“FLOATING” UP TO THE CEILING… REVISITED

Kevin Flanagan — Head of Fixed Income Strategy
05/10/2023

How concerned should investors be about the pending debt ceiling debate? History has shown us that a resolution always seems to be found, but past debt ceiling sagas, as well as the current episode, underscore the point that this has become a very contentious, politically charged issue that takes investors down to the wire.

What Is It?

The debt ceiling, also known as the debt limit, is the total amount of money the U.S. government is allowed to borrow to meet its legal obligations. According to the Treasury Department, since 1960, Congress has acted 78 times to either permanently raise, temporarily extend or revise the definition of the debt limit. For the record, adjustments have been made 49 times and 29 times under Republican and Democratic presidents, respectively. The present debt limit stands at $31.4 trillion, and according to the most recent update from Treasury Secretary Yellen, it looks like the “extraordinary measures” put in place to push out the “day of reckoning” will run out in early June.

Recent Episodes

Unfortunately, debt ceiling sagas have seemingly become more commonplace in recent years, with perhaps the most noteworthy episode occurring in 2011. As the reader will recall, partisan politics was on full display back then as well, as President Obama and the House Republicans were each vying to hold sway, but a budget impasse ensued, with failure to raise the debt ceiling being held hostage in the process. Ultimately, the two aisles came together and produced the Budget Control Act (BCA) of 2011, which ended up increasing the debt limit.

However, the BCA was too little, too late, as S&P still decided to downgrade the U.S. credit rating a notch to AA+ on August 5, 2011, only days after the legislation was signed into law. The move reflected S&P’s opinion that “political brinksmanship” was making “America’s governance and policymaking becoming less stable, less effective and less predictable.” Interestingly, as recently as March of this year, S&P Global Ratings affirmed the U.S. AA+ rating with a stable outlook.

What Should Investors Focus On

It looks like the “2023 version” will be “messy” as well. What exactly do we mean by “messy”? The answer is essentially twofold. Obviously, the political process comes to mind, but we are also going to take a look at the ramifications for the U.S. Treasury (UST) market, more specifically, t-bills. T-bills are the focus because these are the instruments that market participants feel have a higher possibility of being negatively impacted if the debt limit is not raised on a timely basis due to the weekly maturity feature of these securities. In other words, the t-bill maturity dates would potentially be occurring right around, or right after, the debt ceiling needed to be raised, and the overarching concern is that failure to raise the debt ceiling on a timely basis could lead to a delayed payment. Interestingly, there seems to be a broad consensus that t-bill holders would eventually get paid, so it’s more of a “delayed payment” anxiety.

That Was Then

Prior debt ceiling episodes provide a good snapshot of what investors could potentially expect to see if there is no agreement as the deadline date looms ahead. Obviously, past experiences don't necessarily mean a similar result for present occurrences, but they do offer some useful insights, nonetheless. The Federal Reserve Board has published a study in the past showing how t-bill yields performed during the 2011 and 2013 episodes. They noted that in each instance, t-bills maturing around the projected deadline date did experience an uptick in yield, with the bills slated to be the second to come due after this date revealing the largest gains. For the 2011 chapter, the peak increase was 19 basis points (bps), while in 2013, the increase was more than twice as big at 46 bps.

This Is Now

Post-May FOMC meeting, some t-bills that will mature in early June of this year are trading with higher yields due to the debt ceiling effect. Remember, June has seemingly become the consensus estimate for the deadline date this time around. In fact, last week's 1-Month t-bill auction registered a record yield of 5.84%. However, it should be noted that the yield has come back down to the 5.35%–5.40% vicinity as of this writing.

What If the Unthinkable Happens?

Interestingly, during the 2011 episode, Treasury and the Fed produced a "plan" of sorts in case the debt ceiling was not raised in time. With respect to the financial markets, the most important part of this plan stated that principal and interest on Treasuries would be made on time. For maturing principal, Treasury would have "auctions that would roll over those maturing securities into new issues," and for timely interest payments, it would be "holding back other government payments" and use accumulated "sufficient cash balances in its Fed account." Needless to say, "prioritization" is a politically charged concept, as it means the risk of payment delays and/or partial payments for other government obligations.

Reducing the Potential Uncertainty Quotient

While there are probably some who feel that this time around, there may not be a solution on a timely basis, the lion's share of participants seems to be operating under the assumption that the U.S. government will ultimately meet their obligations. However, even the slightest prospect of a temporary technical default can create investor anxieties, a sentiment one does not usually think about with "safer" investments. As I've detailed, the UST market, specifically t-bills, has the potential to see increased volatility in the days/weeks ahead. For those investors who wish to avoid the potential debt ceiling scenario that could be forthcoming, the WisdomTree Floating Rate Treasury Fund (USFR) offers an alternative that focuses on floating rate Treasuries with stated maturities of essentially 1–2 years.

Important Risks Related to this Article

There are risks associated with investing, including the possible loss of principal. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates but may decline in value. The issuance of floating rate notes by the U.S. Treasury is new, and the amount of supply will be limited. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

Related Content

+ Office Hours: 'Floating' up to the Ceiling

For the top 10 holdings of USFR please visit the Fund's fund detail page at https://www.wisdomtree.com/investments/etfs/fixed-income/usfr

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

Related Blogs

+ "Floating" Up to the Ceiling
+ USFR: A Low-Volatility Call Option on U.S. Government Dysfunction?
+ Fed Watch: The Waiting Is the Hardest Part

Related Funds

+ WisdomTree Floating Rate Treasury Fund

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an “as is” basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the “MSCI Parties”) expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Credit ratings : An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor's, Moody's or Fitch.

AA+ Credit Rating : The AA+ rating is issued by S&P and is similar to the Aa1 rating issued by Moody's. This rating is of high quality and falls below the AAA ranking. It comes with very low credit risk, even though long-term risks may affect these investments. The AA+ rating is considered one of the rankings for investment-grade debt.

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.

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).

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

Basis point : 1/100th of 1 percent.

Volatility : A measure of the dispersion of actual returns around a particular average level. .