VIEWPOINTS

Debt Ceiling Debate: Examining Risks Around the X Date

Debt ceiling concerns are rippling through financial markets. We discuss the potential risks and opportunities for investors.

BY **LIBBY CANTRILL**, **JEROME M. SCHNEIDER**, **TIFFANY WILDING** | APRIL 27, 2023

We anticipate progress on the U.S. debt ceiling, and while there may be volatility in markets in the interim, we nevertheless expect a resolution, although possibly not until the eleventh hour.

As we write this, the House of Representatives has passed a bill that will be dead on arrival in the Senate, and President Joe Biden has said he would veto it anyway.

Still, while the bill – and the associated spending cuts and rollback of the Inflation Reduction Act – are merely symbolic and have no chance of becoming law this Congress, we nevertheless view its passage as an important first step to more formal negotiations among the House, the Senate, and the White House to ultimately reach a deal.

The timing is also important. With U.S. Treasury funding needs tracking somewhat higher than they were this time last year, the so-called X date – the estimated date when the Treasury can no longer pay its bills – may well arrive sooner than the July to September timeline estimated by the Congressional Budget Office. This is important for markets because it could also pull forward the acute phases of the political volatility, which in the past has coincided with elevated volatility in equity and bond markets.

Avoiding default still our base case – with high conviction

A debt ceiling deal continues to be our base case – with high odds – meaning that while a technical default is possible (as is the case whenever Congress is obligated to increase the country's debt limit), we think such a catastrophic outcome will be avoided for the very reason that default would be catastrophic, not just for the for the markets and economy, but also *politically*.

After all, 2023 is not 2011. In 2011, the Tea Party and political support for spending cuts were at an apex; Republicans had a significant majority in the House, negotiating from a position of strength; and they were dealing with President Barack Obama, who was open to fiscal reforms. None of this is the case now, plus more than 70% of Americans support avoiding a default even if there are no spending cuts (see poll data here). In other words, default is not a political winner, and everyone in leadership – on both sides of the aisle – realizes this.

Although we are confident that a resolution will occur before the debt ceiling deadline, the timing and the composition remain to be seen. If past is prologue, we believe it will likely happen at the eleventh hour and only after some brinksmanship (as one senior staffer noted: Some members of Congress may have to touch the hot stove before agreeing to a resolution).

The likely contours of a deal *may* consist of 1) suspending or outright raising the debt ceiling – ideally in a way that pushes the next deadline beyond the November 2024 election; 2) including some form of the energy-permitting reform bill that President Biden supported last year – but was never brought up – which also would help their most vulnerable Democratic senator, Joe Manchin, who is up for reelection in 2024; 3) clawing back unused COVID-19 money; and 4) possibly creating a debt commission to look at the stickier and bigger parts of the growing U.S. debt, namely entitlements. Reinstatement of the tax credit for research and development or the imposition of spending caps may be on the table as well.

The X date

While we expect a resolution, the timing is clearly affected by the X date, when the Treasury exhausts its emergency funding measures. The X date is always uncertain due to the inexact nature of tax collections and certain government payments, and this year, with the tax collections around the April 15 payment deadline running well below last year's levels, Treasury's funding needs have risen.

Taking this and other factors into account, we estimate that Treasury's cash buffer will fall dangerously low ahead of June 15 – the scheduled date for quarterly corporate tax payments. As a result, we expect the Treasury will provide additional guidance soon – perhaps as early as next week's refunding announcement. This could also pull forward the acute phase of the political volatility, which is important for markets.

Immediate market implications

We are already seeing market impact from the debt ceiling debate and the uncertainty regarding the X date as some investors shun Treasury bills ahead of any potential – albeit unlikely – default. Market and investment implications worth flagging:

- **One-month Treasury bills** with maturities before the projected X date remain richly priced (i.e., have lower yields). Indeed, one-month T-bills have yields of 1% (or 100 basis points (bps)) or more below both the Federal Open Market Committee's (FOMC) benchmark target rate (fed funds) and the Secured Overnight Financing Rate (SOFR) index. While there currently remains a positive nominal yield of around 3.60% for one-month bills held to maturity, investors are paying a premium (by earning a lower return) to be "ahead" of any default concerns.
- **Further out on the money market curve,** Treasury bills with maturity dates around the currently projected X date (from mid-June to August) offer yields that are higher and more closely aligned with the FOMC's benchmark rate, although they still trade at lower yields than the SOFR benchmark given the structural demand for short-maturity Treasuries from Treasury-only money market funds. However, should investors become increasingly concerned about the possibility of a default, we would expect these yields to move much higher, perhaps 100+ basis points higher in yield, given our previous experiences with debt ceiling market dynamics.
- **Repos for cash investing have become more attractive as** the desire to avoid X date risks has created a large differentiation in yields for short-dated high quality investments. For example, repurchase agreements (repos) to invest cash offer higher yields relative to short-dated bills by 50–100 bps. PIMCO considers these repos to be a foundational element of cash management given their overnight liquidity and overcollateralized structure. Generally, bilateral repos trade in relative proximity to the Fed's Reverse Repurchase Rate (RRP) of 4.80%, offering distinctly more yield than most bills ahead of the X date.

Bigger-picture risks and opportunities

While we believe a U.S. debt default is very unlikely, if this were to come to pass, interest and maturity payments could be delayed. While there have been rumors that Treasury could prioritize bond payments over other obligations like Social Security, for example, Treasury hasn't publically confirmed this, and there are questions about its operational ability to do so.

Given the discount nature of T-bills (they are issued at a discount price and mature at par), T-bill investors would likely not be made whole *on time* for any accrued interest from delayed maturity payments, and net implied-yield returns would be less than originally projected. Since T-bill maturity ladders are typically an important part of individual and corporate cash management strategies, a delayed payment could have cascading effects for other private sector payments.

To be sure, in the event of a technical default, the Federal Reserve may try to step in, buying in-default T-bills and swapping good collateral for bad. However, the Fed would not be able to ameliorate the large fiscal cliff if Treasury stops making Social Security and other payments, which amount to over $100 billion per month.

Again, we do not expect a default, but we also do not expect a resolution until the eleventh hour and very likely will see some market volatility beforehand. For example, the average peak-to-trough performance of the S&P 500 in the month before a debt ceiling resolution over the past dozen years has been about −6.5%, although other factors have driven some of that, including the European debt crisis in 2011. While risk market performance has usually retraced after a resolution, we could nevertheless see a lingering impact in the cash markets even *after* a debt ceiling deal.

Finally, we suggest investors keep an eye on liquidity costs and conditions even after a debt ceiling deal. The Treasury will likely look to rebuild its cash balances, which will continue to be spent down in anticipation of the X date, and we should expect T-bill supply to increase substantively – perhaps by $1 trillion or more – after a deal. This significant issuance will take excess liquidity out of the market ahead of year-end. Although a reasonable amount of this cash would be offset by a reduction in the Fed's RRP balance, there may be implications for broader costs for funding and liquidity across capital markets.

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CMR2023-0426-2870933