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Implications of the Debt Ceiling Showdown for Investors

As the "x-date" approaches, our portfolio managers and experts are closely monitoring developments

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As the date approaches when the U.S. Treasury Department will no longer be able to meet its obligations unless the legislative limit on the national debt is raised—the so-called x-date—investors may have questions about the implications for the economy and markets. We recently gathered T. Rowe Price fixed income and equity portfolio managers, as well as the firm's economists and regulatory analysts, to share their insights about the fluid situation and how they are preparing for the possibility of volatility ahead.

Q: How likely is a debt ceiling crisis (and will this time be different)?

In the view of T. Rowe Price Washington, D.C., Associate Analyst Michael Pinkerton, the political jostling could take negotiations further down to the wire.

While he acknowledges that the hurdles to an agreement have proved larger than expected, Michael still believes that Congress is likely to again find a way to avert a default on the government's debts.

Markets appear to have reacted positively to recent reports of progress on an agreement from both President Joe Biden and Speaker Kevin McCarthy.

"There was an overwhelming consensus...that defaulting on the debt is simply not an option," Biden said in remarks following a May 16 meeting with Republican leaders, although he cautioned that "there's still work to do."

Q: When will the government run out of money?

U.S. Treasury Secretary Janet Yellen has continued to warn that the "extraordinary measures" the Treasury is taking now that the government has surpassed its official debt limit might be exhausted as soon as June 1.

The actual date the government runs out of cash remains a moving target based on several unknowns, but April's individual tax receipts came in somewhat below expectations—making upcoming data on corporate tax receipts even more important.

If the Treasury manages to conserve enough cash through June 15, when corporate tax payments are due, the next crucial date for an agreement might be late July or early August.

Q: What is the likelihood of an agreement to temporarily extend the debt ceiling?

Both President Biden and Speaker McCarthy have publicly disavowed any intention of agreeing to a "kick-the-can," short-term extension of the debt limit.

T. Rowe Price's Michael Pinkerton believes that a temporary extension remains unlikely. An extension is only probable if the two sides agree on a topline cut in government spending.

In this scenario, White House and congressional negotiators would then be given a window to decide on where the specific spending cuts would fall.

Q. What happens if neither a short-term nor a long-term agreement is reached?

If the government runs out of cash, some believe that the Treasury Department would then choose to prioritize payments to those who own U.S. Treasury securities (e.g., bills, notes, and bonds).

However, Secretary Yellen has stated that "Treasury systems have all been built to pay all of our bills when they're due and on time and not to prioritize one form of spending over another."

The potential impact on Social Security payments, for example, remains unclear.

Q: What does this mean for investors?

Volatility in the bond and stock markets has risen and fallen moderately on negotiations prospects, but it may pick up as the U.S. Treasury gets closer to running out of money to pay its obligations.

To date, the stock market has performed much better than it did during a similar showdown in 2011, which may reflect the exceptionally fragile and slow economic recovery that followed the global financial crisis of 2008–2009.

However, the current debt ceiling fracas is also coming on the heels of tightening credit conditions—if not of the same magnitude—due to Federal Reserve rate hikes and turmoil in the banking sector, which may eventually aggravate the economic and market impact.

The worst-case scenario would be if the showdown leads to the government missing a debt payment for the first time, which might result in a widespread or lasting downgrade to the credit rating of U.S. Treasuries.

In late 2011, Standard & Poor's downgraded U.S. Treasuries by one notch, from AAA to AA+, but the other major rating agencies didn't follow.

So many assets are priced in direct relation to U.S. Treasuries that the turbulence from a more pronounced downgrade would be felt in markets worldwide.

Q: What would be the implications for the global economy?

T. Rowe Price Chief Global Economist Nikolaj Schmidt believes a default on U.S. Treasury obligations would push an already weak global economy into recession, but he thinks that the more likely scenario is that the U.S. government suspends paying domestic obligations, such as Social Security payments and government salaries.

Even in the latter scenario, he worries that a resulting recession in the U.S., should it occur, would then drag Europe into one as well.

Nikolaj notes that the U.S. makes up about a quarter of the global economy, and the ripple effects of its slowdown would quickly make European economies unable to withstand tight monetary conditions.

In the event of a true default, T. Rowe Price Chief European Economist Tomasz Wieladek believes that German sovereign bonds (bunds) would become a favored "safe haven" for global investors.

All else being equal, this would drive up the value of the euro and favor investors in bunds, but he agrees it would take a large toll on the already weak European economy.

In the event that a default is avoided but progress on negotiations stalls, Tomasz thinks investors will still perceive the bund as even more of a safe-haven asset than they do currently.

Q. How would Treasuries and other government-backed securities respond to a U.S. government default or downgrade by one or more major credit rating agencies?

A one-notch downgrade of U.S. Treasuries would likely create short-term market volatility.

Some believe that U.S. Treasury yields could increase, and other government-backed debt securities—such as GNMA, Fannie Mae, Freddie Mac, and Sallie Mae securities—could be affected, too.

That outcome is not assured, however, as evidenced by a decline in Treasury yields in 2011.

Over the long term, we believe that the economy, inflation, and the Fed's monetary policy will be the primary drivers of interest rate movements.

A default would be a much more serious problem, but we believe this outcome is highly unlikely.

In a hypothetical default scenario, forced sales of Treasuries by certain investors would probably create high volatility and illiquid market conditions.

The fact that Treasury yields have not spiked thus far in anticipation of a possible debt ceiling crisis is a reassuring signal that investors continue to favor the liquidity and low risk of U.S. Treasuries.

Portfolio Impacts and Activity

Q: How does the debt ceiling showdown affect how T. Rowe Price is managing holdings of U.S. Treasury securities?

We are monitoring progress on political solutions while preparing for the unlikely probability that no resolution is met before the Treasury runs out of cash.

Doug Spratley, who manages money market portfolios for T. Rowe Price, is planning to maintain liquidity in non-Treasury debt, such as repurchase agreements or issues from government-sponsored entities that are immune to the debt ceiling, to avoid having to sell Treasuries that are directly impacted.

Doug is also spreading out the range of maturities in his portfolios to minimize concentration in one that might bear most of the impact, while targeting maturity ranges that are likely to bear the least—such as those maturing in the weeks after corporate tax payments are due on June 15.

Like Nikolaj, Doug believes the most likely outcome in the event the government runs out of cash is that the Treasury prioritizes making principal and interest payments on Treasury securities, which would likely be made on time while other government payments would be delayed.

This scenario would have the least impact on money market funds, which will also benefit from regulatory protections passed in 2014.

Q. What steps are T. Rowe Price's equity managers taking in the event of a breakdown in negotiations or an actual default?

U.S. Equity leadership is partnering with the T. Rowe Price risk assessment team to stress test the firm's portfolios in the case of a short-term technical default.

The firm's portfolio managers and analysts regularly evaluate the risks for each of their largest holdings, including analyzing downside scenarios and talking to company management teams about potential problems.

The firm's fixed income and equity analysts often share information and insights, and they are collaborating on evaluating risks where appropriate.

Michael Pinkerton, who is the firm's Washington regulatory expert, is leveraging his experience and relationships on Capitol Hill to provide frequent written and verbal insights to our investment teams on political developments, outlining areas of risk as well as potential paths to a positive resolution.

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