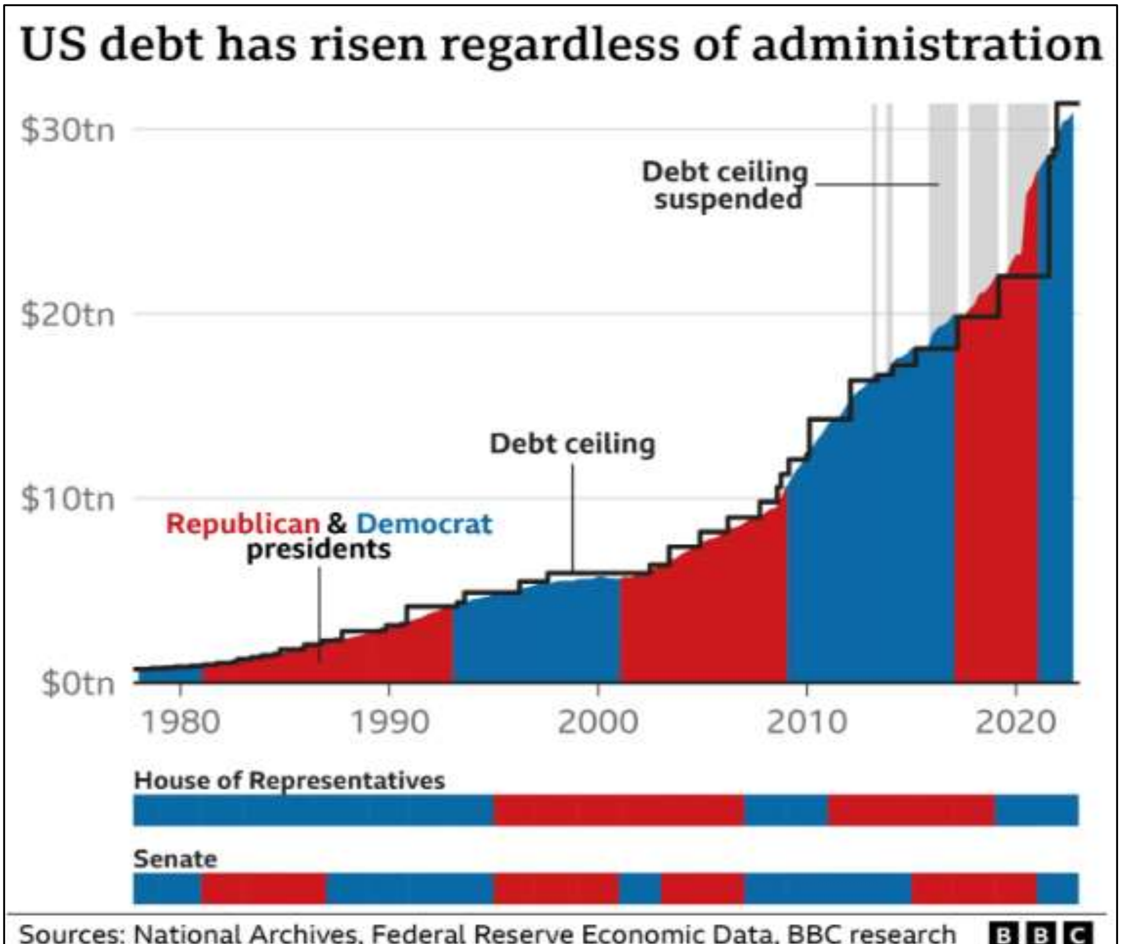
The Debt Ceiling

Rising concerns that U.S. Treasury could hit its debt limit in the coming months are leading investors to shun certain Treasury bills & pour into others as they seek out low risk places to park cash. That has led 1-month bill yields to tumble & the spread between 1-month and 3-month bills to expand to its widest level since the 1-month bills were introduced in 2001.

In 1917, the U.S. federal debt was approximately $5.7 billion. Today it is approximately $31 trillion, which represents a nominal increase of over 5,000-fold in 106 years. Due to constant deficits, the government has to constantly issue new debt to pay off maturing debt.

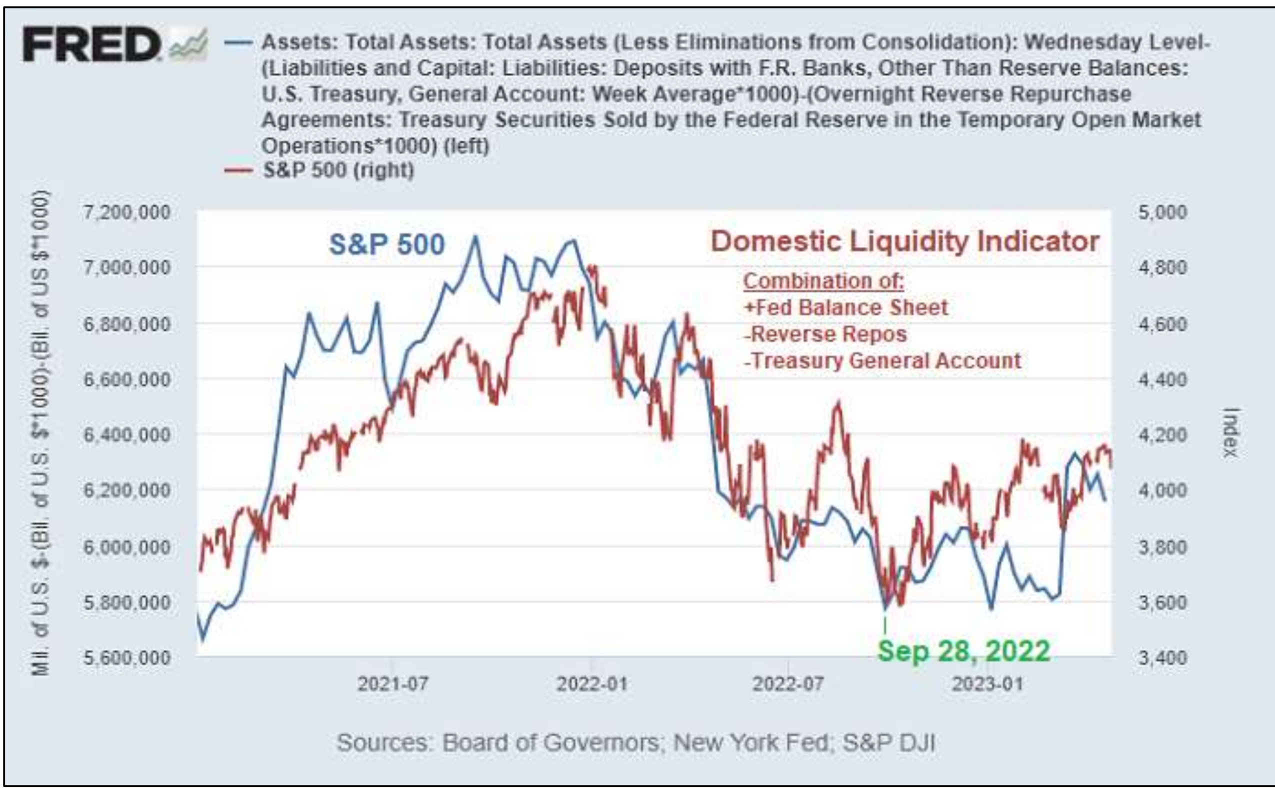
When the debt ceiling is not agreed to be increased as it normally is, the U.S. Treasury begins to take "extraordinary measures". Primarily, they begin drawing down their existing cash balance to fill the gap. Currently they target to maintain around $500 bn in their cash account, but during debt ceiling debates, they can draw that down to nearly zero, which allows them to keep spending without issuing new debt for several months. When those types of measures eventually become tapped out, the risk of an actual default occurs.



(Source: Lyn Alden)

The Post-Debt-Ceiling Liquidity Crunch

Since early 2022, the Federal Reserve has been doing quantitative tightening, meaning it is gradually destroying base money in an effort to rein in price inflation. This sucks liquidity out of the financial system and is usually negative for financial asset performance. However, since late September 2022, the Treasury General Account has been drawing down as well. Unlike the Federal Reserve balance sheet, a drawdown in the Treasury General Account is positive for financial system liquidity. When it draws down, it pushes liquidity back into the system that it had previously removed. Overall domestic liquidity has been rather flat, as the Federal Reserve and Treasury Department effectively offset each other. Risk assets have generally followed suit.



We've indeed been in that sideways liquidity situation, and the bank failures actually gave us a mild boost in liquidity in March. In a couple months, however, we're set to enter that next phase: a potential negative double-whammy for liquidity.

Once the debt ceiling is resolved, the Treasury will be legally able to increase its general account back to its target level (which is negative for liquidity when it happens) as the Federal Reserve continues to pull liquidity out of the system (which is also negative for liquidity).

(Source: Lyn Alden)

The problem, however, is that bank cash levels as a percentage of bank assets are at pretty low levels in the post-2008 regulatory environment, especially for small banks. Sucking $500 billion of liquidity out of bank reserves to refill the Treasury General Account might not be tenable, and would likely be negative for financial assets. A background problem is that the U.S. government is running very large deficits. The U.S. federal government ran a $1.1 trillion deficit over the past six months, and will continue to run large deficits going forward.

Way Forward

a) The Federal Reserve could capitulate, and begin buying Treasuries. This would mark the end of quantitative tightening and a shift towards quantitative easing, which if price inflation is still elevated would threaten Federal Reserve credibility.

b) The U.S. Treasury Department could issue a ton of T-bills to refill its general account, rather than issue long-duration bonds. This would reduce the average duration of government debt, and is currently the most expensive part of the Treasury curve to issue debt on, but it would likely suck cash out of reverse repos and allow the Treasury to refill its account without damaging commercial bank liquidity.

c) If the dollar weakens enough, then foreign buyers might step back in to buy Treasuries with offshore dollars. Combined with non-bank domestic buyers and large bank buyers (small banks are basically tapped out), this might be enough to avoid having the Federal Reserve or Treasury Department change their course. However, the foreign sector tends to buy Treasuries during weak dollar periods and sell Treasuries during strong dollar periods, and the problem is that liquidity-negative conditions usually result in a strong dollar.

The likelihood of going down one path or another is partially dependent on human choices by those in power, and thus is hard to predict. Will Congress suspend or raise the debt ceiling before or after a temporary default, and by what magnitude? After the debt ceiling is resolved, will Treasury Secretary Yellen seek to refill the cash account quickly, or try to draw the process out longer to reduce the near-term liquidity impacts? Will BRICS nations continue their current spurt of de-dollarization and reserve diversification, or take a break from that process for a bit and re-accumulate some Treasuries?

(Source: Lyn Alden)

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