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Down to the Wire on the Debt Ceiling

Elevated inflation readings, the unfolding banking crisis, and angst about the debt ceiling dominated the tone for fixed-income markets. Most fixed-income sectors outperformed since economic releases generally showed signs of improvement.

Insight from sub-adviser Wellington Management

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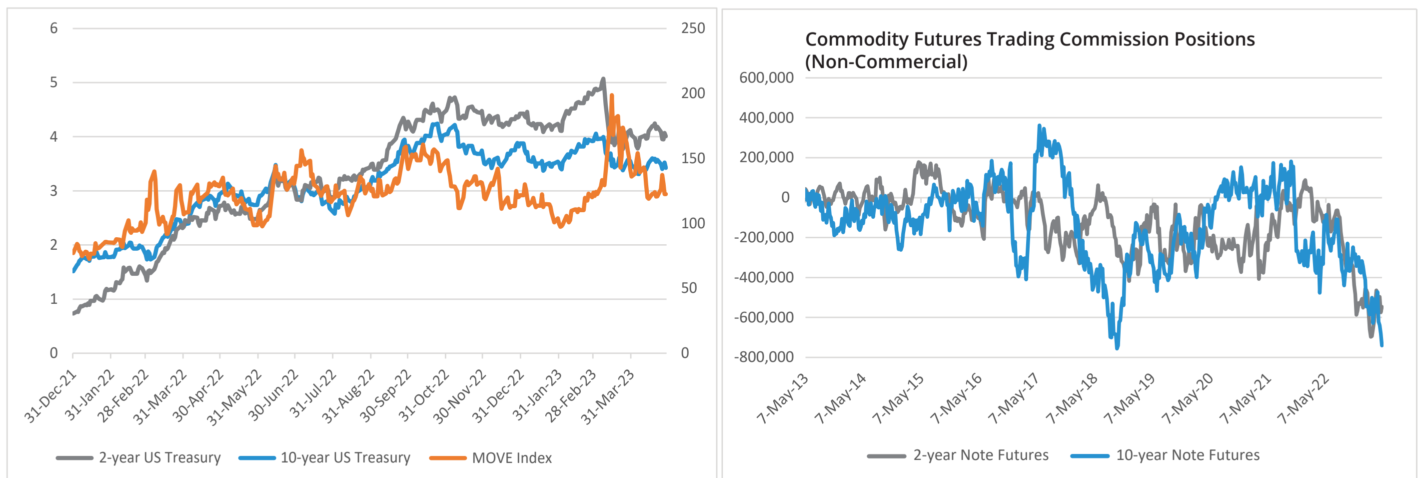
What's Driving Markets…

1. **Economic data was broadly resilient amid banking sector stress, with a bit of tug-of-war in various data releases.** US inflation, as measured by the Consumer Price Index (CPI),[1] remains elevated, though wages moderated to provide some relief despite nonfarm payroll gains exceeding estimates. Housing data rebounded as a result of lower mortgage rates, but on the negative side, retail sales fell sharply, led by declining autos and electronics sales, as cautious consumers cut back spending.

   Eurozone consumer confidence improved on rosier outlooks for financial and economic situations; manufacturing and services purchasing manager indices remained well into expansionary territory. China's industrial production rose as post-COVID recovery continued, and year-over-year CPI ticked down helped by lower food prices. Japan's industrial production rose, supported by growth in the motor-vehicle industry, while Tokyo inflation surprised to the upside.

   US dollar rates were relatively stable over the month compared to what we've experienced since the end of 2021, but market participants were quite short duration[2] heading into April (**FIGURE 1**).

FIGURE 1: Fixed-Income Markets Are Showing Signs of Concern



As of 4/28/23. The MOVE, or Merrill Lynch Option Volatility Estimate Index, measures bond-market volatility. Source: Bloomberg.

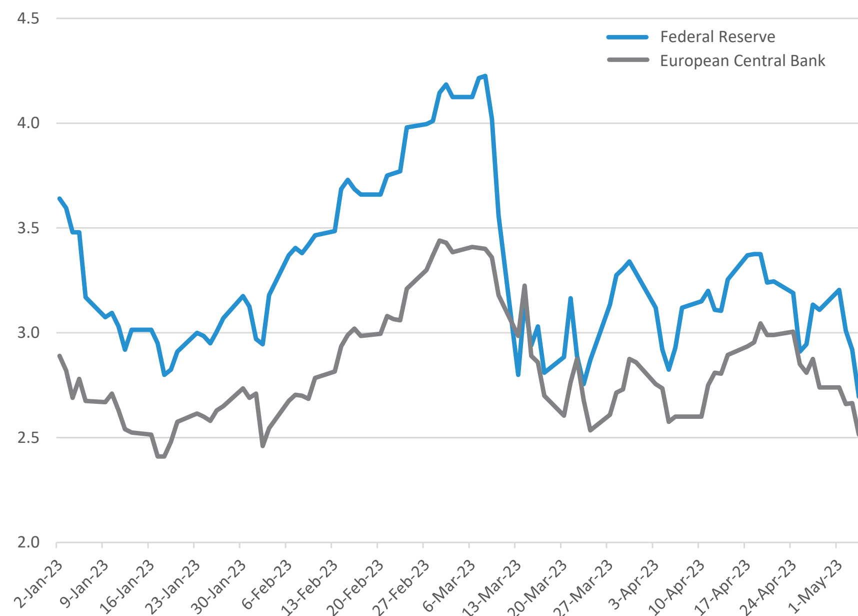
2. **Monetary policymakers kept market participants on their toes** with a few surprising developments. The Federal Reserve (Fed) hiked rates 0.25% as expected, but Chair Jerome Powell left open the possibility of additional hikes in his post-meeting press conference. Conversely, market pricing continues to anticipate rate cuts as early as the third quarter. The European Central Bank also hiked rates by 0.25%, though most had forecast 0.50%, and

[1] CPI is the Consumer Price Index, a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

appears more concerned than the Fed with the tightening in credit standards from banking-sector stress (**FIGURE 2**). Meanwhile, the Bank of Japan (BOJ) meeting was interpreted as dovish—though the BOJ dropped part of its forward guidance on rates, it made no changes to yield-curve control[3] and announced a comprehensive review of its policies that could take 1-1.5 years.

FIGURE 2: US and European Rate Expectations (%) Through December 2023



As of 5/5/23. Source: Bloomberg.

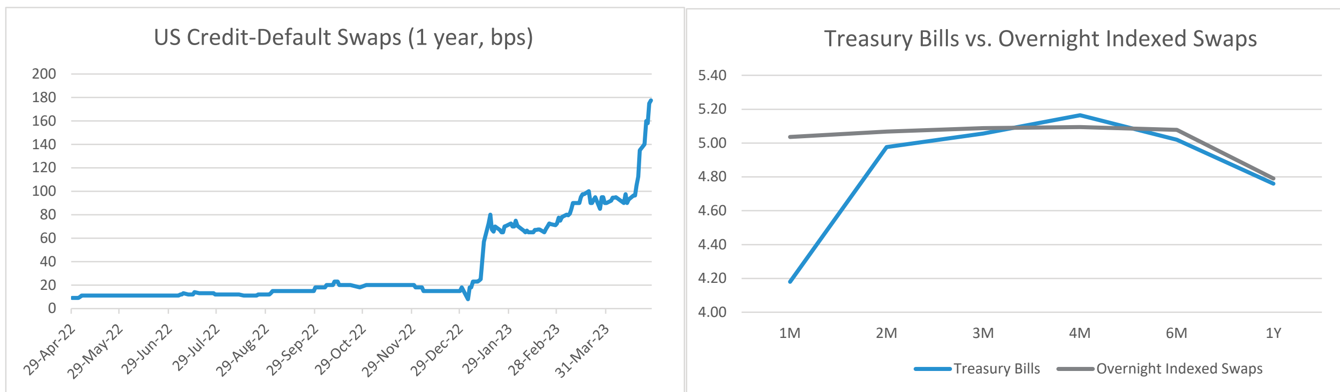
Debt-ceiling fears are now reflected in capital markets.

3. **Debt-ceiling fears are now reflected in capital markets**. As a quick reminder, the Treasury Department ran out of its statutory limited borrowing capacity early this year. It has been utilizing extraordinary measures for additional debt-management maneuverability. Since 2011, administrations have refused to negotiate on the debt ceiling; instead, they ask Congress for a clean vote to raise the ceiling. This is, in part, because the debt ceiling is an output of the budgetary process: Congress has already decided the US government's spending and taxation … the differential between the two is the debt needed to be raised from the public. (For an understanding of the origins of the debt ceiling, we highly recommend Ken Garbade's "*Birth of a Market*.")

   However, with House Speaker Kevin McCarthy (R-CA) holding a thin majority, we see little room for maneuvering from the majority. Treasury Secretary Janet Yellen has indicated that the X-date, or the date that the US Treasury is unable to meet all of its obligations with certainty, is June 1. US 1-year credit-default swap (CDS) markets (a thinly traded market) are now pricing at 180 basis points (bps)[4] (see **FIGURE 2 left**). And 1-month Treasury bills remain exceptionally well-bid vs. 3-month maturities (see **FIGURE 2 right**). The recent 4-week bill auction came in at an eye-popping 5.84% (this auction took place after the below data on the right was reported), indicating major reluctance by market participants to hold paper that matures at or near the announced X-date.

[3] In 2016, the BOJ enacted a strict yield-curve control policy that limited yields on Japan's 10-year Treasury bonds to 0.25%. The BOJ recently relaxed the policy.
[4] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

FIGURE 3: Fixed-Income Investors Are Bracing for Potential Default



As of 4/28/23. Source: Bloomberg

The debt-ceiling debate has a few possible resolutions short of a default:

i. Congress raises the debt ceiling, either through a "clean" raise similar to 2013 and 2015, or through a negotiated process such as in 2011 with budgetary outcomes. A clean raise might be short term, aligning the debt ceiling with the appropriations process for the Federal government's fiscal year-end in September.

ii. Congress does not raise the debt ceiling in time for Treasury to meet all of its obligations (i.e., X-date), and the Treasury Department prioritizes payments to Treasury security coupons and principal. This would be problematic from an operational perspective (given the hundreds of billions of dollars into and out of Treasury coffers and the complexity of the task). Additionally, it may not be legal, given the fact that Treasury is not allowed to determine which payments it is authorized to make in the normal fiscal process, but rather treats all payments as equal.

iii. Treasury and the administration attempt an unorthodox outcome: Either via signaling through the 14th Amendment or a newly issued "platinum coin" that it considers the debt inviolate. While this is the least likely outcome, and was disavowed during the Obama administration, some legal scholars are now considering it a more viable path ... though one fraught with political repercussions.

4. **The FDIC stepped in to seize First Republic Bank** at the end of the April, asking for bids for assets from JP Morgan and PNC. The demise of First Republic again highlights an ongoing problem for the US banking system: Some banks have assets on their available-for-sale and hold-to-maturity books that are deeply underwater in the current rate environment. Other banks have issues with the composition of their funding, including unsecured deposits. The way forward for the system is likely either 1) more capital, 2) steeper and lower interest rates, which mitigate some losses from bonds in their hold-to-maturity and available-for-sale books, 3) time for banks to accumulate additional capital via earnings, and 4) some type of comprehensive legislative or policy solution, such as the blanket guarantee of uninsured deposits.

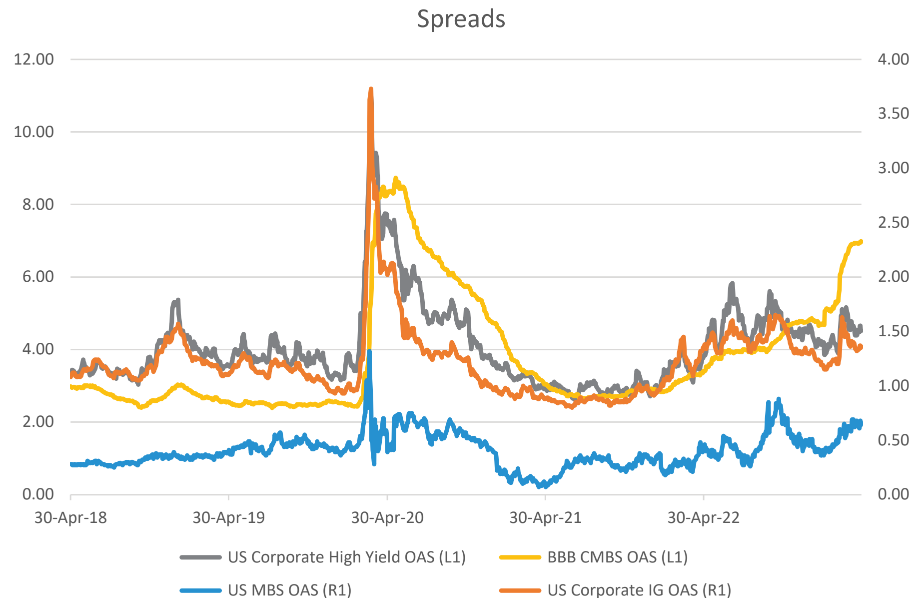
5. **We're starting to see spread dispersion**: Credit spreads[5] tightened over the month and financial conditions eased as the bank run of March moved onto the back burner of market participants' attention (until First Republic and PacWest reignited concerns). This signifies the tug of war between market fragility and the robustness of the economy via consumer spending and tight labor markets, neither of which are signaling recessionary conditions. There are some noticeable exceptions though: commercial mortgage-backed securities (CMBS) and agency

Recent collapses highlight an ongoing problem for the US banking system: Some banks have assets on their available-for-sale and hold-to-maturity books that are deeply underwater.

[5] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

MBS spreads moved wider; the former due to growing concerns regarding tighter bank lending conditions, the latter due to the expected liquidations to come from FDIC holdings.

FIGURE 4: Banking Turmoil Upped Investor's Unease
(Option-adjusted spreads – OAS)[6]



As of 4/28/23. Source: Bloomberg.

6. **The Treasury Quarterly Refunding took place and, in an announcement that surprised many market participants**, the Department announced that it would be launching a buyback program for cash-management and liquidity-management purposes. The hope is that the Treasury would purchase off-the-run coupon securities in exchange for issuing more liquid on-the-run coupon securities. In an era of constrained dealer balance sheets and bouts of illiquidity, the Treasury is hoping to dampen volatility and smooth pricing between different Treasury issues. We think this is a very positive development, and indeed, we publicly called for this action back in December 2021 following the extraordinary market events during the early COVID era.

A default in the US Treasury market would be due to an issue with willingness to pay, not lack of ability to pay.

What's Keeping Us Up at Night…

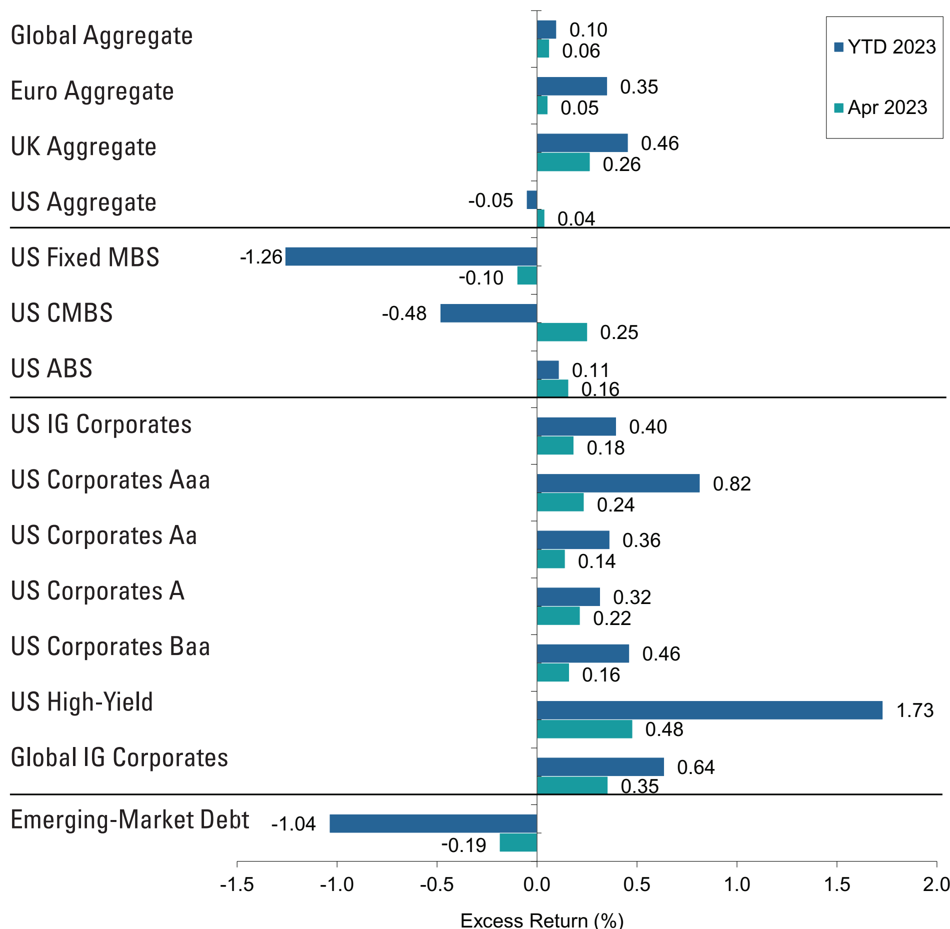
1. **The Debt Ceiling**… While our base case remains that the US debt ceiling will be raised and default will be avoided, the tail-risk scenario does keep us up at night. A default in the US Treasury market would be due to an issue with *willingness* to pay, not lack of ability to pay. Beyond possible downgrades, it would add enormous uncertainty into the deepest and most liquid bond market in the world. It would likely add exceptional volatility into capital markets, such as what we saw in the summer of 2011. Additionally, it would likely create operational nightmares for market participants, as well as deep confusion on next steps. While the 2013 FOMC call on the debt ceiling gives us some insight into what the Fed could or would do, we would consider that more similar to financial trauma management vs. thoughtful policy.
2. **Ukraine/Russia**…There was some type of drone attack on the Kremlin in April. While it is unclear who instigated the attack, and while any damage was minor, it may be a prelude to further escalation.
3. **Bank runs**…it's rather amazing that following the intensive re-regulating and soul searching that went on following the financial crisis, that we are once again dealing with bank runs.

[6] An option-adjusted spread is a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options.

Investment Implications

- We continue to think that we're in the right environment for **global sovereign and currency strategies** to shine: from a total-return perspective, a risk-diversifier approach, and a soundness perspective. This is another, more diversified approach to monetize the ongoing and expected volatility of global capital markets. This can be implemented either via some liquid global-rates strategies with relative-value capabilities or through macro-oriented alternatives.
- Given the overall slowdown in some sectors of the economy, it may also start to make sense to consider **CORE/CORE+ positions**[7] as we approach the end of the tightening cycle. The sell-off in dollar rates, rising geopolitical risk, and slowing economy may make higher-quality fixed income attractive from a recessionary perspective, as well as for a positive relationship between bond prices and bond yields. While inflation surprises still exist, a large portion of the move in rates has likely already occurred, providing substantial cushion and carry in case of upside inflation surprises.
- **Shorter-duration credit** has paid well given the ongoing volatility and uncertainty in markets. For low-risk appetite thresholds, the opportunity cost of this approach has diminished substantially over the last several months, and the "higher for longer" approach would be indicative of robust carry.
- **Securitized credit**[8] may be able to mitigate rate volatility with attractive risk-adjusted spreads. Senior parts of the capital structure, in particular, seem attractive in case the cycle turns faster than expected. For the longer-term investor, if volatility picks up later this year, locking in term financing via the collateralized loan option (CLO) market may make sense through CLO equity.

FIGURE 5: Fixed-Income Sector Excess Returns

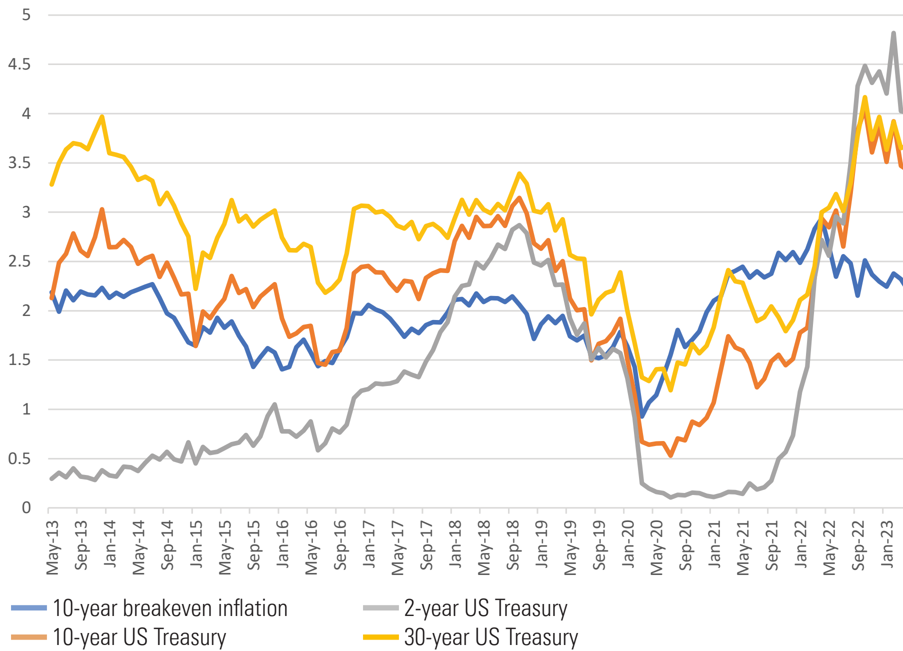


As of 4/30/23. **Past performance does not guarantee future results.** Investors cannot directly invest in indices. See last page for index definitions. Sources: Bloomberg, JP Morgan, Wellington Management.

[7] Core funds typically invest in a baseline of investment-grade bonds such as government, corporate, and securitized debt. Core plus funds can take that baseline and add additional sectors such as corporate high-yield, emerging-market debt, or non-US currency exposures to enhance returns.

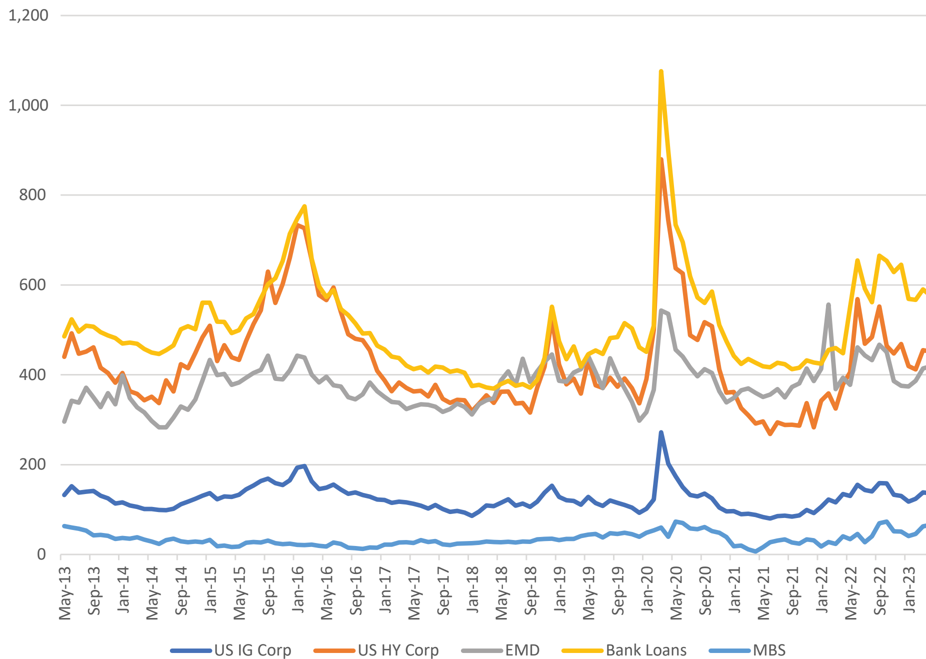
[8] Securitized credit involves pooling a large number of loans into an investable asset. Examples include mortgage-backed or asset-backed securities.

FIGURE 6: US Yields (%)



As of 4/30/23. **Past performance does not guarantee future results.** Source: Bloomberg

FIGURE 7: Fixed-Income Spreads (Basis Points)



As of 4/30/23. Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors. US IG Corp is represented by the Bloomberg US Corporate Bond Index; US HY Corp is represented by the Bloomberg US Corporate High Yield Index, EMD is represented by the JP Morgan EMBI Plus Index, Bank Loans are represented by the LSTA Leveraged Loan Index; and MBS is represented by the Bloomberg US MBS Index. See last page for representative index definitions. Sources: Bloomberg, JP Morgan, Morningstar LSTA.

To learn more about opportunities in fixed income, please talk to your financial representative.

Global Aggregate is represented by the Bloomberg Global Aggregate Index, a broad-based measure of the global investment-grade fixed-rate debt markets. **Euro Aggregate** is represented by the Bloomberg Global Aggregate Index - European Euro, which includes fixed-rate, investment-grade Euro denominated bonds. **UK Aggregate:** Bloomberg Global Aggregate Index - United Kingdom which includes fixed-rate, investment-grade sterling-denominated bonds. **US Aggregate:** Bloomberg US Aggregate Bond Index is composed of securities from the Bloomberg Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index. **US Fixed MBS:** Bloomberg Agency Fixed-Rate MBS Index tracks fixed-rate agency mortgage backed passthrough securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). **US CMBS:** Bloomberg CMBS ERISA Eligible Index, which measures the performance of investment-grade commercial mortgage-backed securities, which are classes of securities that represent interests in pools of commercial mortgages. The index includes only CMBS that are Employee Retirement Income Security Act of 1974. **US ABS:** Bloomberg Asset-Backed Securities Index, the ABS component of the Bloomberg US Aggregate Index, which has three subsectors: credit and charge cards, autos, and utility. **US IG Corporates:** Bloomberg US Corporate Bond Index covers all publicly issued, fixed rate, nonconvertible, investment-grade debt. **US Corporates Aaa:** Bloomberg Aaa Corporate Index designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aaa; **US Corporates Aa:** Bloomberg Aa Corporate Index; **US Corporates A:** Bloomberg A Corporate Index, designed to measure the performance of investment-grade corporate bonds that have a credit rating of Aa; **US Corporates Baa:** Bloomberg Baa Corporate Index; designed to measure the performance of investment-grade corporate bonds that have a credit rating of Baa; **US High-Yield Corporates:** Bloomberg US Corporate High Yield Index is an unmanaged broad-based market-value-weighted index that tracks the total return performance of non-investment grade, fixed-rate, publicly placed, dollar denominated and nonconvertible debt registered with the Securities and Exchange Commission. **Global IG Corporates:** Bloomberg Global Credit - Corporate Index is an unmanaged index considered representative of fixed rate, non-investment grade debt of companies in the US, developed markets, and emerging markets. **Emerging-Markets Debt:** Bloomberg Emerging Markets Hard Currency Index includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. **Bank Loans**: LSTA Leveraged Loan Index, which is a market-value-weighted index that is designed to measure the performance of the US leveraged loan market based upon market weightings, spreads, and interest payments. **JP Morgan Emerging Markets Bond Index Global Index** is a broad-based, unmanaged index which tracks total return for external currency denominated debt (Brady bonds, loans, Eurobonds and US dollar-denominated local market instruments) in emerging markets. **Bloomberg US MBS Index** tracks fixed-rate agency mortgage backed pass-through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

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