Invesco Fixed Income Investment Insights

The US debt ceiling saga resumes

August 16, 2017

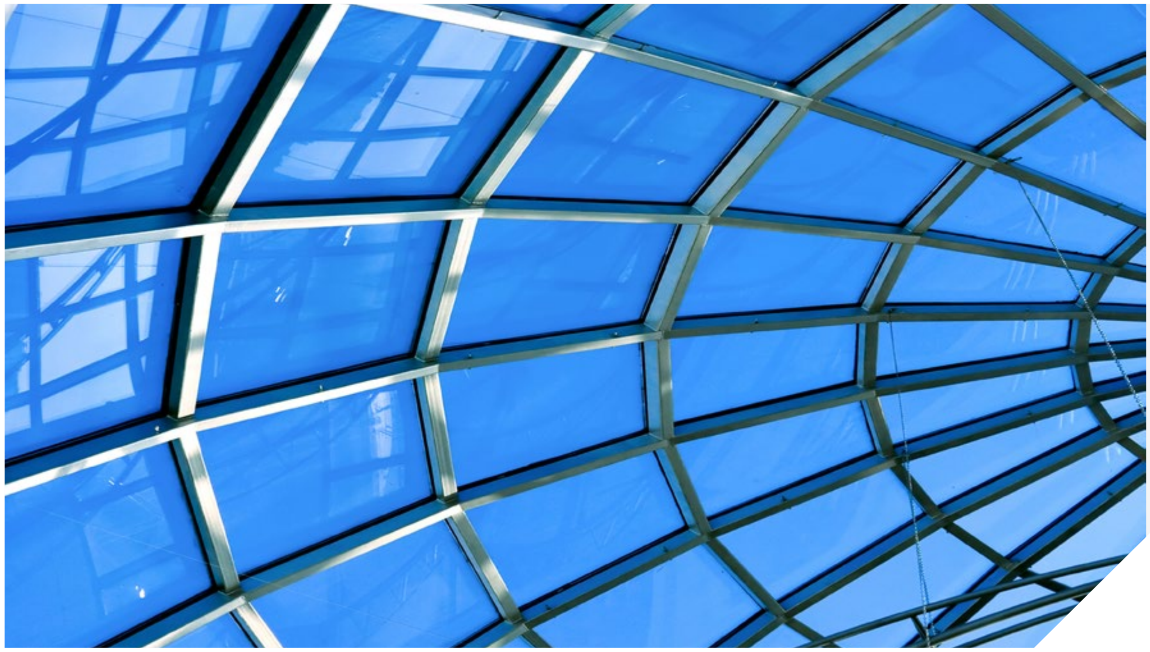

Image source: Vladitto/Shutterstock.com

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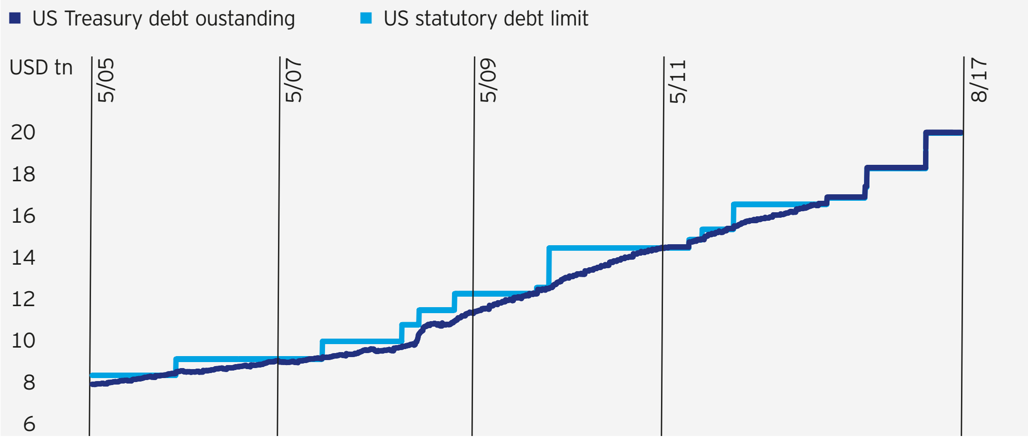
Key takeaways

- The US Congress is again being asked to raise the federal borrowing limit, or debt ceiling.
- US Treasury Secretary Steven Mnuchin told Congress that the debt ceiling should be raised by September 29, or the government risks running out of funds to pay its obligations.[1]
- Since March 2017, the Treasury has utilized "extraordinary measures" to meet its obligations, but these are estimated to run out in late September or early October.
- We remain optimistic that the US Congress will pass legislation to raise the debt ceiling (or temporarily suspend it), although the decision will likely come down to the wire and the process will likely be contentious.
- We expect yields on US Treasury bills (T-bills) that mature in early October to be the most affected and rise significantly as we approach the September 29 deadline.
- However, we expect the longer segment of the US Treasury bill yield curve to be pressured downward as the US Treasury cuts T-bill supply to comply with the current debt limit.

Once again, the US debt ceiling is in focus. Since March, the US Treasury has employed "extraordinary measures" to fund the US government, such as halting contributions to certain government pension funds and borrowing money set aside to manage exchange rate fluctuations. But those measures are set to run out this fall.

Figure 1: US Treasury debt outstanding versus debt limit



Source: Bloomberg L.P., data from May 3, 2005 to Aug. 2, 2017. Gaps in data are due to the temporary suspension of the debt ceiling from Feb. 2013-May 2013, Oct. 2013-Feb. 2014, Feb. 2014-March 2015 and Oct. 2015-March 2017.

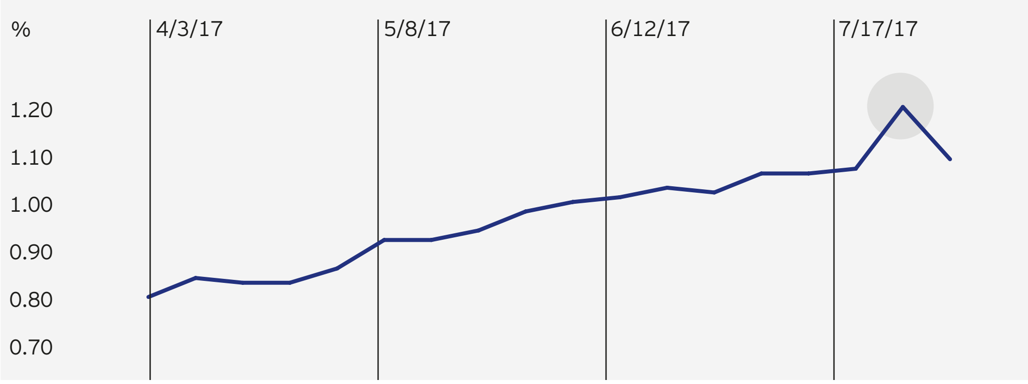
US Treasury Secretary Steven Mnuchin told Congress in late July that the federal borrowing limit must be raised by Sept. 29 or the US government risks running out of funds to pay its obligations.[1] The US Treasury projects that its cash on hand to handle emergencies and other expenses will fall to USD60 billion by the end of September, well below its preferred cash balance of around USD300 billion.[2]

So the US Congress is, again, being asked to raise (or temporarily suspend) the debt ceiling to allow the US Treasury to issue more debt, and continue honoring its obligations. We expect the debate to be contentious. Some Republican members of the US House of Representatives may demand concessions in return for supporting debt limit legislation, but Democrats may not go along. Further complicating discussions, the 2018 budget negotiations will also be underway. There may be attempts to join the two issues, either formally or informally.[3] Failure to agree on a budget resolution increases the risk of triggering a government shutdown, but we believe this is a low probability event.

Implications for short-term debt markets

Invesco Fixed Income believes that the US Congress will likely raise the debt ceiling or suspend it, which would allow the US government to resume normal debt issuance and financing activities. However, in the next several weeks, US short-term bond markets could be choppy. We have already seen uncertainty over the debt ceiling manifest itself in the US T-bill market. Yields on 3-month US T-bills maturing in October spiked to 1.18% in late July, as shown in the chart below, inverting the US Treasury yield curve.[4] This quickly reversed, however, after Secretary Mnuchin urged lawmakers to act by the end of September. Yields on bills that mature in October ("October bills") remain elevated.

Figure 2: 3-month US Treasury bill auction yields



Source: Bloomberg L.P., data from April 3, 2017 to July 31, 2017. Past performance is not a guarantee of future results.

Reduced US Treasury bill issuance

As we head toward September, we expect several developments to further impact short-term markets. It is likely that the US Treasury will reduce its issuance of T-bills to provide capacity for the issuance of longer-term "coupon" bonds (bonds with maturities of two years or more). US T-bills are the most vulnerable to fears of payment delays, which could pressure yields on October T-bill maturities upward and sharply increase government funding costs. The US Treasury is also likely to increase its issuance of cash management bills (CMB), which have maturities of less than one month.

With resolution of the debt ceiling debate likely to go down to the wire, reduced T-bill supply could exert downward pressure on T-bill yields for maturities that extend beyond October. October US T-bill yields, on the other hand, could rise by more than 25 basis points, based on moves seen during previous debt ceiling debates.[5] With US T-bill supply cuts looming, we anticipate not only yield declines in the longer segment of the T-bill yield curve, but also an impact on overnight repurchase (repo) rates. As market participants avoid US T-bills maturing around early October, constrained repo supply could pressure repo rates lower. We expect repo rates to closely track the US Federal Reserve's overnight repo facility.

Once there is a resolution to the debt ceiling issue, we anticipate significant T-bill issuance by the US Treasury. The increased supply of investable short-term securities should provide much needed relief to the market and help alleviate yield compression that resulted from the debt ceiling constraints.

Resolution to debt ceiling may be hard-fought

Some politicians and policy makers have suggested prioritizing payments as a way for the US Treasury to manage its obligations without raising the debt ceiling. However, in keeping with his predecessor, Secretary Mnuchin has stated that he has no intention of prioritizing payments, thus putting pressure on the US Congress to raise the borrowing limit.[6]

Agreeing to raise the debt limit may prove particularly challenging for a Congress that has struggled to find common ground to pass other legislation like health care and tax reform. And we know from previous episodes of the debt ceiling debate that using it as a political lever can create financial market disruption and investor uncertainty. The US Congress faces many challenges, and has a full agenda that includes health care and tax reform, but at present, Invesco Fixed Income remains optimistic that Congress will be able to resolve this year's version of the debt ceiling debate, and quell investor concerns.

1 Source: US Department of the Treasury, July 28, 2017. Wall Street Journal, July 31, 2017.
2 Source: US Department of the Treasury, July 31, 2017.
3 Source: Observatory Group, Aug. 2, 2017.
4 Source: TreasuryDirect, July 14, 2017.
5 Source: US Department of the Treasury, Sept. 23, 2013 to Oct. 8, 2013.
6 Debt prioritization is an option, as confirmed by a released transcript of Fed officials during an emergency Federal Open Market Committee conference on August 1, 2011, where it was confirmed that it is technically possible to prioritize US Treasury security principal and interest payments before other government obligations.

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