it has in the past. Nevertheless, we believe that liquidity investors should consider establishing portfolios with laddered maturities and high-quality credit instruments to weather the ups and downs of a market buffeted by the daily headlines.

What Are the "Extraordinary Measures" and How Long Can They Last?

In her January 2023 letter to Congress, Secretary Yellen said the Treasury Department would no longer invest funds for certain federal health and retirement plans, including suspending the daily reinvestment of securities held by the Treasury's Exchange Stabilization Fund and temporarily moving money between U.S. government agencies and departments. By redirecting investments and payments meant for its internal accounts, these measures create more headroom to satisfy public debt payments without hitting the limit. Once new borrowing is authorized, the U.S. government can replenish those accounts under its control. These extraordinary measures may allow the department to procure some $800 billion additional funds to keep the U.S. government going for some time.

What Is the X-date?

This X-date is the date that the U.S. government may literally run out of cash and is unable to issue new debt and pay its bills, including interest to bondholders, payroll checks to U.S. government employees and military personnel, and social security checks. Beyond this point, a technical default of the U.S. government debt becomes possible.

How Accurate Is the X-date Estimate?

As we have seen from Secretary Yellen's updated estimate, there can be considerable uncertainty around the X-date that depends both on the amount and the timing of U.S. government expenditures and tax receipts.

Prior to her May 1st, 2023, letter, estimates for the X-date varied widely between June and November 2023, primarily because of uncertainty of income tax payments before the April 18th, 2023, Internal Revenue Service (IRS) tax-filing deadline. Officials now know that revenue was less than anticipated relative to baseline budget projections. Moreover, the CBO noted that, compared to COVID-19 related delays in 2022, the IRS will finish processing tax returns more rapidly this year, leading to the receipt of fewer additional payments in May and beyond. When this is combined with less-than-expected receipts through April 2023, the result is the Treasury's extraordinary measures being exhausted sooner than previously projected. However, the projected X-date remains uncertain because the timing and amount of revenue collections and outlays continue to be difficult to predict.

What Happens If the U.S. Government Defaults on Its Debt?

If Congress fails to act, the U.S. government may be forced to default on its debt obligations for the first time in history. The event not only would shake investor confidence in U.S. government bonds, raising the prospect of a US recession, global market volatility and reduced liquidity, but also threaten the reserve currency status of the US dollar, invite more ratings downgrades, and likely raise borrowing costs. Missed payments on other U.S. obligations, including Medicare and Social Security benefits, could cause tremendous economic pain on individuals and businesses.

What Can the Treasury Department Do to Avoid Defaulting on Its Debt?

The Treasury Department in the past had a plan for "extra-extraordinary measures." During the 2011 debt limit debacle, an idea emerged that the Treasury could give priority to certain outlays over others and thus avoid

defaulting on debt payments. Past Treasury officials called such a plan unworkable, but the transcript of an August 2011 private meeting between Federal Reserve and Treasury officials revealed that a plan was indeed formalized to make on-time payments on Treasury debt and delay paying other bills should the debt limit talk fail.[4]

This revelation underpins rating agencies' confidence that the US would not immediately default on its debt, as Moody's "believes that the Treasury would prioritize interest payments over other expenses to preserve the full faith and credit of the U.S. government and avoid significant disruptions to global financial markets." [5] By paying bondholders first, the Treasury could theoretically forestall a financial market disaster.

But as the U.S. government runs a budget deficit, those "extra-extraordinary measures" would only be a stop-gap solution. They also could be logistically cumbersome, and in choosing to pay foreign debtholders over domestic workers, soldiers, retirees, and healthcare systems, they could prove to be politically disastrous.

How Will Payment Prioritization Work in Practice and Will It Work Properly?

According to the transcript from the FOMC conference call on October 16th, 2013, principal payments on maturing Treasury securities would be funded by rollover Treasury auctions. Interest would be paid with cash in the Treasury general account, which would require the Treasury to delay or hold back making other U.S. government payments. [6]

This arrangement is theoretically doable as bond payments are handled by the Fedwire® Securities payment system, while other U.S. government obligations are paid through a different computer system. Notwithstanding the political firestorm it likely will cause, it is unclear whether the Treasury will execute this plan without a hitch operationally as it has never done something like that in practice.

Can the Federal Reserve Do Something About It?

By law, the Federal Reserve cannot lend directly to a federal department. Fed officials also avoid discussing the debt limit to preserve its independence from the legislative process and partisan politics. The central bank, however, has several options to mitigate or lessen negative ramifications from the threat of a default.

As noted earlier, should the Treasury decide to prioritize payments, the Fed will be tasked to "pend" them in its electronic funds transfer system. As more transactions move online, the task gets easier for the Fed to track and manage them. The Fed may also purchase Treasury securities that mature around the X-date to take them out of money market and retirement funds to preserve market liquidity and stability. It could also accept them as collateral for repurchase agreements. In the unlikely event of a default, it could even purchase defaulted securities outright or swap them for non-defaulted ones, albeit at reduced market prices, to keep the market functioning.

[4] Kate Davidson, Officials planned to prioritize debt payments as 2011 debt-ceiling deadline loomed, The Wall Street Journal: Economy | Central Banks, January 12, 2017, https://www.wsj.com/articles/officials-planned-to-prioritize-debt-payments-as-2011-debt-ceiling-deadline-loomed-1484257028.
[5] Moody's: FAQ on US Government's debt limit and potential sovereign rating implications of a missed interest payment, November 16, 2021, https://www.moodys.com/research/Moodys-FAQ-on-US-Governments-debt-limit-and-potential-sovereign--PBC_1311160. Subscription required.
[6] "Conference Call of the Federal Open Market Committee on October 16, 2013," The Federal Reserve Board, https://www.federalreserve.gov/monetarypolicy/files/FOMC20131016confcall.pdf.

The downside for the Fed to get involved, besides political ramifications, includes the moral hazard of bailing out the U.S. government that makes future fights more frequent and last longer. For these concerns, the Fed will likely stay on the sideline unless needed as a last resort.

What About the 14th Amendment Mentioned by President Biden?

The 14th amendment to the Constitution reads, "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned." Invoking the 14th Amendment by issuing debt to prevent a default and ignoring the statutory debt limit was discussed in past episodes as a possible but unlikely solution due to a Constitutional crisis it likely will cause. The matter gained more attention when President Biden told reporters on May 9th, 2023, that he was considering invoking it. [7]

Legal experts are skeptical that the Biden administration will take that route due to inevitable court challenges. Top Biden officials also distanced themselves from this option. Treasury Secretary Yellen told the press repeatedly that the amendment would cause a "constitutional crisis." Even President Biden himself qualified it in his statement in a some-what long-term context, expecting the issue to be decided by the court system "months down the road," "whether or not it does work." [8] Thus, the 14th Amendment is likely more of a negotiation tactic for the Biden administration than a workable solution to the current situation, at least not one that can be reliably used in the near-term.

What Does the X-date Mean for Cash Investors?

Knowing the X-date is important for CFOs and other managers responsible for corporate cash investments and liquidity. However unlikely, a delayed bond payment on the stated maturity date may result in bond maturity miss-matches in portfolios in relation to monthly or quarterly cash withdrawal estimates. For this reason, cash managers may prefer to avoid holding securities that mature around the X-date to minimize liquidity impact and operational difficulties. This is also why Treasury securities that mature around the X-date tend to see their yields rise, which move in the opposite direction to prices. All else being equal, one strategy to avoid the X-date is to consider selective investments in high-quality securities with longer maturities in order to avoid missed coupon and/or maturity payments from US Treasury securities.

How Should Liquidity Investors Prepare Themselves During This Period?

We believe liquidity investors may benefit from following strategies that worked in previous debt ceiling episodes. They should not be overly concerned with the headline risk but instead monitor the timing of the X-date and allocate their liquidity targets accordingly. Although we are confident (but not blindly so) that the debt limit will be lifted in time and a default avoided, we recommend that investors consider a liquidity portfolio with laddered maturities and high-quality credit instruments, as market liquidity may be choppy as investors process the highs and lows of the negotiations.

With past experience as a guide, investors should remain calm as negotiations are underway and not give in to the temptation of reacting to the 24-hour headline coverage. Expect yields on Treasury securities that mature around the X-date to rise along with the potential for less liquidity. Investors typically select securities of longer maturities in order to avoid missing maturity payments.

[7] Jennifer Haberkorn, "Biden says he's exploring 14th Amendment to defuse debt ceiling standoff," Politico, May 9, 2023, https://subscriber.politicopro.com/article/2023/05/biden-says-hes-exploring-14th-amendment-to-defuse-debt-ceiling-standoff-pro-00096089.
[8] Elizabeth Elkind, Can Biden use 14th Amendment to avert a debt limit crisis? Legal experts weigh in, Fox News, May 10, 2023, https://www.foxnews.com/politics/biden-use-14th-amendment-avert-debt-limit-crisis-legal-experts-weigh-in.

Liquidity investors should review their portfolios with their investment advisors, repurchase agreement counterparties, and money market fund managers to limit exposure to securities with at-risk maturities, and refrain from buying securities with elevated yields near the X-date.

What Should Investors Do with Treasury Securities in Their Portfolio Within the X-date Window?

Cash investors generally prefer to avoid holding securities facing delayed maturity payments. Since Secretary Yellen's estimate for the X-date is significantly sooner than earlier market projections, some liquidity portfolios, including money market funds, may own securities in this time window. As discussed earlier, a delayed maturity payment is a curable liquidity situation, not a credit event, as the U.S. government's ability to honor its obligations is never questioned. To the extent an investor does not rely on these securities for immediate liquidity, it may be prudent to hold on to them as the baseline outcome remains that the debtholders will be made whole.

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