RBC Global Asset Management

The debt ceiling: History repeating

At the beginning of 2023, the United States hit its debt limit, otherwise known as the debt ceiling. “The debt limit is the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds, and other payments.”[1]

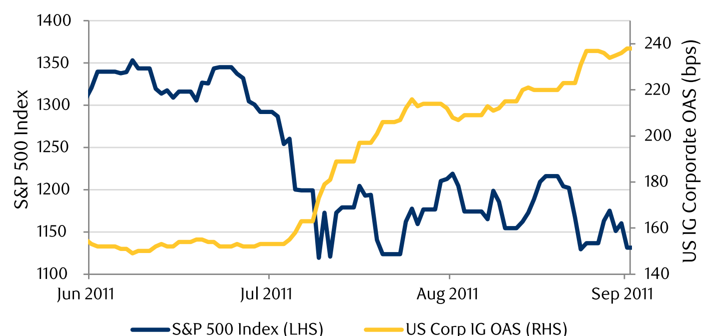
Delays in raising this debt limit create uncertainty in financial markets. Past debt ceiling episodes, most notably in 2011, caused liquidity disruptions in the US Treasury market and added to volatility more broadly across global markets. Fortunately, liquidity concerns for Treasury securities were limited to bonds that were maturing in the window where default was thought to be highest risk. Bonds outside of this “default zone” actually had more demand and strong liquidity, because any technical default by the US Treasury was (and still is) expected to be short lived.

The “default zone” this time around is expected to be in the third quarter 2023. In January, the US Treasury announced that it had hit the current debt limit of $31.4 trillion and instituted “extraordinary measures” to ensure the Federal government keeps paying its debts. These measures are essentially accounting tricks the US Treasury department is authorized to use, which involves actions such as suspending certain investment programs and reinvestment in special issue Treasury securities to free up space to meet other obligations. Treasury Secretary Janet Yellen expressed to Congress that it is uncertain exactly how long these extraordinary measures will last but it is unlikely it’ll be exhausted before June. The amount the Treasury collects from individual tax receipts in April and Corporate tax receipts in June will also have a big impact on timing. As those come in the default date will become more certain and the default zone will narrow.

This tension isn’t new. The debt ceiling has been a routine part of government procedure since the 1950’s, and both Republicans and Democrats have used the issue to make the other look fiscally irresponsible. The reality is that the ceiling only affects the government’s ability to pay what it already owes. In fact, Congress has acted 78 separate times since 1960 to accommodate increases in the level of US government debt. Without such action, the US Treasury would effectively default on its legal obligations, which would have catastrophic consequences and create turmoil for global markets, potentially pushing the US economy into recession.

Despite the negative consequences of not raising the US debt ceiling, members of Congress have weaponized the limit in recent history as a way of garnering concessions for other causes, most notably pushing for budget cuts and reductions in government spending. This political brinksmanship has brought the US to the edge of default several times. The most notable episode occurred in 2011 when negotiations went down to the final hours and were finally resolved with the passage of the Budget Control Act of 2011. As a result of the disarray, Standard & Poor’s (S&P) downgraded the US credit rating for the first time, and credit and equity markets tumbled.

Equity and Credit - Summer 2011



Source: Bloomberg

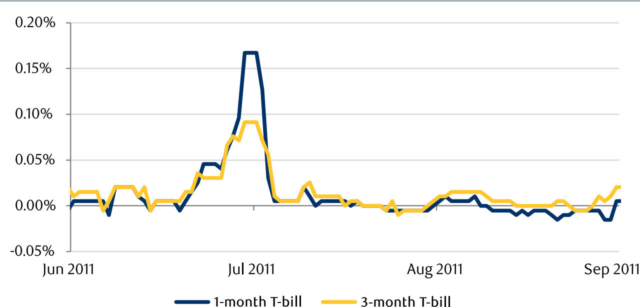
[1]https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/debt-limit

10-Year Treasury Yields - Summer 2011

Source: Bloomberg

There are many parallels in the present situation to 2011. The US Government is once again split with Republicans controlling the House and Democrats controlling the Senate and Presidency. The Speaker of the House is also again forced to contend with a small but extremely vocal minority in his own party that intend to gain as much leverage as possible from the situation. A key difference this time, however, is the Republican majority in the House is much narrower. The clash in 2011 came on the heels of huge gains in the mid-term elections and the Republican caucus is much less united behind Speaker Kevin McCarthy now. Meanwhile the Democrats have thus far held firm that they will not negotiate around the debt ceiling. The political dynamics make it hard to predict how a resolution will come into focus.

US T-Bills Yields - Summer 2011



Source: Bloomberg

Given recent history of debt ceiling episodes and the expectations that this one could be more contentious, we should be prepared for the likelihood that any resolution will once again occur at the 11th hour or even just past the point of default. In our view, avoiding Treasuries all together is difficult and may not be the best strategy. For example, in the August 2011 episode we saw a significant widening of spreads, and in some cases no bid, in everything from commercial paper to agency discount notes. While there was no place to hide in 2011, the 2013 experience was a bit more subdued for risk assets, but worse for the Treasuries maturing in late October and early November (the "default window" of that year). It is important to note that the Treasuries most feared for default still traded, but at lower prices than other maturities that had less concern associated with them. Even bonds maturing a few weeks later had little disruption in trading. It is also notable, at no time in any past episode did Treasuries trade at "distressed" levels. Bid/ask spreads widened significantly based on the illiquidity of the default-feared securities, not based on any perceived credit default/recovery concern.

It's also important to consider the broader economic and financial markets picture. Unlike in 2011, the Federal Reserve (Fed) and other central banks globally have been engaged in aggressive monetary tightening policy to combat persistently high inflation. This has contributed to higher rates and much tighter financial conditions. In 2011, the world was still recovering from the Great Financial Crisis, and central banks were much more accommodative. In the present, there is concern that tighter conditions could lead to recession in 2023. Thus far the US economy has proven to be resilient, but a recession coupled with uncertainty around a US default would no doubt lead to a spike in volatility.

Bottom line, a US default would be viewed as a liquidity event, not a solvency event. Bondholders will recover principal plus accrued interest as soon as the debt ceiling is raised, and financial market stability is restored. However, the fallout in other markets is hard to predict and will contribute uncertainty at a time where the US economy could be more fragile. This leads us to conclude in a particularly acute US default scenario, there are few places to hide, but US Treasuries are still likely to perform best on a relative basis.

Investors particularly worried about 2023 being a bad episode should increase liquidity (most likely in Treasuries) – and if possible, avoid Treasuries maturing between July and September 2023. It may seem a bit silly, but such is the nature of a US "default".

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