LORD ABBETT®

May 16, 2023

Investment Perspectives

Investment Brief: The U.S. Debt Ceiling Debate

A concise guide to what's at stake as the United States approaches its statutory debt limit—and the implications for investors

Jeffrey Herzog,
Managing Director and
Portfolio Manager

Timothy Paulson,
Investment Strategist

Market participants, and the U.S. Federal Reserve (Fed), are increasingly focused on the looming showdown over the U.S. budget and the statutory limit on issuing new debt, popularly known as the debt ceiling. As of this writing, White House and Congressional leaders were conducting negotiations to raise the debt limit from its current $31.4 trillion. Treasury Secretary Janet Yellen has indicated that the U.S. Treasury will likely no longer be able to satisfy all the government's obligations if Congress has not acted to raise or suspend the debt limit by early June. Any disruption to the timely payment of U.S. fiscal spending obligations or government debts would severely impact financial markets and the U.S. economy—and may reverberate across the global economy.

While the details of this debt-limit debate can seem overwhelming to the casual observer, it's important to understand the key elements of what is happening and identify the potential implications for financial markets. Here, we will focus on three key questions:

1. Will the debt ceiling be raised before the government runs out of money?
2. What can the government do to prevent a U.S. default if the issue is not resolved in time?
3. If no agreement is reached, what are the potential ramifications for investors?

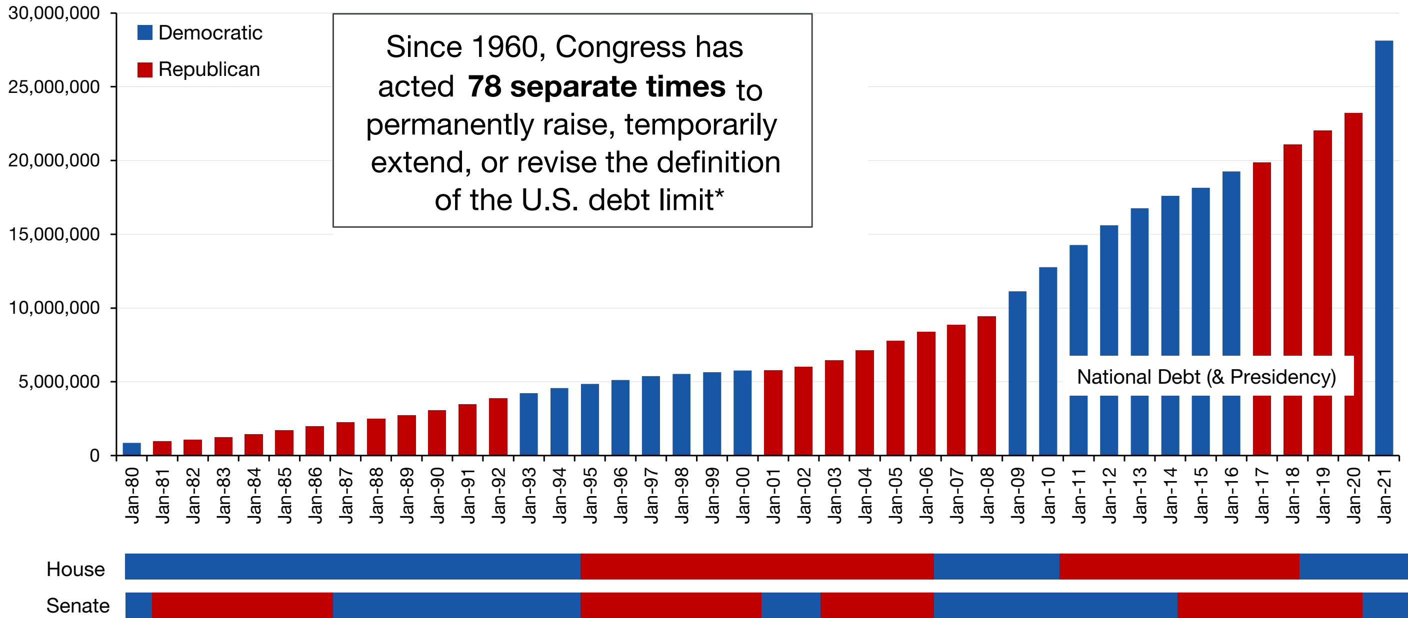
A Century-Old Ceiling

The debt ceiling was first established in 1917 through the Second Liberty Bond Act, which moved Congress away from tediously approving each U.S. government bond issue to simply deciding on a total issuance authorization. If the U.S. Treasury were precluded from borrowing due to a binding debt limit in times when federal outlays outpaced government revenues, the government would no longer be able to meet its legal obligations, raising the specter of default on U.S. sovereign debt.

In prior years, the passage of legislation to raise the debt ceiling to keep the United States on track to meet its obligations would have been considered a bit of legislative housekeeping. In recent decades, however, the U.S. debt limit has become a point of contention in debates over fiscal policy, resulting in two partial government shutdowns (in 2013 and again in 2018-19).

Figure 1. The Inexorable Upward March of U.S. Government Debt

Gross federal debt (in US$) in the United States, 1980-2021



*Source: U.S. Treasury Dept.

Source for chart: Federal Reserve Bank of St. Louis FRED database. For illustrative purposes only.

As noted earlier, the debt ceiling conflicts of recent years have come as Democrats and Republicans have struggled to find common political ground.[1] While prior debt-ceiling conflicts have ultimately been resolved, there is a level of political brinkmanship that makes markets understandably nervous. Enough "unthinkable" events have occurred in recent years that we must ask ourselves what can go wrong should politicians push too far. Certainly, the size of the U.S. budget and Treasury market means that even small disruptions can have an outsized impact.

Now, let's address the questions raised above.

1. Will the debt ceiling be raised before the government runs out of money?

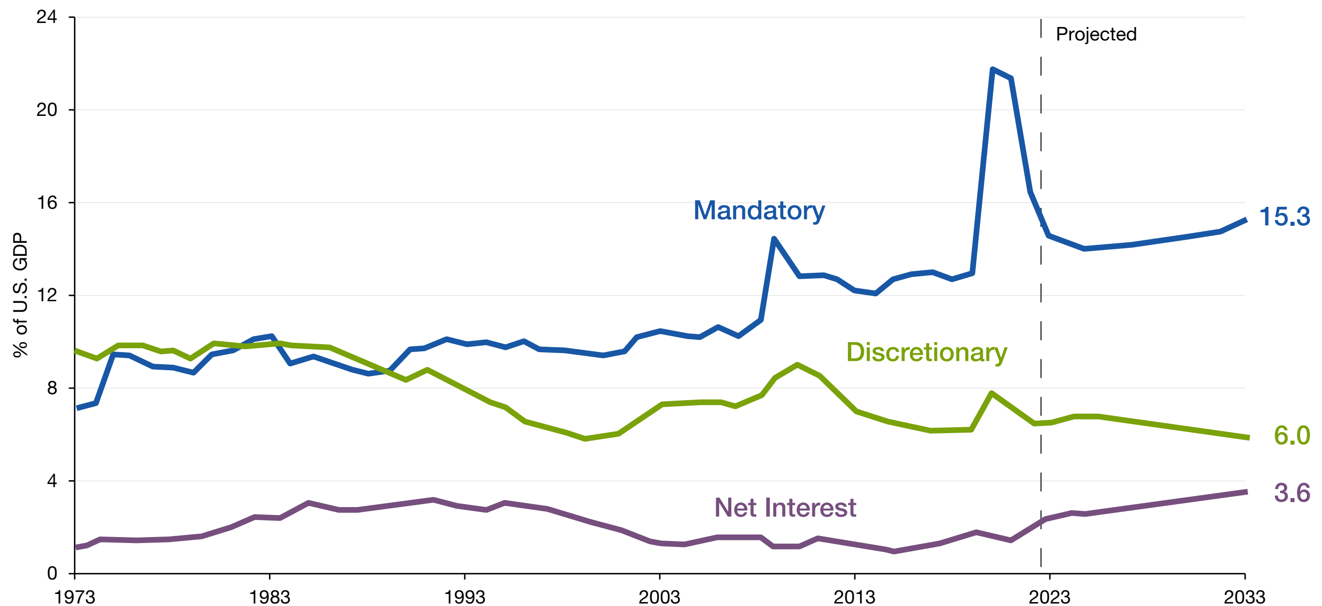
The answer to that one is a stark and simple "nobody knows." Twice in the past decade, politicians have failed to come to an agreement before the so-called "X date,"[2] and it seems entirely possible that we will see this happen for a third time. In this political game of chicken, where both sides hope the other will capitulate first, there is a very real possibility that each side believes that growing political and economic pressures—and the possibility of pronounced market volatility—will force the other side to cave first. Moreover, with two prior episodes in which negotiations extended beyond the X date without incurring a total catastrophe, many politicians may feel they can disregard warnings. Meanwhile, the Congressional calendar may be cutting into available time for negotiating, with Congress expected to head into recess on May 26.

2. What can the government do to prevent a U.S. default if the issue is not resolved in time?

Every year, the U.S. government spends far more than it takes in and must increase its outstanding debt to do so. While the government can control the timing of its spending, budget officials can only guess as to the timing of tax receipts. Thus, they can provide only imprecise estimates as to when the government may "run out of money." Moreover, running into the debt ceiling does not mean that all government functions will come to a halt. It simply means that Washington can no longer spend more than it takes in. At that point, the government will prioritize spending on items deemed essential and may cut lower-priority outlays. The Congressional Budget Office has a considerable amount of useful and publicly available information, including a decomposition of spending into "essential and nonessential" expenditures.

LORD ABBETT®

Figure 2. Discretionary Spending Has Decreased as a Percentage of Total U.S. GDP



Source: U.S. Congressional Budget Office. GDP = Gross domestic product. See spending category definitions under "Glossary & Index Definitions," below. For illustrative purposes only.

We know from prior shutdowns that many services the government provides can be put on hold, including the temporary closures of national parks and monuments, and also that many employees may be put on involuntary leave. In both the 2013 and 2018 shutdowns, roughly 800,000 employees were furloughed, with Congress quickly voting to provide back pay for that period when the debt ceiling was lifted.

What spending is considered essential? Items such as Social Security checks, Veterans Administration benefits, critical government functions, and of course, the servicing of U.S. Treasury debt. Prior shutdowns that involved these furloughs, and the suspension of many taken-for-granted services, proved so unpopular that congress agreed to a ceiling raise within several weeks. And while there is some potential for limited economic pain as various paychecks and services are suspended, the real risk to the system comes from questions about servicing the U.S. government debt.

3. Is a technical default even possible? And what are the possible market implications of a government shutdown?

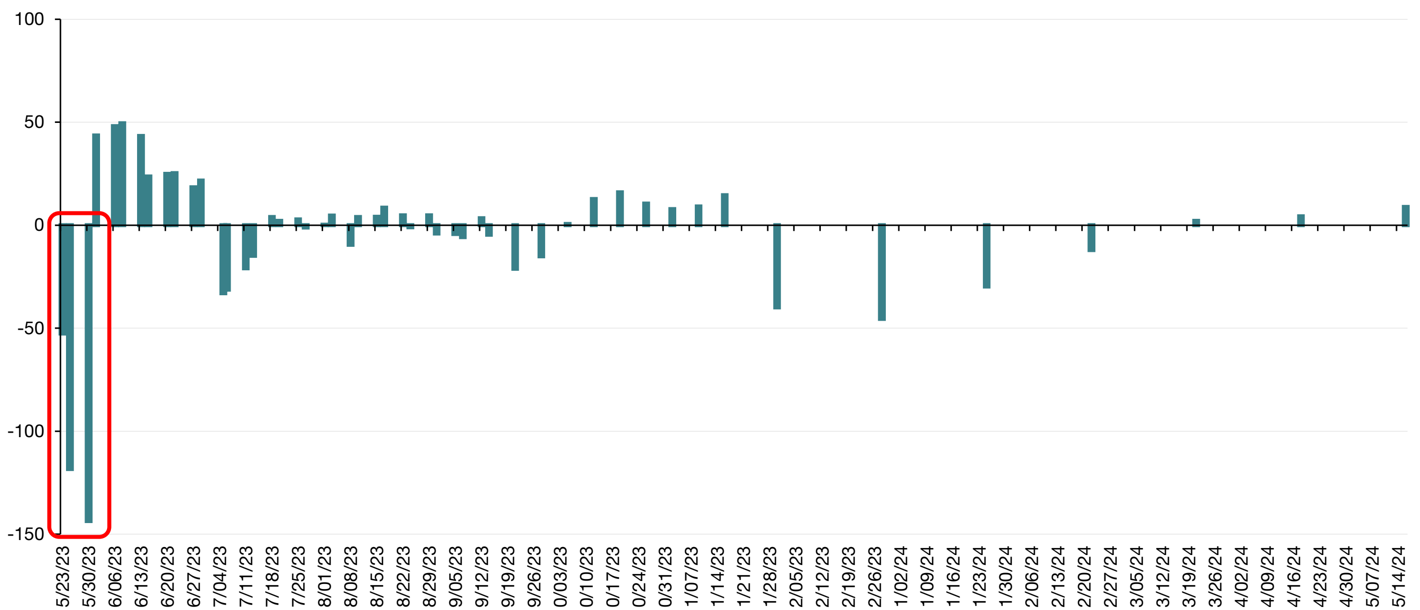
In theory, a "default" on U.S. government debt could have massive ramifications for investors. However, few observers believe a true default—as in, the government saying it will not make good on U.S. sovereign and agency debt—is a possible outcome, for several reasons. First, any issues that might create a technical default are self-inflicted, and come from an easily resolved technicality, not from an actual ability to pay. Also, all parties involved know that the ramifications of default by the most "risk-free" borrower in the world, and linchpin of the global financial system, would be catastrophic for global markets. But even a short-term failure to pay on a timely basis, known as a "technical default," could create some serious issues for markets and investors, and most analysis focuses on the implications of this latter scenario. (Note that according to the International Swaps and Derivatives Association, there is a three business-day grace period for Treasuries before a "failure to pay," or event of default, is declared.[3])

So, a technical default is possible (although unlikely). One actually occurred in 1979 for small investors holding U.S. Treasury bills. This instance, caused by a glitch in word-processing equipment, took a few weeks to sort out, but yields increased by 60 basis points in the meantime.[4]

Many investors are already positioning themselves for a 2023 recurrence of this low-likelihood event, as we can see distortions in the T-Bill (or short-term debt) market.

Figure 3. Spreads Between U.S. T-Bills and the SOFR Financing Rate Point to Investor Nervousness About U.S. Default

Spread between U.S. Treasury bills and the U.S. SOFR financing rate for the indicated dates



Source: Bloomberg. Data as of May 17, 2023. The chart shows the spread between off-the-run U.S. Treasury bills and the U.S. SOFR financing rate, which is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Figure 3 shows that based on spreads between T-bills and the U.S. SOFR financing rate, investors are demanding additional compensation, in the form of higher yield, to take the risk of delayed payments in June 2023. (For example, T-bills due May 30, 2023, recently traded at a yield of 3.59%, while T-bills due June 1 traded at 5.48%.) Notably, they are also doing so in October, as there is some speculation that a short-term, stopgap debt-ceiling measure could push the budgeting issue to the fall, while T-bills that mature before June are seeing heavy investment even as the Treasury has stopped issuing that paper as part of existing “extraordinary measures” to borrow time before the X date.

How might the debt ceiling affect individual Treasury securities? Mostly through the delay of principal or coupon payments, as it seems likely that Congress would vote to make good on any missed payments (they voted, for example, to provide back pay for all furloughed government employees in both 2013 and 2019). Here’s how it might work: The Treasury extends the original principal payment date, and the payment on any Treasury instrument on the Fedwire settlement system is pushed back one day to what is now referred to as the operational maturity date (OMD). Every day Congress continues to negotiate, the OMD is pushed back an additional day. At some point in the future, the government will need to decide if there will be an additional makeup payment to account for unaccrued interest on the delayed coupon payments.

There is no cross-default provision for Treasuries, so if one issue (or CUSIP, in market parlance) is affected, this will not spill over to other Treasury issuance. In short, a technical default creates an incredible number of manual interventions in what are supposed to be automatic payment and settlement systems, suggesting some strange errors, and payment delays, may happen.

How might a technical default impact the broader fixed income and currency markets? The consensus is that long-term Treasury yields would decline, credit spreads would widen, and the U.S. dollar would weaken relative to other major developed currencies, according to a recent polling of investors by JP Morgan.

Here, we think it would be useful to look at the experience of financial markets during past periods of U.S. budget turmoil. Figure 4 shows the performance of U.S. stock and bond benchmarks during the last three government shutdowns: 2011 (first Obama Administration), 2013 (Obama second term), and late 2018-early 2019 (Trump Administration).

Figure 4. Markets Have Proven Resilient During Prior Periods of U.S. Fiscal Drama

How have stocks and bonds performed during previous U.S. Government shutdowns?

Period	S&P 500 Index®	10-Year U.S. Treasuries	U.S. High Yield Bonds	U.S. Corporate Bonds
07/22/2011 - 08/10/2011	-16.6%	7.3%	-4.5%	2.4%
10/01/2013 - 10/17/2013	2.3%	0.6%	1.3%	1.1%
12/21/2018 - 01/25/2019	10.4%	0.6%	4.1%	1.3%

Source: Bloomberg and ICE Data Indices. Data as of May 16, 2023. 10-Year U.S. Treasuries = Bloomberg 10-Year U.S.> Treasury Index. U.S. High Yield Bonds = ICE BofA U.S. High Yield Constrained Index. U.S. Corporate Bonds = ICE BofA U.S. Corporate Bond Index.

Past performance is not a guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

In the 2013 and 2018 shutdowns, we can see that markets did just fine. However, we have no great template for considering what might happen in the event of a technical default. Some analysis considers market performance when the United States was downgraded in 2011, as many observers reasonably assume that a technical default might result in a ratings downgrade. However, the few weeks that followed the 2011 S&P downgrade were quite turbulent; this period also coincided with the early stages of the European debt crisis, which dominated investor attention. Indeed, a decline in Treasury yields (as we saw in 2011) is an odd reaction to a credit downgrade and illustrates both the unique standing of U.S. Treasuries as a haven asset, and the fact that, at least in this case, an issuer's lowered credit rating did not seem to matter to investors.

Of course, any negative developments around the debt ceiling and the ability of the U.S. government to meet its obligations could spill over into other markets. Other potential impacts we would be closely following:

- The intermediation of the global foreign exchange market would likely come under stress, as global foreign exchange markets depend heavily on Treasury yield calculations for the smooth functioning of currency trades. Volatility in these massive and liquid markets would be a sign of decreased market functioning in the global market for dollars.
- Hedge funds have recently become more enamored with the Treasury cash-futures basis trade, taking short positions on Treasury securities. To the extent a technical default either induces a wider spread, higher rate volatility, or higher margin requirements for Treasuries, this could be a pathway for financial amplification of a technical default.[5]
- Treasuries are also used for collateral in a variety of securities transactions. Should clearinghouses ask counterparties to replace Treasuries affected by delayed payments or coupons with other securities for collateral, there could be increased volatility in securities lending markets.

LORD ABBETT®

In short, U.S. Treasuries serve as the underpinnings for a wide range of financial transactions around the world. It is impossible to fully assess the range of implications of a technical default, but we have highlighted a few areas of concern, and remain vigilant for other consequences. Certainly, many market participants are well positioned for market volatility. Across our portfolios, we have placed a greater emphasis on higher-quality, more liquid securities.

Notably, there are legitimate concerns beyond that of default. For example, furloughing nearly one million government employees, while shutting down many services, could have a chilling effect on U.S. economic growth, at a time when many investors are already worried about the implications of tightening lending standards from regional banks. However, any impact would likely be short-lived, as we witnessed with prior shutdowns.

Summing Up

So, what should investors be thinking about if the "unthinkable" comes to pass?

We don't believe it would be wise to bet on the possibility and specific timing of T-bill principal or interest payments in the event of a possible technical default by the U.S. government; there is simply too much we don't know about an already unlikely scenario. However, investors who are truly concerned about this possibility may want to reconsider investing in T-bills in favor of other high quality short-term debt, such as bonds issued by large corporations. It is also difficult to know what may happen to interest rates; it seems most likely that in an extended shutdown, rates on very short-term instruments like T-bills may rise the most, while longer rates fall (on fears of economic weakness), but again, there is no precedent for such a situation. In the meantime, investors may want to consider just how diversified their portfolios are, as diversification can be their best friend during volatile and uncertain investment environments.

---

[1]https://www.pewresearch.org/short-reads/2022/03/10/the-polarization-in-todays-congress-has-roots-that-go-back-decades/

[2]"X date" refers to the estimated date that the U.S. Treasury may no longer be able to fulfill its obligations if the U.S. borrowing limit is not increased.

[3]International Swaps and Derivatives Association, "CDS on US Sovereign Debt – FAQ," October 9, 2013.

[4]https://www.reuters.com/article/usa-debt-default/factbox-the-day-the-u-s-defaulted-idUSN1E76A0XA20110711

[5]https://www.bloomberg.com/news/articles/2023-05-08/hedge-funds-face-into-bank-turmoil-with-epic-short-treasury-bets

LORD ABBETT®

Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies.

Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets.

No investing strategy can overcome all market volatility or guarantee future results.

The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice.

Projections should not be considered a guarantee.

Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Glossary & Index Definitions

A **basis point** is one one-hundredth of a percentage point.

The **Federal Reserve (Fed)** is the central bank of the United States. The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

The **federal funds rate** is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

The **option-adjusted spread (OAS)** is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

U.S. Government spending definitions:

Discretionary spending is money formally approved by Congress and the President during the appropriations process each year. Generally, Congress allocates over half of the discretionary budget towards national defense and the rest to fund the administration of other agencies and programs. These programs range from transportation, education, housing, and social service programs, as well as science and environmental organizations.

Mandatory spending, also known as direct spending, is mandated by existing laws. This type of spending includes funding for entitlement programs like Medicare and Social Security and other payments to people, businesses, and state and local governments. For example, the Social Security Act requires the government to provide payments to beneficiaries based on the amount of money they've earned and other factors. Last amended in 2019, the Social Security Act will determine the level of federal spending into the future until it is amended again. Due to authorization laws, the funding for these programs must be allocated for spending each year, hence the term mandatory.

Net outlays for interest consist of the government's interest payments on federal debt, offset by interest income that the government receives.

Supplemental appropriations, also known as supplemental spending, are appropriations enacted after the regular annual appropriations when the need for funds is too urgent to wait for the next regular appropriations.

The **Bloomberg U.S. Treasury Index** is the U.S. Treasury component of the Bloomberg U.S. Government Index. The Bloomberg 10-Year U.S. Treasury Index is a maturity-specific component of the Bloomberg U.S. Treasury Index.

Bloomberg Index Information

Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Bloomberg owns all proprietary rights in the Bloomberg Indices. Bloomberg does not approve or endorse this material or guarantee the accuracy or completeness of any information herein, or make any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, shall not have any liability or responsibility for injury or damages arising in connection therewith

The **ICE BofA U.S. Corporate Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market

The **ICE BofA U.S. High Yield Constrained Index** is a capitalization-weighted index of all US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

Source ICE Data Indices, LLC ("ICE"), used with permission. ICE PERMITS USE OF THE ICE BofA INDICES AND RELATED DATA ON AN "AS IS" BASIS, MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE ICE BofA INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THE USE OF THE FOREGOING, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND LORD ABBETT, OR ANY OF ITS PRODUCTS OR SERVICES.

This material may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

LORD ABBETT®

The views and opinions expressed are as of the date of publication, and do not necessarily represent the views of the firm as a whole. Any such views are subject to change at any time based upon market or other conditions, and Lord Abbett disclaims any responsibility to update such views. Lord Abbett cannot be responsible for any direct or incidental loss incurred by applying any of the information offered.

This material is provided for general and educational purposes only. It is not intended as an offer or solicitation for the purchase or sale of any financial instrument, or any Lord Abbett product or strategy. References to specific asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations or investment advice.

Please consult your investment professional for additional information concerning your specific situation.

This material is the copyright © 2023 of Lord, Abbett & Co. LLC. All Rights Reserved.

Important Information for U.S. Investors

Lord Abbett mutual funds are distributed by Lord Abbett Distributor LLC.

FOR MORE INFORMATION ON ANY LORD ABBETT FUNDS, CONTACT YOUR INVESTMENT PROFESSIONAL OR LORD ABBETT DISTRIBUTOR LLC AT 888-522-2388, OR VISIT US AT LORDABBETT.COM FOR A PROSPECTUS, WHICH CONTAINS IMPORTANT INFORMATION ABOUT A FUND'S INVESTMENT GOALS, SALES CHARGES, EXPENSES AND RISKS THAT AN INVESTOR SHOULD CONSIDER AND READ CAREFULLY BEFORE INVESTING.

The information provided is not directed at any investor or category of investors and is provided solely as general information about Lord Abbett's products and services and to otherwise provide general investment education. None of the information provided should be regarded as a suggestion to engage in or refrain from any investment-related course of action as neither Lord Abbett nor its affiliates are undertaking to provide impartial investment advice, act as an impartial adviser, or give advice in a fiduciary capacity. If you are an individual retirement investor, contact your financial advisor or other fiduciary about whether any given investment idea, strategy, product or service may be appropriate for your circumstances.

Important Information for non-U.S. Investors

Note to Switzerland Investors: In Switzerland, the Representative is ACOLIN Fund Services AG, Leutschenbachstrasse 50, CH-8050 Zurich, whilst the Paying Agent is Bank Vontobel Ltd., Gotthardstrasse 43, CH- 8022 Zurich. The prospectus, the key information documents or the key investor information documents, the instrument of incorporation, as well as the annual and semi-annual reports may be obtained free of charge from the representative. In respect of the units offered in Switzerland, the place of performance is at the registered office of the representative. The place of jurisdiction shall be at the registered office of the representative or at the registered office or domicile of the investor.

Note to European Investors: This communication is issued in the United Kingdom and distributed throughout Europe by Lord Abbett (UK) Ltd., a Private Limited Company registered in England and Wales under company number 10804287 with its registered office at Tallis House, 2 Tallis Street, Temple, London, United Kingdom, EC4Y 0AB. Lord Abbett (UK) Ltd is authorised and regulated by the Financial Conduct Authority (FRN957140).

Lord Abbett (Middle East) Limited is authorised and regulated by the Dubai Financial Services Authority ("DFSA"). The entire content of this document is subject to copyright with all rights reserved. This research and the information contained herein may not be reproduced, distributed or transmitted in any jurisdiction or to any other person or incorporated in any way into another document or other material without our prior written consent. This document is directed at Professional Clients and not Retail Clients. Any other persons in receipt of this document must not rely upon or otherwise act upon it. This document is provided for informational purposes only. Nothing in this document should be construed as a solicitation or offer, or recommendation, to acquire or dispose of any investment or to engage in any other transaction. Nothing contained in this document constitutes an investment, an offer to invest, legal, tax or other advice or guidance and should be disregarded when considering or making investment decisions.

Lord, Abbett & Co. LLC | 90 Hudson Street | Jersey City, NJ 07302-3973 | T 1.888.522.2388 | lordabbett.com

Copyright © 2023 by Lord, Abbett & Co. LLC/Lord Abbett Distributor LLC. All rights reserved.

IP-DEBTCEILING
05-23

NOT FDIC INSURED–NO BANK GUARANTEE–MAY LOSE VALUE