May 24, 2023

DWS

Debt ceiling Q&A

What is the debt ceiling?

The debt ceiling is the maximum amount of debt that the U.S. government can amass. The U.S. government has ongoing payments to make for things such as Social Security and Medicare benefits, military salaries, federal pension payments and paying interest and principal on the national debt. To pay its bills, the U.S. government generally runs a deficit, meaning the government spends more money than it generates in revenue. To cover this shortfall, the U.S. Treasury needs to borrow money by issuing debt. While the U.S. Congress authorizes spending, it also sets a statutory borrowing limit or "debt ceiling" for the Treasury.

What is happening now?

Currently, Congress is called upon to consider raising the limit on the amount of debt the U.S. Government can incur to meet existing obligations. Although Congress (under both Republican and Democratic administrations) to date has never failed to raise the debt limit, more recent increases in the debt limit have occurred well after the limit was reached, and only after "extraordinary measures" were nearly exhausted. This has been the pattern since 2011, when debt levels significantly increased during the 2008-2009 financial crisis. Since that time, congressional action only temporarily resolves the debt limit crisis, either through suspension of, or marginal increases to, the debt limit.

When will the U.S. exhaust "extraordinary measures"?

While the answer to this question is highly fluid and can change based on near-term tax receipts and government spendings, recent comments from Janet Yellen put the "X-date" on or about June 1, 2023.[1]

What happens if the debt ceiling is not raised?

It is hard to say and is dependent on how and when the issue is resolved. If the debt ceiling is not raised prior to the "X-date", the federal government could continue to pay certain obligations from cash flows, but without the ability to take on additional debt, some obligations would not be paid. The inability to pay these in full, for any amount of time, would put the U.S. in a technical default on its obligations. During past debt ceiling standoffs in 2011 and 2013, plans were made to ensure that interest on federal debt would continue to be paid to avoid defaulting on such obligations in the event a resolution was not reached. Prioritization of spending is now being explored as part of the current debt ceiling debate, primarily to ensure that bondholders and Social Security recipients continue to get paid in the event the debt ceiling is not raised prior to the "X-date".

Beyond the potential effect on government bondholders and individuals who rely on federal government benefits, the effects of a default would reverberate throughout the economy. First, a potential downgrade in the credit rating for Treasurys could make borrowing more expensive for the government, which would only worsen the federal deficit. Furthermore, higher interest rates on Treasurys could have a domino effect on other interest rates, making borrowing more expensive for individuals and corporations already facing the highest interest rates seen in over a decade.

[1] The X-date is the day the U.S. Government says it can no longer fulfill all its financial obligations.

Has the U.S government faced a similar situation in the past?

Yes, there has been ongoing negotiations of the debt limit going back for decades; however, the 2011 debt limit standoff is the most equivalent to the current situation. During last two debt ceiling standoffs in 2011 and 2013, contingency plans were made to ensure that interest on federal debt would continue to be paid to avoid defaulting on such obligations in the event a resolution was not reached.

How was the 2011 standoff resolved?

On July 31, 2011, Congress and the President agreed to lift the debt limit several days before U.S. Treasury was expected to exhaust its borrowing authority after agreeing to future spending cuts as part of the Budget Control Act of 2011.

How did market react during the 2011 debt limit negotiations?

There was an associated flight-to-quality associated with the 2011 debt limit crises. While an agreement to raise the debt limit was reached on July 31, 2011, the effects of the crises lingered into the fall. For example, on August 5, 2011, S&P downgraded U.S. Treasury debt to AA from AAA. Between the period of July 7, 2011 and October 3, 2011, the S&P 500 lost 17.52% while high-yield credit lost 7.29%. U.S. Treasuries gained 6.88% and IG credit gained 2.83%.

What options are there if there is no agreement reached and extraordinary measures are exhausted?

If the debt limit is not raised then the government will have to delay making payments for certain activities (such as federal employee pension payments, pay for Federal employees), default on its debt obligations or a combination both. We believe a U.S. Government default is highly unlikely.

What are the potential scenarios of how the current negotiations will play out?

We see four likely scenarios associated with the debt limit standoff.

Scenario 1 | Kick the can

Congress and the President come to an agreement to temporarily lift the debt limit prior to the X-date. This is DWS's baseline view.

Scenario 2 | Delayed kick the can

Congress and the President come to an agreement to temporarily lift the debt limit after X-date but prior to any Treasury note maturities coming due. We anticipate this would lead to some early June Treasury Bills to have maturities extended. Ultimately, all debt payments will be made.

Scenario 3 | Full resolution

Congress and the President agree to a permanent lift of the debt limit prior to X-date.

Scenario 4 | No resolution

Congress and the President do not reach an agreement before the first Treasury Notes mature. Worst-case scenario, which we put a near-zero probability on occurring.

For registered representative and retail use only. Not for public viewing or distribution.

How does DWS anticipate the market will react to each scenario?

Scenario 1

We do not believe there will be any material impact on equity or credit markets in the near-term. However, we would anticipate slightly higher Treasury rates—primarily on the front-end of the curve—as new U.S. government borrowing will be required to cover an increase in additional spending.

Scenario 2

We anticipate a flight-to-quality trade until a deal is struck. This leads to Treasury rates falling across most parts of the curve and equity and non-Treasury related credit market selling off. It is difficult to assess the extent of any market sell-off but anticipate it would be milder than 2011.

Scenario 3

We anticipate a selloff in Treasuries and a rally in risk-assets. We expect that more than $1 trillion of new Treasury issuance will be required over the next 12-months to cover future spending needs driving rates higher across the curve.

Scenario 4

This would be new territory for the U.S. Government which makes the potential market reaction highly uncertain. We would anticipate a significant risk-off trade negatively impacting equities and shorter-term Treasuries but potentially driving investors into longer maturity Treasuries until Congress and the President come to a resolution.

What are you doing within portfolios to address the current situation?

Near-term, money funds carry the most exposure to fall-out from a delay in lifting the debt ceiling given the potential risk for early June Treasury Bills maturities to be extended. In order to defend against this risk, the team has increased liquidity across all portfolios and eliminated exposure to any bills maturing in early June. Additionally, we have asked counterparties to exclude June 1st maturities from all repo contracts. Those exclusions will continue to roll into the next maturity as long as the situation hasn't been resolved.

Across other portfolios, teams have generally positioned portfolios more defensively to protect again near-term volatility if no agreement is reached before the X-date.

For registered representative and retail use only. Not for public viewing or distribution.

Important information

The brand DWS represents DWS Group GmbH & Co. KGaA and any of its subsidiaries such as DWS Distributors, Inc., which offers investment products, or DWS Investment Management Americas Inc. and RREEF America L.L.C., which offer advisory services.

This material was prepared without regard to the specific objectives, financial situation or needs of any particular person who may receive it. It is intended for informational purposes only. It does not constitute investment advice, a recommendation, an offer, solicitation, the basis for any contract to purchase or sell any security or other instrument, or for DWS or its affiliates to enter into or arrange any type of transaction as a consequence of any information contained herein. Neither DWS nor any of its affiliates gives any warranty as to the accuracy, reliability or completeness of information which is contained in this document. Except insofar as liability under any statute cannot be excluded, no member of the DWS, the Issuer or any office, employee or associate of them accepts any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage whether direct, indirect, consequential or otherwise suffered by the recipient of this document or any other person.

The views expressed in this document constitute DWS Group's judgment at the time of issue and are subject to change. This document is only for professional investors. This document was prepared without regard to the specific objectives, financial situation or needs of any particular person who may receive it. No further distribution is allowed without prior written consent of the Issuer.

Investments are subject to risk, including market fluctuations, regulatory change, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you might not get back the amount originally invested at any point in time.

© 2023 DWS Investment GmbH, All rights reserved. R-096101-1 (5/24)

For registered representative and retail use only. Not for public viewing or distribution.