DUCENTA SQUARED
ASSET MANAGEMENT

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The Debt Ceiling – Here We Go Again

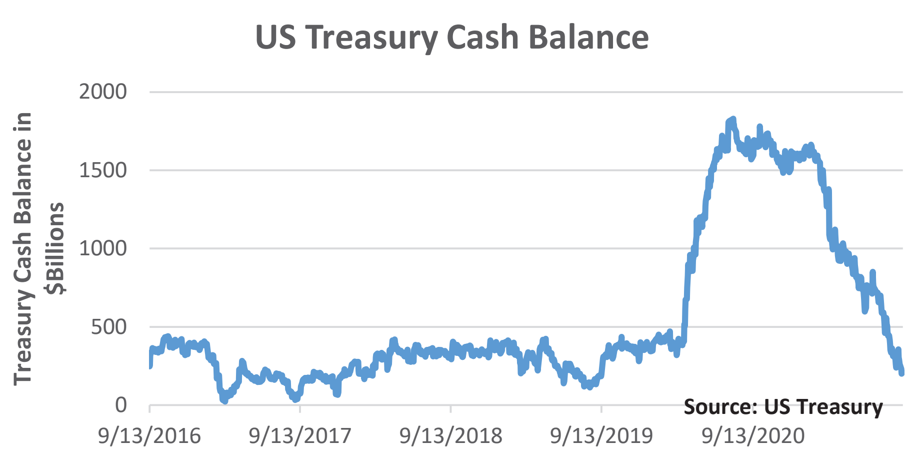
The US government is quickly approaching the late October 2021 deadline to either raise the debt ceiling or risk a technical default on US Treasury debt. We have seen this political brinkmanship before, most notably in 2011 when Standard & Poor's downgraded the country's credit rating to AA+ from AAA, based in part on its assessment that US policy makers failed to stabilize the government's medium-term debt dynamics. Complicating matters currently, the debt ceiling appears down the list of priorities on a very busy Congressional agenda, which includes a $1 trillion infrastructure bill, President Biden's controversial $3.5 trillion spending package, and a continuing resolution authorizing fiscal year 2022 spending. In this month's DSAM Fixed Income Insight we consider the landscape and what to expect as the debt ceiling again figures into the political agenda.

What is the debt ceiling?

The debt ceiling, set by Congress, places a limitation on the amount that the US Treasury department can borrow to pay already approved government commitments. Since its inception in 1917, the debt ceiling has been routinely increased, as needed. More recently, however, policy makers have used the limit as a political tool to gain leverage over the fiscal agenda. Past debt ceiling standoffs brought the US dangerously close to default but were ultimately resolved. In 2019, the debt ceiling was suspended until July 31, 2021. On August 1, 2021, the balance of Treasury debt reached the $28.5 trillion statutory limit. Consequently, US lawmakers will need to either again suspend the rule or raise the debt ceiling to raise new debt.

How much time remains?

Since the expiration of the suspension at the end of July, the US Treasury has been utilizing a variety of "extraordinary measures" to temporarily manage the outstanding balance of national debt. Treasury Secretary Janet Yellen recently warned Congress that these measures will likely be exhausted by the middle of October. At that time, the government could run out of cash and potentially default, if it can't borrow to fund debt maturities, interest payments or other expenditures. As Secretary Yellen stated, the exact drop-dead date is difficult to estimate given the uncertainty regarding government cashflows, particularly in the post-pandemic environment. The graph below highlights the US Treasury's cash balance, which ballooned with pandemic relief measures but has since dropped below the pre-pandemic average of approximately $225 billion.



How to fix the problem?

Congress returns to session on September 20, 2021, so debate regarding the debt ceiling may increase in coming weeks. Mitch McConnell, Republican Senate Minority Leader, recently stated that Republicans oppose raising the debt ceiling "not because it doesn't need to be done" but because doing so would pave the way for Democrats to pass a $3.5 trillion human infrastructure bill that would undo much of former President Trump's 2017 tax cut. However, Democrats could use the reconciliation process to raise the debt ceiling, which would require no Republican support. Unfortunately, this route could take time and face other difficulties, as the debt ceiling increase was not attached to the new budget resolution passed by House and Senate Democrats. Clearly, at issue is a willingness rather than an ability to fund the government, and neither political party wants to be responsible for a default. Nevertheless, it seems that the debt ceiling resolution will again go down the wire.

What are the consequences?

In her message to Congress, Secretary Yellen stated, "a delay that calls into question the federal government's ability to meet all its obligations would likely cause irreparable damage to the US economy." She also warned "of an immediate blow to business and consumer confidence, higher borrowing costs that could precipitate a global crisis and another hit to the country's credit rating, which was downgraded in 2011 amid a previous debt-ceiling clash." Despite these dire warnings, the bond markets have become desensitized to the debt ceiling politicking. In the past, delays in increasing the debt ceiling raised investor fears regarding timely payment, resulting in higher yields on Treasury Bills maturing around the debt ceiling drop-dead date. The uncertainty could increase risk aversion and drive credit bond yields higher; but we suspect in today's yield-hungry environment that any sell-off would be short-lived. We will be watching closely to see how debt ceiling negotiations unfold, but we currently believe the markets will ultimately look past any political gamesmanship and that the ceiling will again be raised.