TCW

INSIGHT

VIEWPOINT

Debt Ceiling Dynamics: A Noisy Distraction or a Market-Moving Game of Chicken?

TIMOTHY BITSBERGER | AUGUST 29, 2017

Timothy Bitsberger
Managing Director
Client Services – Fixed Income

Mr. Bitsberger serves as a Portfolio Specialist and Senior Account Manager in the Client Services group. He will work to enhance client relationships with significant institutions both in the U.S. and internationally. Previously, he worked at BNP Paribas from 2010 to 2015 where he created and led the Official Institutions Coverage team for the Americas. He also served at Freddie Mac as Senior Vice President and Treasurer from 2006 to 2009. In this capacity, he was responsible for the debt and mortgage funding programs and investor relations, overseeing a team of approximately 70 people. In 2004, Mr. Bitsberger was nominated by President Bush, and confirmed by the U.S. Senate, as the Assistant Secretary for Financial Markets at the U.S. Treasury. He served as Deputy Assistant Secretary for Federal finance at the Treasury from 2001 to 2003. He has appeared on numerous television programs, including Bloomberg TV and Fox Business News. He has worked on Wall Street for more than 15 years, primarily as a trading manager and also as a fixed income and derivatives trader. He serves on the Board of Directors of the CME Group and is the Board Chair for the Finance Committee at IREX, Washington DC. Mr. Bitsberger graduated from Yale University with a BA in Economics and an MBA from Harvard Business School. Mr. Bitsberger holds series 63 and 79 licenses

Once again, the need for Congress to pass legislation raising the debt ceiling is fast approaching, likely by early to mid-October. For the past 15 or so years, this otherwise rote process has brought about extremely partisan and contentious debates, typically because neither party has had control of both the executive and legislative branches. With Republicans currently in control of these two branches, one would expect successful legislation ahead of schedule. Yet we know politicians and the media like to use the debt ceiling as a platform to promote, criticize and debate fiscal policies. Moreover, the Trump Presidency so far lacks a natural Congressional constituency and is struggling to unify a fractured Republican Party and its legislative priorities, lending additional uncertainty to the backdrop this year.

Congressional inability to pass legislation in a timely manner has real market consequences, ranging from pockets of illiquidity in the U.S. Treasury market to a sovereign ratings downgrade resulting in meaningful credit spread widening. The threat of default becomes real in the eyes of many market participants. As a result, there have been calls – and even expectations – for the Treasury to consider other options in order to stave off any potential for default as the debt ceiling limit nears.

Our expectation is that debt ceiling legislation will ultimately pass, hopefully in a timely manner. However, there are already threats to shut down the government if funding is not appropriated for some of the Administration's or other Congressional priorities. Even in the event of legislation eventually being passed, market participants should prepare for a drawn out process and the accompanying political rancor concerning fiscal priorities and the debt ceiling legislation. **The potential for unintended consequences seems higher this time around. Even after passage by Congress, the President still needs to sign the legislation. The opportunity for TCW, should it get to that point, will be to take advantage of any broader credit market disruptions.**

Background

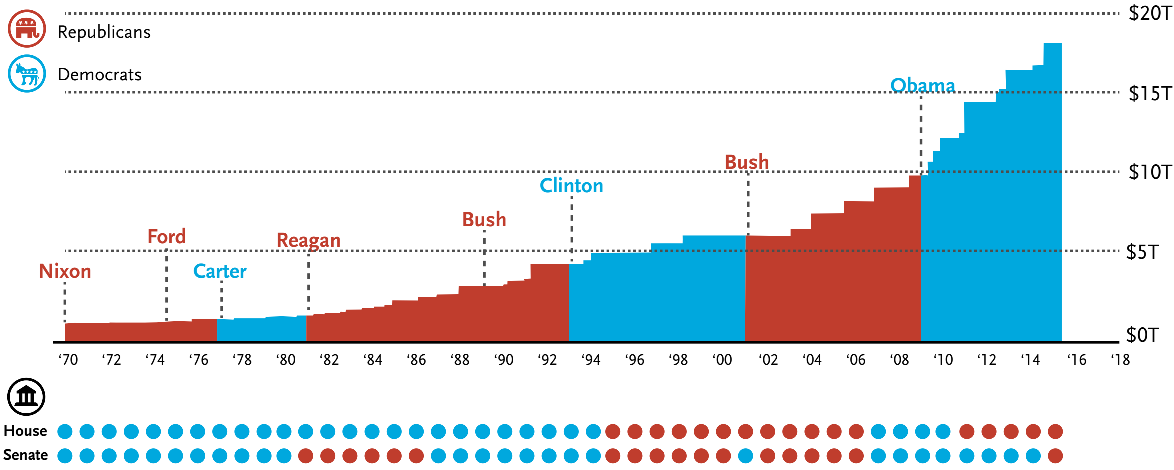
The debt ceiling is a limit, set by Congress, on the amount of public debt that can be issued by the Department of the Treasury. Total public outstanding debt is the sum of both marketable debt (bills, notes and bonds) and the intragovernmental accounts, the largest of which are Social Security and Medicare/Medicaid. The debt ceiling determines how much flexibility the Treasury has both in issuance and intragovernmental accounting (more on this below) to meet spending obligations, as well as when this authority expires.

Action on the debt ceiling is legislatively distinct from the annual budget process. Statutorily, Treasury can only issue debt up to the amount authorized by the existing debt ceiling even though Congress may have appropriated expenditures above that limit in prior budget legislation. Social Security and Medicare/Medicaid expenditures are not part of the annual budget but, again, do count towards total public debt outstanding and thus play a large role in determining when the debt ceiling is reached.

Notwithstanding the legislative distinctions, the debt ceiling and budget debates are often linked together. Twice these debates have sparked government shutdowns in 1995-1996 and again in 2013 due to the lack of appropriated funds to run the government, which, again, is distinct from the debt ceiling. During the height of the 2011 debt ceiling debate, Standard & Poor's downgraded Treasury debt. As a reminder, it is instructive to note credit spreads widened on the downgrade as 10-year Treasury securities rallied approximately 50 bps. Frustrated market participants viewed this action as more indicative of political and economic deadlock than any increased risk of default.

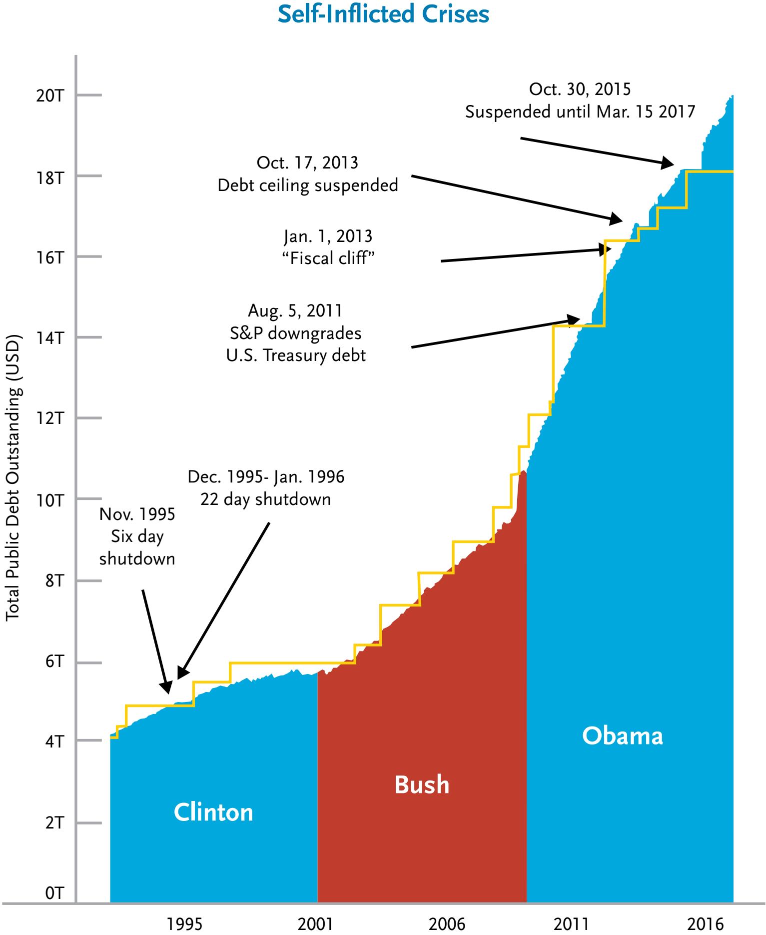
Discussion over debt ceiling legislation provides an often-contentious reminder of previous fiscal appropriations. Purposeful delays in the passage of debt ceiling legislation can ignite intense political passion and friction contributing to market uncertainty.

The U.S. Debt Ceiling Has Risen No Matter Who is in Office



Source: Visualcapitalist.com

Self-Inflicted Crises



Source: U.S. Treasury

What happens when the debt ceiling is reached?

As Treasury approaches the debt ceiling limit, the Secretary of the Treasury sends a letter to the Congressional leadership indicating the Treasury is entering a "debt suspension period" and will be utilizing existing authorized "extraordinary measures" to manage the debt outstanding until a new debt ceiling is passed. The debt suspension period sets off a chain of events, but we will just focus on the highly impactful ones. We are in that period now.

Debt suspension allows Treasury to use about $388 billion in government trust funds until the debt ceiling is increased or, said another way, the Treasury has an additional $388 billion of borrowing power. The bulk of these dollars comes from several intragovernmental funds - primarily the pension and retirement plans for government employees. The non-marketable bonds that were previously issued to fund these plans are not reissued when they mature, thus creating more room under the debt ceiling cap. Treasury makes these plans "whole" once the legislation passes. This bookkeeping exercise is easily executed largely because the math is simple as these accounts are an unfunded liability.

The real impact to investors during the debt suspension period is usually in bill issuance. Treasury needs to closely monitor its cash balance and does so by issuing cash management bills that coincide with outlays and receipts. This sometimes results in inconsistent and unexpected issuance amounts in the regularly scheduled bill auctions. Additionally, bills scheduled to mature around the expected "drop dead" date (the date on which Treasury can no longer lawfully issue debt) typically lose liquidity and cheapen up. Typically, coupon auctions are unaffected, though maturing coupons could be.

Does Treasury have contingency options if Congress cannot pass legislation?

Legislatively, Treasury has no other options to issue debt above the debt ceiling limit beyond the above mentioned extraordinary measures. Only Congress can amend or give Treasury new extraordinary measures. Despite this, the recent heightened rancor and subsequent market uncertainty has pressured Treasury to consider new, untested contingencies in case legislation fails to pass. The pressure to consider new options comes from many sources, including the market, Congress, the Federal Reserve and Treasury itself.

The following are some of the ideas that have sparked debate.

1. Treasury could issue a platinum coin(s).
2. Treasury could "borrow" from the Social Security trust fund in the same way it borrows form the government retirement and pension plans.
3. Treasury could "prioritize" principal and interest (P&I) payments on all outstanding and maturing debt securities, and make no other payments while staying under the debt ceiling cap.

Let us examine the first two options before focusing on prioritization.

PLATINUM COINS: Treasury is lawfully allowed to issue platinum coin(s) via the U.S. Mint. Interestingly, those coins would not count against the debt limit even though they provide a source of funding for the Treasury. These coins could be used, for example, to pay down existing debt allowing Treasury to make all scheduled payments and continuously fund the government. However, the operational and logistical framework to get coins minted, distributed and settled are cumbersome and time consuming precisely when Treasury will be under time pressure. There are also real questions that need to be vetted. How and when would the coins be redeemed? What if platinum coin redemption(s) caused a debt ceiling breach? This option was fun for pundits to discuss in 2013 but has too many questions and practical shortcomings. Most importantly, the sale of platinum coins requires Fed approval and the Fed has given no such indication it would (ever) do so. This option is an unintended loophole in the debt ceiling discussion and bypasses in principal, the congressionally mandated debt ceiling limit.

SOCIAL SECURITY: "Selling" the bonds that fund Social Security is similar to the extraordinary measures already used by Treasury. If Treasury can utilize funds from other intragovernmental pension plans, why not from Social Security as well? This may be operationally possible, but is considered politically unworkable and harmful. One can imagine the headlines and rhetoric around "stealing" from Social Security to fund the government to the benefit of bondholders. Again, this action has no precedent and Congress has purposely not authorized the inclusion of those funds as part of the extraordinary measures in the same way the other funds were intentionally included.

PRIORITIZATION: Market participants and even some in Washington view the third option – prioritization of Treasury P&I payments – as the only real viable contingency. The concept is easy to understand and is generally viewed as the least bad option facing the Treasury, should Treasury ever run out of borrowing authority.

The release of Fed minutes in January 2017 chronicling the 2011 debt ceiling crisis confirmed to the market that Treasury via the Fed could prioritize P&I payments and withhold all other payments while staying under the debt ceiling cap. Until these comments, many viewed P&I prioritization as unworkable. The plan is operationally possible largely because the Fed is the fiscal agent for the U.S. Treasury. In this role, the Fed has many responsibilities including acting as the interface between the U.S. Treasury and its bondholders. The Fed is also responsible for the Fedwire, the electronic platform where all U.S. Treasury securities transactions are credited and debited. According to the quoted Fed official, Treasury was comfortable with P&I prioritization, though no senior Treasury officials ever formally commented on or publicly approved this plan.

Additionally, the 14th amendment of the Constitution lends support to this option stating: "The validity of the public debt of the United States, authorized by law...shall not be questioned." Does that mean that honoring debt obligations statutorily supersedes the debt ceiling limit? Unclear. The courts or Congress have never ruled or commented on this issue. Yet this does give the argument for P&I prioritization some credibility.

Though P&I prioritization is operationally possible, the legal and debt management staff opinion at Treasury is that prioritization lacks both precedent and Congressional or legal approval. In their report following the 2011 debt ceiling debate, the Treasury Inspector General summed up the traditional view of prioritization at Treasury:

The Inspector General's office in the Treasury Department filed a report on the 2011 debt ceiling debate to the Senate Committee on Finance in August 2012. The Inspector General's office found that "Treasury also reviewed the idea of attempting to prioritize the many payments made by the federal government each day. Treasury noted that it makes more than 80 million payments per month, all of which have been authorized and appropriated by Congress. According to a Treasury official, the payments cover a broad spectrum of purposes deemed important by Congress. While Congress enacted these expenditures, it did not prioritize them, nor did it direct the President or the Treasury to pay some expenses and not pay others. As a result, Treasury officials determined that there is no fair or sensible way to pick and choose among the many bills that come due every day. Furthermore, because Congress has never provided guidance to the contrary, Treasury's systems are designed to make each payment in the order it comes due."

Putting aside P&I and the Fedwire, the other legacy systems used by Treasury do not have the functional capability to make some payments and not others. Manual labor would be required to sort through the 4-5 million daily "checks" issued by Treasury to decide which ones would be "sent" and which ones would be held back. This further highlights the potential legal argument Treasury lawyers worry about -- that any prioritization is arbitrary because Treasury does not have the operational or legal authority to determine the winners and losers in terms of who gets paid versus who doesn't. Taken to the extreme, this becomes an emotional argument when one considers dependent vendors or necessary social payments.

Would Treasury Prioritize?

The decision to prioritize P&I could ultimately come down to political will and that will be a contentious argument with strong opinions coming from both sides. On the one hand, Treasury lawyers argue that the Secretary of the Treasury has no statutory authority to prioritize and by doing so is likely to set off a legal chain of events. Yet others, including the Fed, will argue that the risk of systemic consequences of a real Treasury default on maturing securities would have far-reaching systemic consequences, affecting settlements, clearing, and all the related derivative contracts. From a policy perspective, one of the key lessons from 2008 is that policymakers underestimated the interconnectivity of markets. Therefore, how policymakers view this interconnectivity of U.S. Treasury market participants will have a huge bearing. Any decision on prioritization during a default– no matter what the decision - would be open to intense ex post criticism, including likely legal actions.

Endgame

Treasury likely has a very good idea when the "drop dead" date falls on the calendar. Staff knows the dates and amounts of expenditures, as well as the flexibility of the debt issuance calendar. However, estimating tax receipts – the incoming revenues – on an $18 trillion economy is hard. Most analysts are calling for Treasury to run out of borrowing authority by early-mid October. (Now $5 billion of GSE payments to the Treasury are on the table further complicating the matter, but this is an entirely different political issue.) Though Treasury staff probably knows the end date, they will refrain from publicly discussing it in order to give themselves some flexibility. In other words, though Secretary Mnuchin had recently said Treasury will run out of borrowing authority by September 29, 2017, the internal Treasury estimate is almost assuredly a later date. This could create even more mistrust between the administration and Congress. In addition, Treasury reportedly told primary dealers in mid-July that prioritization is not an option. It will likely continue to assert that position, essentially trying to force legislative action.

If debt ceiling legislation goes down to the wire, expect tense final days. In 2017, this is further compounded by the fact that so many key positions at Treasury have just been recently filled or remain vacant. The workload increases as the date nears and a significant amount of time is taken in meetings within Treasury, the White House, the Hill and the Fed. This can create a highly pressurized environment, particularly for a relatively new admnistration.

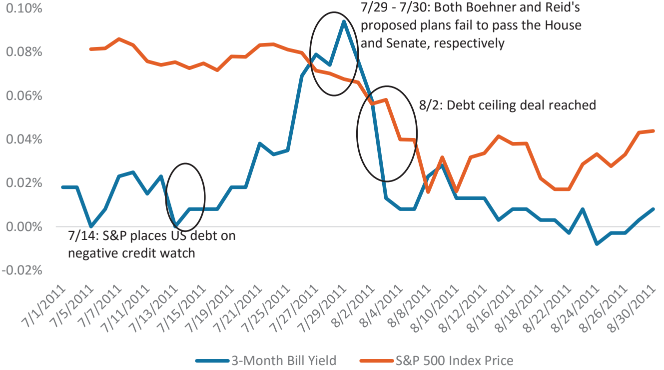
Treasury will have prioritization as an operational and policy option should they run out of extraordinary measures. There will need to be a political first for prioritization to actually happen – the failure to pass debt ceiling legislation in time. At that point, political tensions and mistrust will likely be quite high. Markets will be nervous. For P&I prioritization to actually happen, both a strong

political and market-based belief will need to prevail that P&I prioritization is unequivocally the right thing to do to avoid any systemic financial market (and other) failures. Certainly, the argument can be made that the interconnectivity of Treasury market participants as it relates to settlements, clearing, derivative agreements, bank liquidity, money market funds, etc. could create systemic unintended consequences. The benefit of prioritization will be weighed against the statutory, legal and political fallout of prioritizing bondholders over others owed by the U.S. Treasury.

Another key factor will be the markets themselves. Pockets of illiquidity may not be enough to force Treasury's hand. However, markets in freefall and lacking confidence in the political system could create the sense of urgency for Treasury to act. Though this is a lose/lose decision for Treasury and the administration, not prioritizing could make a bad situation worse.

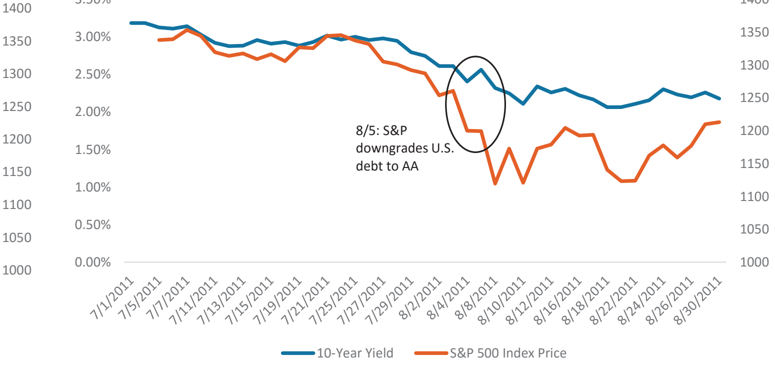
Lastly, it is not clear how long prioritization could last. Much depends upon the calendar, including tax receipts and large intragovernmental payments. P&I prioritization is short-term solution. Legislation is still required.

T-Bill Moves During 2011 Debt Ceiling Debate



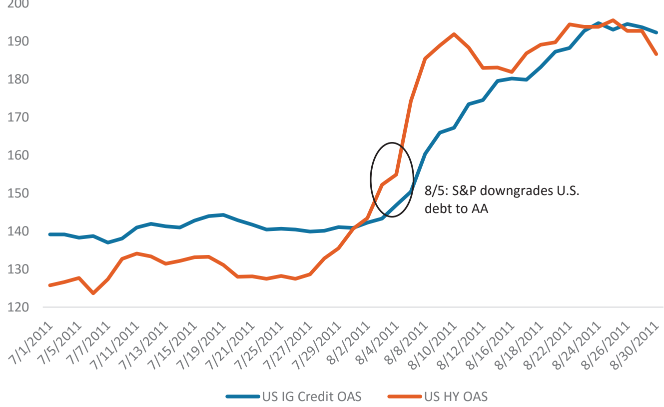
Source: Bloomberg

10-Year UST Moves During 2011 Debt Ceiling Debate



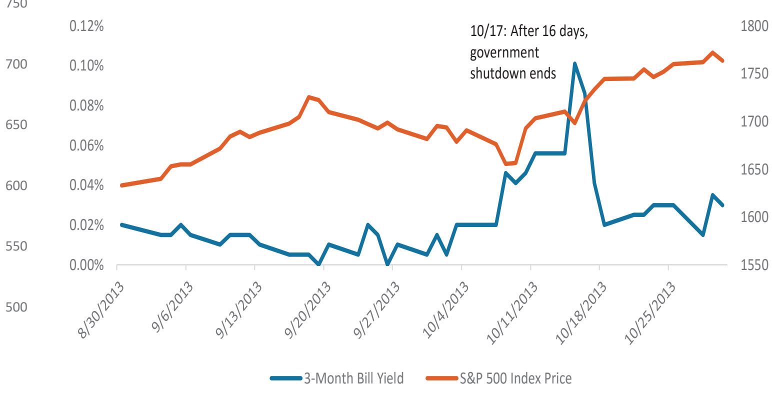
Source: Bloomberg

Credit Spread Moves During 2011 Debt Ceiling Debate



Source: Bloomberg

T-Bill Moves During 2013 Government Shutdown



Source: Bloomberg

Opportunities for TCW

What does this mean for TCW? Again, our base case is that this gets resolved in time. But if the debate over the debt ceiling escalates and the fiscal deadlines draw nearer, volatility could increase. Initially, Treasury notes and bills that mature or have scheduled interest payments right after the drop dead date would have the greatest potential to experience price weakness. Even if one maintains that debt ceiling legislation always gets passed, taking advantage of some of the interim volatility may warrant a look, particularly if the prioritization talk becomes a real possibility. **However the real opportunity could be in the broader credit markets.** In both 2011 and 2013, interest rates moderately rose as the debate went down to the wire. The most dramatic market response occurred in 2011 when U.S. sovereign debt was downgraded. There was a flight to quality as longer dated Treasury securities rallied. As in these prior episodes, we expect market noise surrounding any resolution. Yet, we are also in a tense, unpredictable reactive political state. Could this debate become so combustive it sparks a third party response, such as a large bond sales or a ratings agency downgrade? Will the volatility this time around have the added potential to be the catalyst for a broader deleveraging event? The current market environment is especially vulnerable to shocks due to complacency and end-of-cycle dynamics. Additionally, the market structure is far different than it was prior to 2008. Banks and other regulated entities are most likely unwilling or unable to absorb unexpected liquidity, particularly in riskier credit.

The debt ceiling debate is an added risk factor that investors should continue to view as a nuisance. Though we have made it through more than one debt ceiling crisis before, it is prudent to monitor the situation as there is no guarantee of a clear path this time around. ■

BLOOMBERG is a trademark and service mark of Bloomberg Finance L.P. BARCLAYS is a trademark and service mark of Barclays Bank Plc, used under license. Bloomberg Finance L.P. and its affiliates (collectively, "Bloomberg") or Bloomberg's licensors own all proprietary rights in the BLOOMBERG BARCLAYS INDICES. Neither Bloomberg nor Barclays Bank Plc or Barclays Capital Inc. or their affiliates (collectively "Barclays") guarantee the timeliness, accuracy or completeness of any data or information relating to BLOOMBERG BARCLAYS INDICES or make any warranty, express or implied, as to the BLOOMBERG BARCLAYS INDICES or any data or values relating thereto or results to be obtained therefrom, and expressly disclaims all warranties of merchantability and fitness for a particular purpose with respect thereto. It is not possible to invest directly in an index. Back-tested performance is not actual performance. Past performance is not an indication of future results. To the maximum extent allowed by law, Bloomberg and its licensors, and their respective employees, contractors, agents, suppliers and vendors shall have no liability or responsibility whatsoever for any injury or damages - whether direct, indirect, consequential, incidental, punitive or otherwise - arising in connection with BLOOMBERG BARCLAYS INDICES or any data or values relating thereto - whether arising from their negligence or otherwise. This document constitutes the provision of factual information, rather than financial product advice. Nothing in the BLOOMBERG BARCLAYS INDICES shall constitute or be construed as an offering of financial instruments or as investment advice or investment recommendations (i.e., recommendations as to whether or not to "buy," "sell," "hold" or enter into any other transaction involving a specific interest) by Bloomberg or its affiliates or licensors or a recommendation as to an investment or other strategy. Data and other information available via the BLOOMBERG BARCLAYS INDICES should not be considered as information sufficient upon which to base an investment decision. All information provided by the BLOOMBERG BARCLAYS INDICES is impersonal and not tailored to the needs of any specific person, entity or group of persons. Bloomberg and its affiliates express no opinion on the future or expected value of any security or other interest and do not explicitly or implicitly recommend or suggest an investment strategy of any kind. In addition, Barclays is not the issuer or producer of the BLOOMBERG BARCLAYS INDICES and has no responsibilities, obligations or duties to investors in these indices. While Bloomberg may for itself execute transactions with Barclays in or relating to the BLOOMBERG BARCLAYS INDICES, investors in the BLOOMBERG BARCLAYS INDICES do not enter into any relationship with Barclays and Barclays does not sponsor, endorse, sell or promote, and Barclays makes no representation regarding the advisability or use of, the BLOOMBERG BARCLAYS INDICES or any data included therein. Customers should consider obtaining independent advice before making any financial decisions. ©2017 Bloomberg Finance L.P. All rights reserved.

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2017 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup