



MACRO STRATEGY

Does the Debt Ceiling Really Matter?

May 25, 2023

Concerns about the debt ceiling tend to focus on the most unlikely outcome—a true default by the U.S. government. Even in a scenario where the government misses an interest payment, the most likely scenario is a delay in the payment rather than a true loss of principal. The increase in market volatility that is likely to result from a debt “default” would likely be more troublesome than any direct economic impact from reduced cash flows or transfers to beneficiaries or vendors.

The Federal Reserve (the Fed) has detailed a “playbook” for containing the effects of a debt-ceiling-led default as we approached similar crises in the past—in 2011 and 2013. Minutes from a conference call in 2013 suggested that the Fed would first look to address market strains by using traditional tools—outright purchases of Treasury securities, securities lending, rollovers of existing debt, repurchase agreements (for monetary policy purposes) and the discount window. These facilities would accept Treasury securities currently in default at “their potentially reduced market prices.”¹

Other potential issues could be addressed by being a source of “unblemished (i.e., not in default) Treasury collateral” and by providing additional funding to dealers through repurchase agreements (not for monetary policy purposes). More aggressive actions could be taken as needed, including quantitative easing or the swapping of good CUSIPS for those in default.¹

Some operational issues would potentially be created under a default scenario, which would be dealt with by the Treasury authorizing the Federal Reserve Bank of New York to “extend on Fedwire the maturity date of any security maturing the next day.”¹

If a default results in a significant issue that cannot be contained, the Fed has also estimated the impact on the economic outlook and markets—growth would be expected to be sharply lower as direct government spending and government-supported consumer spending would be curtailed. The Fed model would expect Treasury yields to rise and spreads in other debt assets to widen significantly.² History also suggests that the equity market could decline on a sustained basis.

We believe that the impacts noted above are highly sensitive to the exact timing of the event. A default that occurs at a time of the month that does not impact Social Security payments, for example, is likely to have a much less significant impact than one that results in a delay in those cash transfers to recipients. Further, when the last debt ceiling crisis occurred—one that resulted in a downgrade to U.S. government debt rather than a default—U.S. Treasury yields moved lower—the opposite move from what would be expected for a security class that was just downgraded by a rating agency. As such, what we can be reasonably sure of is that a default would result in a volatility-boosting event and a likely negative impact on liquid assets.

This focus on default ignores the most likely near-term risk—the debt ceiling is raised, and the Treasury Department is able to issue debt normally and return the Treasury General Account, the checking account of the U.S. government held at the Fed, to more normal levels.

The Fed’s securities portfolio (System Open Market Account, or SOMA) peaked in May 2022 at \$8,504 billion. At the May 2022 FOMC meeting, the Committee announced that the balance sheet would be allowed to shrink. The Fed would commence Quantitative Tightening (QT), beginning June 1, 2022. As the Fed’s securities portfolio is the core asset held by the Fed to back the U.S. money supply, this action can be seen as an effort to reduce the amount of money outstanding and/or the liquidity in the economy. Since the start of QT, the Fed’s securities portfolio has shrunk by more than \$700 billion.³

This shrinkage has been offset by two factors. First, the recent banking turmoil has resulted in an increase in other assets such as loans on the Fed’s balance sheet. These other assets are almost \$250 billion higher than they were at the peak of the Fed’s securities portfolio.³ As a result, since the Fed announced QT, the Fed’s overall balance sheet (the portfolio plus other assets) has only contracted by \$458 billion.³

The second factor is more troubling as it has the potential to reverse itself quickly if the debt ceiling is raised—the Treasury General Account (TGA) balance. The TGA had a balance of \$867 billion during the period when the Fed’s securities portfolio peaked.³ Now, because of efforts by the Treasury to avoid breaching the debt ceiling, it has a balance below \$100 billion.³ This reduction

in the TGA balance has boosted the amount of liquidity in the economy (money held at the Fed is outside of the banking system) and has more than offset the impact of the Fed's QT efforts. In fact, between the Fed's actions to support the banking sector and the TGA flows, there has been a net increase in liquidity in the economy since the Fed began QT.

Should the debt ceiling be lifted, and the Treasury is able to return the TGA to a more normal size, it could result in a significant increase in the TGA within a relatively short time frame. That could be the equivalent of several months of QT. So, while the consensus is that market participants should be worried about default risk, there is also the risk of a liquidity shock once the debt ceiling issue is resolved, as the Treasury moves to rebuild the balance of the TGA, creating a liquidity drain.

Endnotes

¹ Federal Reserve, FOMC Conference Call, October 16, 2013

² Federal Reserve, Possible Macroeconomic Effects of a Temporary Federal Debt Default, October 4, 2013

³ Federal Reserve, H4.1 report

Author



DREW T. MATUS
Chief Market Strategist

About MetLife Investment Management

MetLife Investment Management (MIM)¹ serves institutional investors around the world by combining a client-centric approach with deep and long-established asset class expertise. Focused on managing Public Fixed Income, Private Credit, and Real Estate assets, we aim to deliver strong, risk-adjusted returns by building sustainable, tailored portfolio solutions. We listen first, strategize second, and collaborate constantly to meet clients' long-term investment objectives. Leveraging the broader resources and 150-year history of MetLife provides us with deep expertise in skillfully navigating markets. We are institutional, but far from typical.

For more information, visit: investments.metlife.com

Disclaimer

This material is intended solely for Institutional Investors, Qualified Investors and Professional Investors. This analysis is not intended for distribution with Retail Investors.

This document has been prepared by MetLife Investment Management (“MIM”)¹ solely for informational purposes and does not constitute a recommendation regarding any investments or the provision of any investment advice, or constitute or form part of any advertisement of, offer for sale or subscription of, solicitation or invitation of any offer or recommendation to purchase or subscribe for any securities or investment advisory services. The views expressed herein are solely those of MIM and do not necessarily reflect, nor are they necessarily consistent with, the views held by, or the forecasts utilized by, the entities within the MetLife enterprise that provide insurance products, annuities and employee benefit programs. The information and opinions presented or contained in this document are provided as of the date it was written. It should be understood that subsequent developments may materially affect the information contained in this document, which none of MIM, its affiliates, advisors or representatives are under an obligation to update, revise or affirm. It is not MIM’s intention to provide, and you may not rely on this document as providing, a recommendation with respect to any particular investment strategy or investment. Affiliates of MIM may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives) of any company mentioned herein. This document may contain forward-looking statements, as well as predictions, projections and forecasts of the economy or economic trends of the markets, which are not necessarily indicative of the future. Any or all forward-looking statements, as well as those included in any other material discussed at the presentation, may turn out to be wrong.

All investments involve risks including the potential for loss of principle and past performance does not guarantee similar future results. Property is a specialist sector that may be less liquid and produce more volatile performance than an investment in other investment sectors. The value of capital and income will fluctuate as property values and rental income rise and fall. The valuation of property is generally a matter of the valuers’ opinion rather than fact. The amount raised when a property is sold may be less than the valuation. Furthermore, certain investments in mortgages, real estate or non-publicly traded securities and private debt instruments have a limited number of potential purchasers and sellers. This factor may have the effect of limiting the availability of these investments for purchase and may also limit the ability to sell such investments at their fair market value in response to changes in the economy or the financial markets

In the U.S. this document is communicated by **MetLife Investment Management, LLC (MIM, LLC)**, a U.S. Securities Exchange Commission registered investment adviser. MIM, LLC is a subsidiary of MetLife, Inc. and part of MetLife Investment Management. Registration with the SEC does not imply a certain level of skill or that the SEC has endorsed the investment advisor.

This document is being distributed by **MetLife Investment Management Limited (“MIML”)**, authorised and regulated by the UK Financial Conduct Authority (FCA reference number 623761), registered address 1 Angel Lane, 8th Floor, London, EC4R 3AB, United Kingdom. This document is approved by MIML as a financial promotion for distribution in the UK. This document is only intended for, and may only be distributed to, investors in the UK and EEA who qualify as a “professional client” as defined under the Markets in Financial Instruments Directive (2014/65/EU), as implemented in the relevant EEA jurisdiction, and the retained EU law version of the same in the UK.

For investors in the Middle East: This document is directed at and intended for institutional investors (as such term is defined in the various jurisdictions) only. The recipient of this document acknowledges that (1) no regulator or governmental authority in the Gulf Cooperation Council (“GCC”) or the Middle East has reviewed or approved this document or the substance contained within it, (2) this document is not for general circulation in the GCC or the Middle East and is provided on a confidential basis to the addressee only, (3) MetLife Investment Management is not licensed or regulated by any regulatory or governmental authority in the Middle East or the GCC, and (4) this document does not constitute or form part of any investment advice or solicitation of investment products in the GCC or Middle East or in any jurisdiction in which the provision of investment advice or any solicitation would be unlawful under the securities laws of such jurisdiction (and this document is therefore not construed as such).

For investors in Japan: This document is being distributed by MetLife Asset Management Corp. (Japan) (“MAM”), 1-3 Kioicho, Chiyodaku, Tokyo 102-0094, Tokyo Garden Terrace KioiCho Kioi Tower 25F, a registered Financial Instruments Business Operator (“FIBO”) under the registration entry Director General of the Kanto Local Finance Bureau (FIBO) No. 2414.

For Investors in Hong Kong S.A.R.: This document is being issued by MetLife Investments Asia Limited (“MIAL”), a part of MIM, and it has not been reviewed by the Securities and Futures Commission of Hong Kong (“SFC”). MIAL is licensed by the Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

For investors in Australia: This information is distributed by MIM LLC and is intended for “wholesale clients” as defined in section 761G of the Corporations Act 2001 (Cth) (the Act). MIM LLC exempt from the requirement to hold an Australian financial services license under the Act in respect of the financial services it provides to Australian clients. MIM LLC is regulated by the SEC under US law, which is different from Australian law.

MIMEL: For investors in the EEA, this document is being distributed by MetLife Investment Management Europe Limited (“MIMEL”), authorised and regulated by the Central Bank of Ireland (registered number: C451684), registered address 20 on Hatch, Lower Hatch Street, Dublin 2, Ireland. This document is approved by MIMEL as marketing communications for the purposes of the EU Directive 2014/65/EU on markets in financial instruments (“MiFID II”). Where MIMEL does not have an applicable cross-border licence, this document is only intended for, and may only be distributed on request to, investors in the EEA who qualify as a “professional client” as defined under MiFID II, as implemented in the relevant EEA jurisdiction. The investment strategies described herein are directly managed by delegate investment manager affiliates of MIMEL. Unless otherwise stated, none of the authors of this article, interviewees or referenced individuals are directly contracted with MIMEL or are regulated in Ireland. Unless otherwise stated, any industry awards referenced herein relate to the awards of affiliates of MIMEL and not to awards of MIMEL.

¹ As of March 31, 2023, subsidiaries of MetLife, Inc. that provide investment management services to MetLife’s general account, separate accounts and/or unaffiliated/third party investors include Metropolitan Life Insurance Company, MetLife Investment Management, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), MIM I LLC, MetLife Investment Management Europe Limited and Affirmative Investment Management Partners Limited.

L0523032153[exp0525][GLOBAL]