THE DEBT CEILING—ACT 3: NOT A FISCAL CLIFF REDUX

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Leading up to the debt ceiling debate prior to Labor Day, I wrote two blog posts providing our thoughts and additional insights surrounding prior episodes on this topic, and I was fully expecting the third installment to include some potential fireworks. Little did I—or the U.S. Treasury (UST) market, for that matter—know that President Trump would pull a legislative surprise and make a deal with the congressional Democratic leadership that not only suspended the debt ceiling until December 8 but also provided short-term funding for the federal government to avoid a potential shutdown. Alas, this "Debt Ceiling—Act 3" blog post will instead focus on what investors can potentially expect come the new December deadline, and whether this is actually a hard deadline at all.

Certainly, even without the debt ceiling saga to contend with, market participants will still more than likely be confronted with other news events from the nation's capital. Indeed, tax reform/cuts continue to be a topic that should garner headlines in the weeks, if not months, ahead. With respect to the Fed, the results of the September FOMC meeting (a pause in rate hikes and the beginning of a balance sheet normalization process in October) probably takes the monetary policy makers out of the headlines for a while, at least until the December gathering rolls around, as current expectations are for another rate hike at that time (but not sooner).

That brings us to the final month of 2017, when both fiscal and monetary policy issues could be in focus. The aforementioned Federal Reserve (Fed) part of the equation tends to speak for itself, but on the fiscal side, stories have already started mentioning the term "fiscal cliff." As a reminder, this was the situation the federal government found itself in at the end of 2012, when spending cuts and tax increases (or ending tax cuts) were slated to occur simultaneously. In my opinion, 2017 will not rise to that threshold. While a budget for fiscal year 2018 needs to be approved, there is no urgency to avoid tax and spending triggers as was the case five years ago.

Even when one includes the end of the debt ceiling suspension on December 8, the gravity of the situation still doesn't match 2012. In fact, the deadline of December 8 is really not a hard deadline, because, once again "extraordinary measures" are essentially "reset" and can be used to create room for further Treasury borrowing. Consensus analysis tends to place the "drop-dead" date in Q2 2018, but there is a risk it could be pushed up, depending on hurricane relief funding needs and how the outflows look for the tax refund season and the subsequent April tax payment inflows.

Conclusion

How are the markets looking at these potential developments? As the reader will recall, Treasury bills are the focus: due to their weekly maturity feature, these are the instruments that market participants feel have the higher chance of being negatively impacted if the debt limit is not raised on a timely basis. Against that backdrop, investors should look toward the T-bill maturity dates that would be potentially occurring right around, or right after, the date when the debt ceiling needs to be raised. As of this writing, the market is not signaling any overarching concerns, as the December 2017 T-bill maturity yields are not showing any unusual spread to the October/November maturities. Stay tuned…

Unless otherwise noted, data source is Bloomberg, as of 9/25/2017.

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DEFINITIONS

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Treasury Bill : A treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of one month (four weeks), three months (13 weeks) or six months (26 weeks).