"FLOATING" UP TO THE CEILING

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How concerned should investors be about the pending debt ceiling debate? History has shown us that a resolution always seems to be found, but the recent incidents covered in my last post, "U.S. Treasuries: Caution, Low Ceilings," underscore the point that this has become a very politically charged, contentious issue. Based on what happened in 2011 and 2013, one would be forgiven for concluding that the 2017 experience will be messy as well.

What Should Investors Focus On?

What exactly do I mean by "messy"? The answer is essentially twofold. Obviously, the political process comes to mind, but for this post, I am going to look at the ramifications for the U.S. Treasury (UST) market–specifically, Treasury Bills. T-bills are the focus because these are the instruments that market participants believe have the greater possibility of being negatively affected if the debt limit is not raised on a timely basis because of the weekly maturity feature of these securities. In other words, the t-bill maturity dates potentially would be occurring right around or right after the debt ceiling needed to be raised, and the concern is that failure to raise the debt ceiling on a timely basis could lead to a delayed payment, though the consensus is that t-bill holders would eventually get paid.

That Was Then

The debt ceiling experience of 2011 and 2013 provides a good snapshot of what investors could expect to see if there is no agreement as the deadline date looms. Obviously, past experiences don't necessarily mean a similar result for present occurrences, but they offer some useful insights nonetheless. The Federal Reserve (Fed) Board published a study earlier this year showing how t-bill yields performed during the 2011 and 2013 episodes. Board members noted that in each instance, t-bills maturing around the projected deadline date experienced an uptick in yield, with the bills that were slated to be the second to come due after the deadline experiencing the largest gains. In 2011, 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

T-bills that will mature in October of this year have witnessed some modest increases as of this writing. Remember, early October tends to be the consensus estimate for the deadline date this time around. Using a similar approach here in 2017 as we discussed above, the focus thus far has been on the bill that matures on October 19, and just within the last week, the yield climbed 10 bps.

Reducing the Potential Uncertainty Quotient

While there are probably some who feel this time around there may not be a solution on a timely basis, many participants seem to be operating under the assumption that the U.S. government ultimately will meet its 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 weeks/months ahead. For those investors who wish to avoid the potential debt ceiling scenario, the WisdomTree Bloomberg Floating Rate Treasury Fund (USFR) offers an alternative that focuses on floating rate Treasuries with stated maturities of essentially one to two years. In addition, USFR is also an interest rate strategy one could utilize as “Fed protection” to help guard against the possibility for additional rate hikes.

Unless otherwise noted, data source is Bloomberg, as of July 20, 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.

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. .

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.