Will Debt-Ceiling Drama Turn into a Debt-Ceiling Debacle?

Despite the US Treasury potentially being unable to pay all of its bills as soon as June 1, negotiators in Washington remain at an impasse in their discussions over raising the debt ceiling, or the total amount of debt the government is authorized by Congress to borrow.

While the path forward remains highly uncertain, the unprecedented destination of default remains a possibility and would almost certainly have disastrous consequences for markets and the economy. That said, even a last-second agreement that allows the Treasury to continue meeting its obligations—by either increasing the debt ceiling or suspending it for a few months—could have long-lasting destabilizing impacts. Further, it appears unlikely that a resolution to the debt-ceiling drama will include any meaningful and necessary fiscal reform.

As investors, we're left to observe the political kabuki surrounding the debt-ceiling debate from the cheap seats, hoping to glean some semblance of meaning amid the finger-pointing and grandstanding and posturing. That we have grown accustomed to the political brinksmanship that seems to precede every eleventh-hour agreement averting the worst-case scenario, we must be prepared for all potential alternatives. Below, we answer a few questions in an effort to provide some insight into the current circumstances.

Views expressed are as of May 24, 2023.

How Did We Get Here?

> The "x-date" is likely to occur sometime in the first two weeks of June and could happen as early as June 1.

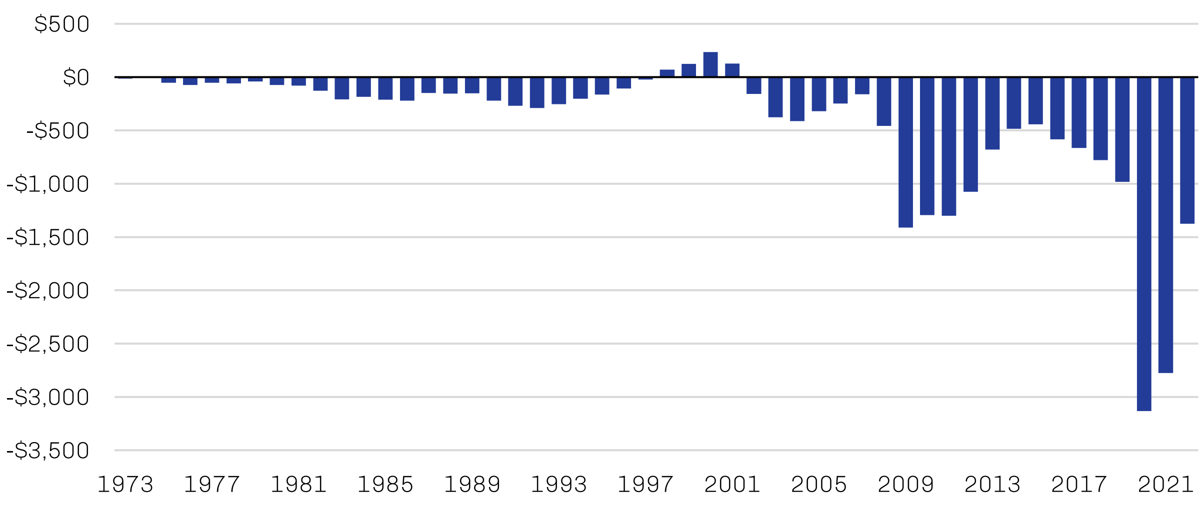
The debt ceiling (or debt limit) is the total amount of money the federal government is allowed to borrow to meet its existing obligations, which include debt-servicing costs, Social Security and Medicare benefits, military and government employee salaries, tax refunds and more. Once the debt ceiling is reached, the government is prohibited from additional borrowing and may be forced to delay making payments for some activities, default on its debt, or both until a higher limit can be established. The debt limit is set by Congress, and since 1960 has been increased 78 times, mostly on a bipartisan basis without conditions. The most recent, in December 2021, brought the ceiling to its current level of $31.4 trillion.[1]

Though the ceiling was reached on January 19, 2023, the government has continued to meet its obligations by spending down cash and through "extraordinary measures" that enable it to borrow additional funds without breaching the limit. Although the "x-date"—the day when the Treasury effectively runs out of cash and extraordinary measures are exhausted—is uncertain given its reliance on the timing and order of revenue collections and outlays, it's likely to occur sometime in the first two weeks of June and could happen as early as June 1. But if the Treasury is able to make it until June 15, the combination of quarterly corporate tax receipts and the availability of additional extraordinary measures may enable it to continue financing government operations through at least the end of July.[2]

The US government almost always operates in a deficit, as federal revenue (which comes primarily through taxes but other sources as well) has exceeded outlays only five times in the past 50 years; the last surplus came in 2001. In fiscal 2022 (ended September), the federal government spent about $6.3 trillion while bringing in about $4.9 trillion in revenue. The resulting deficit of $1.4 trillion needed to be funded through the sale of Treasury securities. Note that the national deficit is different from the national debt, which is equal to the accumulation of deficit borrowing still outstanding and the associated servicing costs. Federal debt held by the public, which excludes intragovernmental holdings, stood near 100% as a percentage of GDP at of the end of 2022.[3]

Outsized Deficits through Much of the Twenty-First Century...

Federal Surplus or Deficit in Billions of Dollars, 1973 through 2022

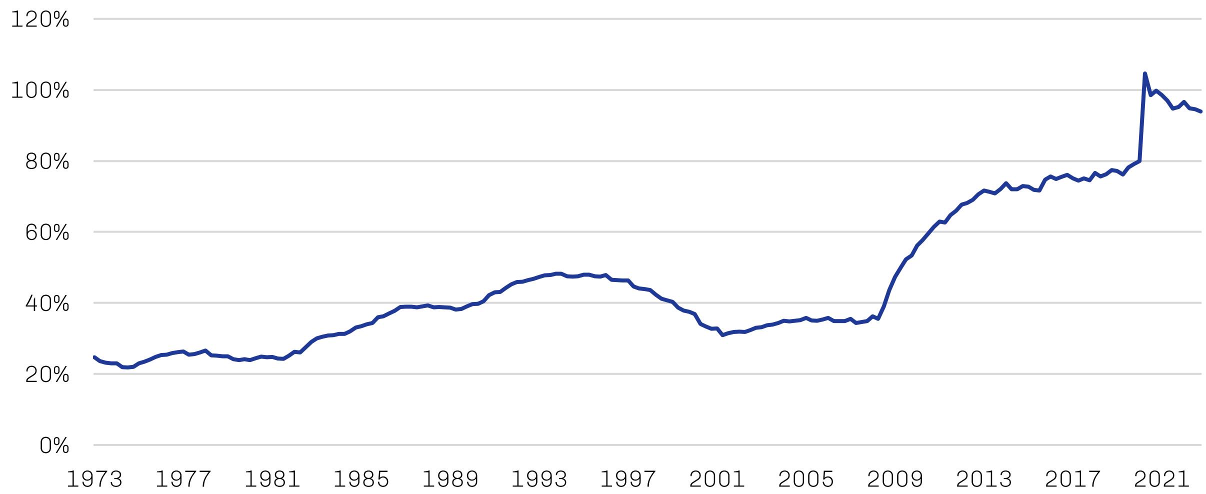


Source: Federal Reserve Board of St. Louis; data as of May 22, 2023.

1. Source: Congressional Budget Office; data as of May 12, 2023.
2. Source: Department of Treasury; data as of April 22, 2023.
3. Source: Federal Reserve Board of St. Louis; data as of September 30, 2022.

...Helped Fuel a Massive Increase in US Federal Debt

Federal Debt Held by the Public as a Percentage of Gross Domestic Product, 1973 through 2022



Source: Federal Reserve Board of St. Louis; data as of May 22, 2023.

Where Do Negotiations Stand?

Republicans have insisted that any bill increasing the debt limit must include spending cuts; the White House wants a clean bill without conditions but recently has warmed to certain spending considerations in an effort to get a deal done. In April, the Republican-controlled House of Representatives passed a debt-ceiling bill that included provisions to slash non-defense discretionary spending and roll back a number of President Biden's legislative achievements. While the bill's chance of getting through the Democrat-controlled Senate was nil, it served as a starting point from which the two sides could attempt to bridge the $4.8 trillion gap between them.

> As was the case with several previous debt-limit standoffs, a deal seems unlikely before the last moment and market pressure truly begins to intensify.

Following weeks of stop/start discussions between negotiating teams and little headway, House Speaker McCarthy and Biden on May 22 had their first in-person one-on-one meeting since February. Immediately afterward, both expressed optimism about their ability to reach an agreement, but details around spending remain a stumbling block. Also at issue is the length of the debt-ceiling increase; Democrats want it to extend beyond the 2024 elections, while Republicans are pushing for March 2024.[4]

As was the case with several previous debt-limit standoffs, a deal—whether to raise the debt ceiling or kick the can down the road with a temporary extension—seems unlikely before the last moment and market pressure truly begins to intensify. However, even if current negotiations culminate in a resolution of the standoff, we believe there's little in Washington's recent track record to suggest progress will be made toward addressing the serious medium-term fiscal challenges facing the country. For instance, negotiations appear to center on discretionary spending caps, which comprise only about a quarter of federal outlays. Placing the US fiscal position on a sustainable trajectory would likely require tax hikes, entitlement reform and cuts to discretionary spending, all hard to imagine in our polarized political environment.

4. Source: *The Wall Street Journal*; data as of May 22, 2023.

How Have Markets Reacted to the Impasse?

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While equity, bond and currency markets have remained relatively stable, Treasury markets are showing signs of dislocation. Treasury bills—which have maturities ranging from four weeks to one year—maturing before June 1 have richened, while the opposite has been true of bills maturing in early June. Yields on short-term paper have moved decidedly higher on a constant-maturity basis.[5] Premiums on Treasury credit-default swaps, which provide the holder compensation in the event of default, have spiked across maturities to all-time highs in recent weeks as market participants began to face the possibility that the government could fail to meet its obligations, if only briefly. While an increase in swap spreads has not been an unusual occurrence during such standoffs, current spreads are well above previous incidents.[6]

Brinksmanship alone historically has created uncertainty in the Treasury markets that ultimately resulted in higher borrowing costs. The Government Accountability Office estimates delays in raising the debt ceiling in 2011 cost the government about $1.3 billion in additional borrowing costs that year—not accounting for the multiyear impact of increased costs on Treasury securities that remained outstanding.[7]

What Would Happen If the Debt Ceiling Were Breached?

As noted earlier, the Treasury would face some difficult choices if it ran out of money and extraordinary measures: It could delay making payments for some activities, default on its debt, or both. Default would almost certainly have catastrophic implications, and even a brief default that was subsequently cured could be enough to tip the already-fragile economy into recession. Beyond unleashing chaos into the $24 trillion market for US Treasuries[8] that would reverberate worldwide, an extended default may erode faith in the creditworthiness of the US and undermine the dollar's status as the global reserve currency.

From a functional standpoint, although the Treasury has not explicitly commented on the actions it would take in the event the debt limit is crossed, we would expect them to prioritize debt-service payments at the expense of obligations to employees, suppliers and programs like Social Security, Medicaid and others. We also expect the Federal Reserve would stand by as necessary to ensure the orderly functioning of financial markets. Both suppositions are consistent with the contingency plan put in place during the 2011 debt-ceiling standoff.[9]

While such an arrangement may enable the government to sidestep a default on Treasury securities, it is still a bad outcome that likely would result in a range of headwinds to economic growth, including a sharp, sudden cessation of government spending, an increase in both private and federal borrowing costs, lower asset prices and widespread disruptions to the global financial system. Spillover effects would have the potential to usher in a new financial crisis and recession at a time when policymakers worldwide are attempting to engineer a soft landing as they battle stimulus-driven inflation.

Of course, a breach of the debt ceiling may not be a necessary condition for negative repercussions; brinksmanship alone has proven to have broad negative impacts in the past. Take 2011, for example. Though a deal was struck just days before the x-date of this impasse, consumer and business confidence fell sharply, job growth slowed, stocks fell, credits spreads gapped and volatility jumped—effects that persisted for months and weakened the economic expansion underway at the time. What's more, the first-ever downgrade of the US sovereign debt rating, by Standard & Poor's, came four days after Congress approved a bill to raise the debt ceiling.[10]

5. Source: Bloomberg; data as of May 22, 2023.
6. Source: Bloomberg, Moody's Analytics; data as of May 1, 2023.
7. "Debt Limit: Analysis of 2011-2012 Actions Taken and Effect of Delayed Increase on Borrowing Costs," Government Accountability Office (July 2012).
8. Source: SIFMA; data as of April 30, 2023.
9. "Transcript of the Federal Open Market Committee Conference Call on August 1, 2011," Federal Reserve (August 1, 2011).
10. "The Potential Macroeconomic Effect of Debt Ceiling Brinksmanship," Department of the Treasury (October 2013).

How Is the Global Value Team Managing Portfolios in This Environment?

Looking back, it's hard not to see parallels between today's crisis and the circumstances that prompted Standard & Poor's to issue its 2011 downgrade of the US: "The downgrade reflects our view that the effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges..."[11]

We've long been concerned about the potential for some sort of financial accident given the vulnerabilities inherent in today's financial system and the potential for unintended consequences as authorities attempt to unwind years of highly accommodative macroeconomic policies. Issues around sovereign credibility had been working their way into our consciousness for some time, and self-inflicted wounds such as those that may result from the debt-ceiling drama do little to bolster that credibility. Combined with a massive stock of public debt and lack of fiscal discipline, it appears possible that investors may soon demand increased risk premia for bonds issued by the US and other national governments.

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As always, the Global Value team remains focused on avoiding the permanent impairment of client capital. We continue to seek resilience from the bottom up, searching for cash-flow-generative companies with strong market positions, healthy balance sheets and prudent management teams, and buying these stocks only when available at a "margin of safety."[12] In addition, we employ gold and gold-related securities as a potential hedge against a range of adverse market developments, including elevated sovereign risk.

11. "United States of America Long-Term Rating Lowered to AA+ Due to Political Risks, Rising Debt Burden; Outlook Negative," Standard & Poor's (August 5, 2011).
12. First Eagle defines "margin of safety" as the difference between a company's market price and our estimate of its intrinsic value. "Intrinsic value" is based on our judgment of what a prudent and rational business buyer would pay in cash for all of a company in normal markets.

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A credit-default swap, most commonly, is a derivative contract that transfers the default risk of a particular fixed income security from the swap buyer to the seller in exchange for a fee.

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