Invesco Fixed Income Investment Insights

Countdown to the US debt ceiling debate

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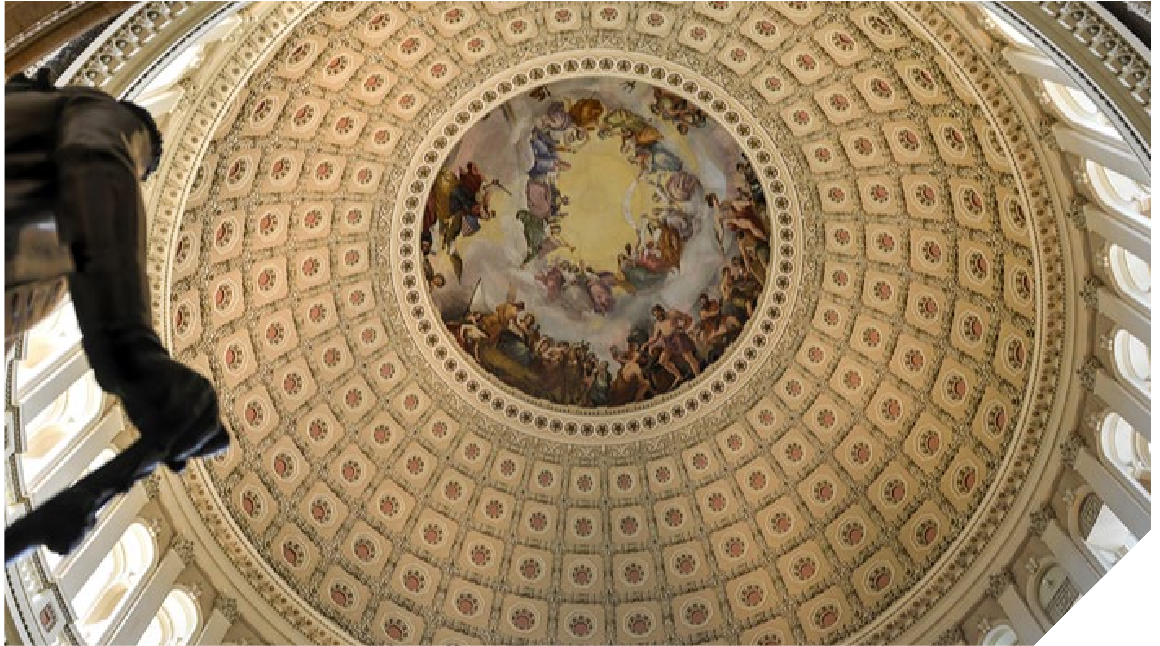

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As the March 15 deadline approaches, US Treasury bills could become increasingly volatile

In the first quarter of 2017, a newly minted Congress will be tasked with approving an increase in the US government's debt limit — the so-called "debt ceiling" — which is set to expire on March 15, 2017. If the debt ceiling is not raised, the US Treasury bill market could experience volatility as investors adjust to a potential reduction in the supply of Treasury bills.

What is the debt ceiling?

The debt ceiling is the total amount of money that the US 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. These obligations currently include approximately USD13 trillion of debt owed to bondholders, including everyone from individuals to foreign governments, plus roughly USD5 trillion in debt the government owes to various government accounts like Social Security and Medicare trust funds.[1] When all goes smoothly, the US Treasury typically covers such debt service expenses by issuing new US Treasury securities (up to the ceiling).

It is important to note that setting the debt limit is separate from establishing the Federal budget and spending limits. In other words, the debt ceiling does not authorize new spending, but allows the government to continue borrowing to cover its existing obligations. Since its introduction in 1917, the debt ceiling has been raised periodically without much fuss. However, in the past few decades, setting the debt ceiling has become

a highly partisan battle, as both political parties have attempted to attach additional proposals and requirements to the bill. In November 2015, Congress agreed to extend the existing debt ceiling until March 15, 2017.

What happens if the debt ceiling is not raised?

If the debt ceiling is not raised in March, the US Treasury's cash balance, which is mandated by law, would need to decrease dramatically, which in turn means a sharp reduction in the need for US Treasury bill issuance. The Treasury's current cash balance is much higher than it has been in recent years, currently totaling around USD340 billion compared with around USD152 billion as of the end of 2015.[2]

Indeed, in anticipation of this eventuality, the US Treasury has already begun drawing down its large cash balance in preparation for meeting the mandate if necessary, and recent Treasury bill auctions have been scaled back. If Treasury bill auction sizes remain relatively low from now through the first quarter of 2017, it could potentially put downward pressure on Treasury bill rates, term impact on global growth.

If Congress fails to increase the debt ceiling by March 2017, the US Treasury can implement "extraordinary measures" to avoid defaulting on its obligations. In fact, we estimate that such accounting techniques — which include halting contributions to specific government pension funds, suspending certain securities issued by state and local governments and borrowing money that has been set aside to manage exchange rate fluctuations — could give the Treasury enough leeway to delay raising the debt ceiling until around mid-2017. However, if no resolution occurs and the Treasury exhausts its "extraordinary measures," interest rates on bills set to mature around the time of a potential payment default could cheapen significantly relative to rest of the Treasury bill curve, as investors would likely avoid owning those bills.

What happens if the debt ceiling is raised?

If the debt ceiling is raised, we believe we could still see a compression in US Treasury bill rates across the yield curve. The Treasury would likely face a short window for increasing its Treasury bill issuance in order to build its cash balances back up to desired levels, potentially pressuring Treasury bill rates higher. But we believe this increased Treasury bill supply would likely be offset by strong demand from government money market funds, Treasury-only funds, and investors seeking liquidity for their portfolios. The US Federal Reserve's overnight reverse repurchase program (RRP) could support Treasury bill rates, but we believe this would likely be outweighed by demand from government funds and Treasury-only funds, which are not eligible for the RRP.

Money market rates could face downward pressure despite debt ceiling battle

With the debt ceiling battle on the horizon, we could see volatility in US Treasury bills in the coming months. Reduced net Treasury bill issuance could pressure Treasury bill rates lower as we approach the March 15 deadline and could put downward pressure on other money market securities such as agency securities and the repurchase (repo) markets.

If Congress raises the debt ceiling, there still could be strong investor demand to keep rates low, but likely with quite a bit less volatility. Therefore, despite some volatility likely due to uncertainty over the debt ceiling, we are constructive on Treasury bill rates over the next few months.

1 Source: Committee for a Responsible Federal Budget (Oct. 22, 2015). "Everything you should know about the debt ceiling."
2 Source: Wrightson ICAP, LLC, as of Dec. 6, 2016, and Dec. 31, 2015.

Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.

Obligations issued by US government agencies and instrumentalities may receive varying levels of support from the government, which could affect a portfolio's ability to recover should they default.

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