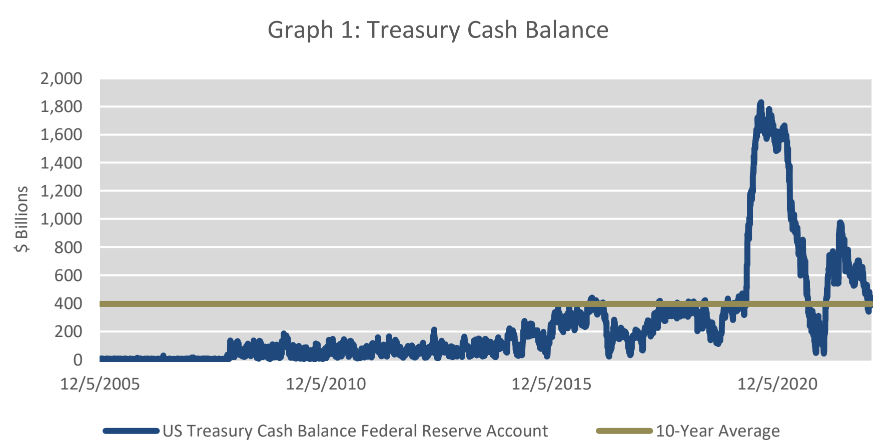
Early Brinksmanship Shines Fresh Light on Debt Limit

House Republicans and Senate Democrats emerged from the November 2022 elections with very slim majorities, posing meaningful challenges over the next two years. The early intra-party tussle to merely elect a Speaker of the House points to a possible rocky road ahead. As a result, there should be heightened attention on one of the most important agenda items of 2023 – the debt limit – and the potential knock-on effects to financial markets. Increased partisanship and rhetoric around fiscal issues raise the prospects of a more drawn-out process and stronger market reaction. History shows that market dislocations are possible and may offer opportunities to add exposure at more attractive levels.



The debt limit, which stands at $31.4 trillion today, is a constraint Congress imposes on the amount of outstanding U.S. Federal government debt. It does not set or authorize new spending, but merely allows the government to meet obligations to which it has already committed. Once the limit is reached, the Treasury Department can't borrow additional funds to cover government operations. The Treasury Department often employs "extraordinary measures" to continue fully funding government operations.[1] Another means to continue meeting obligations are the Treasury's cash reserves. There are currently still cash reserves available (Graph 1[2]), but they have started to draw down and are sitting just below the 10-year average. Once all tools are exhausted, the U.S. government's ability to meet its obligations fully and on time is compromised, which is often referred to as the "X Date." Congress has either temporarily raised or suspended the limit numerous times. Some members of Congress periodically propose abolishing the limit altogether, but that is a very remote likelihood, especially in a divided Congress.

There is consensus among experts that not addressing the debt limit can have serious implications, including but not limited to: (1) defaulting on U.S. obligations; (2) negative credit rating action; (3) negative bond and equity performance; and (4) a tangible impact to the real economy through individuals and businesses.

Recent Debt Limit Debates and Financial Market Reactions

Debt limit debates are not new, and vary in their degree of partisanship, contentiousness, and length. Those factors contribute to how financial markets react. Although it can be difficult to parse the precise response because markets are reacting to numerous factors and events, the effects are more clearly observable in the 2011 and 2013 debt limit crises. Generally, greater uncertainty led to bouts of higher volatility and jumps in Treasury bill yields around key debt ceiling dates. Additionally, greater uncertainty contributed to wider

[1] "The Debt Ceiling: An Explainer," The White House. 2021, October 6.

[2] U.S. Treasury Department

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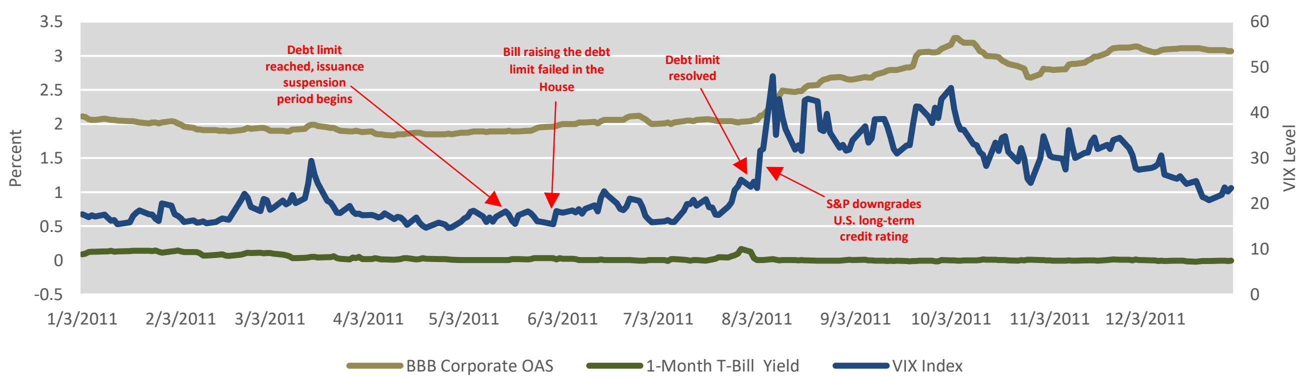
corporate spreads in some instances, such as following credit rating action or a tangible impact of the debt limit debate on consumer and business sentiment. However, 2011 was noticeably different.

The 2011 market reaction (Graph 2[3]) offers an example of the consequences of a more protracted and contentious impasse. At the beginning of 2011, the Treasury Department wrote to Congress requesting it raise the debt limit and estimated that limit would be reached by sometime in the middle of the year. After implementing extraordinary measures and Congress working through multiple iterations of legislation to address the debt limit, Congress ultimately resolved the issue in August 2011 through the enactment of the Budget Control Act (BCA), which imposed caps on discretionary spending among other fiscal provisions.[4]

Graph 2: 2011 Debt Limit



Unfortunately, Congress's eventual action did not fully stave off some of the more serious consequences of a prolonged debate. In August 2011, Standard & Poor's lowered the credit rating of long-term U.S. government debt from "AAA" to "AA+" based on its views of the increased risk to U.S. debtholders, the BCA would not adequately stabilize the U.S. fiscal outlook, and future policy and political uncertainty. Other credit rating agencies did not follow suit.[5]

The debt limit debate of 2013 (Graph 3) is another example of a more pronounced market impact compared to a typical debt limit debate as it coincided with a government shutdown.

[3] ICE BofA BBB Corporate OAS; 1-Month U.S. Treasury Bill Yield; and CBOE Volatility Index

[4] "The Debt Limit: History and Recent Increases," The Congressional Research Service. 2015, November 2.

[5] "Standard & Poor's Downgrade of U.S. Government Long-Term Debt," The Congressional Research Service. 2011, August 9.

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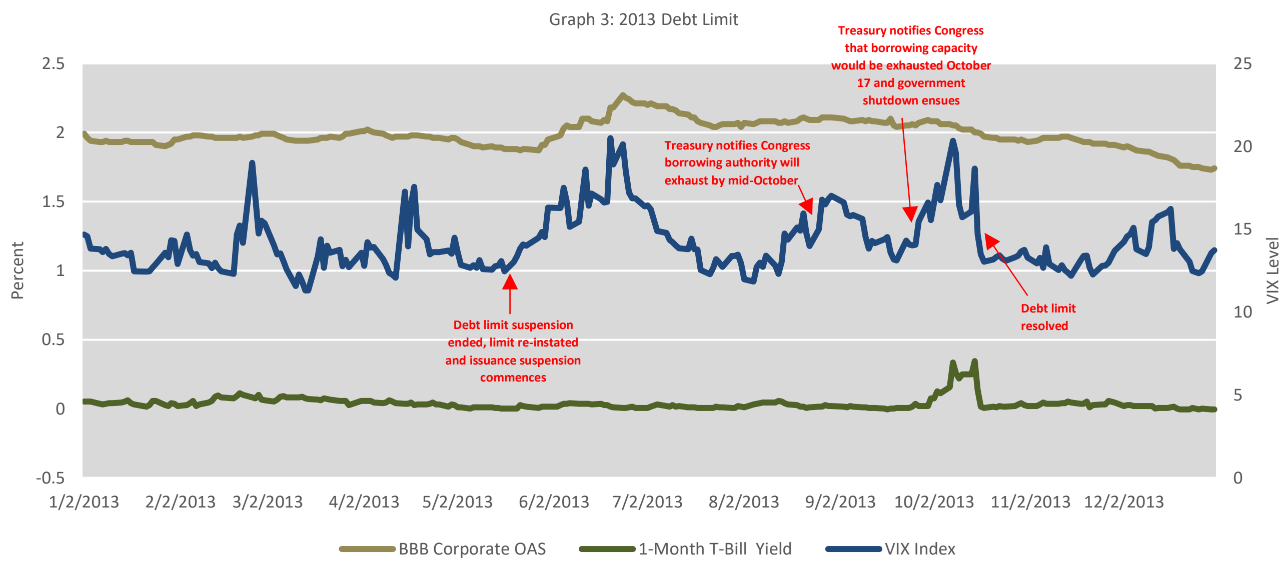

In May 2013, the previous debt limit suspension ended and the debt limit was reinstated. Over the next several months, Treasury Secretary Lew invoked extraordinary measures and prompted Congress to raise the debt limit in a timely manner. Throughout the year, Congress had also held a number of hearings and introduced legislation related to the debt limit. By September, the Treasury Department had notified Congress that the government would exhaust its borrowing capacity around October 17. Further complicating the matter, the government ran out of funding and was shutdown in the first weeks of October. Ultimately, Congress resolved the debt limit as part of a broader appropriations bill.[6]

In contrast to 2011 and 2013, 2019 offered an example of a more muted reaction, which was further clouded by other major events, such as the Federal Reserve cutting rates and trade disputes under the Trump Administration. Regardless, debt limit impasses, especially those with significant uncertainty and that coincide with other economic concerns like looming recessions, can have a material impact on financial markets.

2023 Politics Clouds the Path Forward

What parallels are there today with 2011, and why could we see a stronger market reaction this time around than is typical?

Heightened rhetoric around fiscal issues has already started. In 2011, the new House Republican majority, influenced by the Tea Party movement, wrangled with the Obama Administration over deficit reduction and used the debt limit as a negotiating tool. Ultimately, the longer process culminated in a broader fiscal reform bill, the BCA. Today, a new House Republican majority, along with a small group that often butts heads with Party leadership, is once again raising fiscal concerns in the wake of COVID-era stimulus, the American Rescue Plan, and elevated inflation. Many of the members that opposed McCarthy as Speaker have insisted the

[6] "The Debt Limit Since 2011," The Congressional Research Service. 2022, December 23.

Party fight against a "clean" debt limit bill (i.e., a bill that doesn't include other fiscal reforms, like deficit reduction), to which McCarthy reportedly agreed.

Many House Republicans are frustrated with last year's spending bill negotiated after the elections. Senate Republicans worked with Democrats to negotiate a longer-term spending deal through September 2023. Some House Republicans felt a better option would have been to push a shorter-term spending deal through the first quarter of 2023 until which time the new House Republican majority could negotiate with what they view as more leverage. Despite passing the Senate overwhelmingly 68 to 29 (with 18 Republicans supporting), the longer-term spending bill passed the House by a narrower margin of 225 to 201 (only 9 Republicans supported). The September 2023 deadline for the next round of government funding interestingly coincides with the general timeframe for when experts believe the debt limit will need to be resolved.

Smaller groups will have more power this Congress. Needing 218 votes (if all members are present), Kevin McCarthy required 15 ballots before finally securing the Speaker's gavel in the House, in part because of the very narrow margin in his own Republican conference; only four votes could be lost. To put it into context, prior to this Speaker election, there have been 127 Speaker elections since 1789, of which only 14 required multiple ballots. Out of the 14 requiring multiple ballots, 13 occurred before the Civil War with the other in 1923, and six of the 14 were decided on either the second or third ballot.[7] In order to secure the votes, McCarthy also had to make sizable concessions to the small group opposing him that will impact his ability to govern this Congress. The concessions give smaller groups more leverage in future negotiations, and will influence legislative and procedural matters on the House floor. One such commitment was to reinstate the policy that any single member can force a no confidence vote against the Speaker, which will hang indefinitely over McCarthy's head.

It is true that a Speaker election is different from more conventional legislation because it is more partisan; each Party typically sticks with an individual within their own Party. In that sense, it is possible that moderate Republicans could work with Democrats to resolve the debt limit earlier. However, there are reasons to caution against such optimism:

> (1) House Republican leadership is incentivized to and have reportedly already said they would fight against a "clean" debt limit bill;
>
> (2) Speaker McCarthy now faces the constant threat of any single member bringing a "motion to vacate the chair" (i.e., essentially a no confidence vote of the Speaker) against him if they are unhappy with his performance at any point or his efforts are viewed as lackluster. The threat of this motion was widely understood to have contributed to ending the Speakerships of both John Boehner and Paul Ryan; and
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> (3) Many Republicans may argue that Democrats had the opportunity when they were in full control of both the executive and legislative branches to address the debt limit through reconciliation (i.e., an expedited, but more constrained, process to enact spending or revenue-related legislation with only a

[7] "Speaker Elections Decided by Multiple Ballots," U.S. House of Representatives History, Art & Archives.

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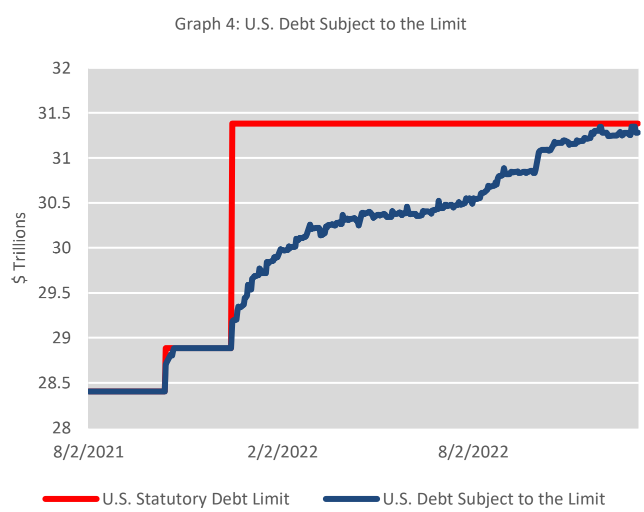
simple majority vote instead of the Senate's typical 60-vote threshold). Instead, Democrats chose to address other priorities under reconciliation, such as the highly controversial $2 trillion American Rescue Plan.

The debt limit stands at $31.4 trillion today (last set in 2021 by legislation raising the level by $2.5 trillion), and the total U.S. debt outstanding that is subject to the limit is fast approaching the constraint (Graph 4[8]). Early estimates place the "X Date" at some point in the latter half of this year.

Therefore, Congress has time to act on the issue. Slim majorities in both chambers, and splits between and within each party, point to heightened potential for a longer and more contentious debate, and higher volatility at some point in 2023. Keep an eye out for important milestones, such as reaching the debt limit, Treasury cash balances drawing down further, Treasury invoking extraordinary measures, and increasing political rhetoric from both sides of the aisle. Higher volatility may not be too far behind.



Assuming Congress will ultimately resolve the issue as it has in every other instance and avoid the worst-case scenario of defaulting on the government's obligations, it is worthwhile to look for opportunities to add up-in-quality credit exposure at more attractive spreads, and pick up short-term Treasuries at heightened yields as the "X Date" approaches.

[8] The U.S. Treasury Department