April 2023 Newsletter: Navigating the Debt Ceiling Impasse

April 26, 2023

Market Overview

Gold Price (oz)	12-Month Change	CAPE Ratio	US Market Valuation
$1,999	6.1%	29.0	High

Silver Price (oz)	12-Month Change	Market/GDP	US Market Valuation
$25.07	7.5%	153%	High

Copper Price (lb)	12-Month Change	CAPE ERP	US Market Valuation
$3.87	-13%	0.04%	Medium

WTI Oil Price (bbl)	12-Month Change	10Yr Yield	Inflation Rate (CPI)
$76.82	-24%	3.40%	4.99%

Bitcoin Price	12-Month Change	10Yr - 3Mo	10Yr Breakeven
$29,704	-24%	-1.72%	2.25%

Latest Article:

- Implications of Open Monetary and Information Networks

The poor tax haul here in April has moved forward the United States' debt ceiling deadline. It's now likely to strike in late spring or early summer.

This newsletter issue discusses some of the nuances and liquidity implications around this event for investors, both before and after it is resolved.

Part One) The Debt Ceiling

Congress is the political body that authorizes spending by the U.S. federal government.

Prior to 1917, Congress also authorized individual bond issuance to supplement tax revenue to fulfill specific spending allocations. Eventually, beyond a certain scale for fiscal spending during World War I, this practice became administratively untenable.

From 1917 onward, Congress (the Legislative Branch) instead allowed the U.S. Treasury Department (part of the Executive Branch) to issue bonds as it sees fit, albeit constrained by a congressionally-set debt ceiling. Put simply, Congress stopped micromanaging Treasury bond issuance to fund spending authorizations but still retained its authority to ensure a division of powers by limiting the total amount of debt issuance, and still retained its power to authorize federal spending.

According to data going back to 1960 by the U.S. Treasury, Congress has raised or suspended the debt ceiling 78 times, including 29 times under Democratic presidents and 49 times under Republican presidents. The reason it increases so much is because the government runs a deficit in most years, meaning that spending exceeds taxation, and must be made up for with an increase in total debt outstanding.

In 1917, the U.S. federal debt was approximately $5.7 billion. Today is is approximately $31 trillion, which represents a nominal increase of over 5,000-fold in 106 years. Due to constant deficits, the government has to constantly issue new debt to pay off maturing debt.

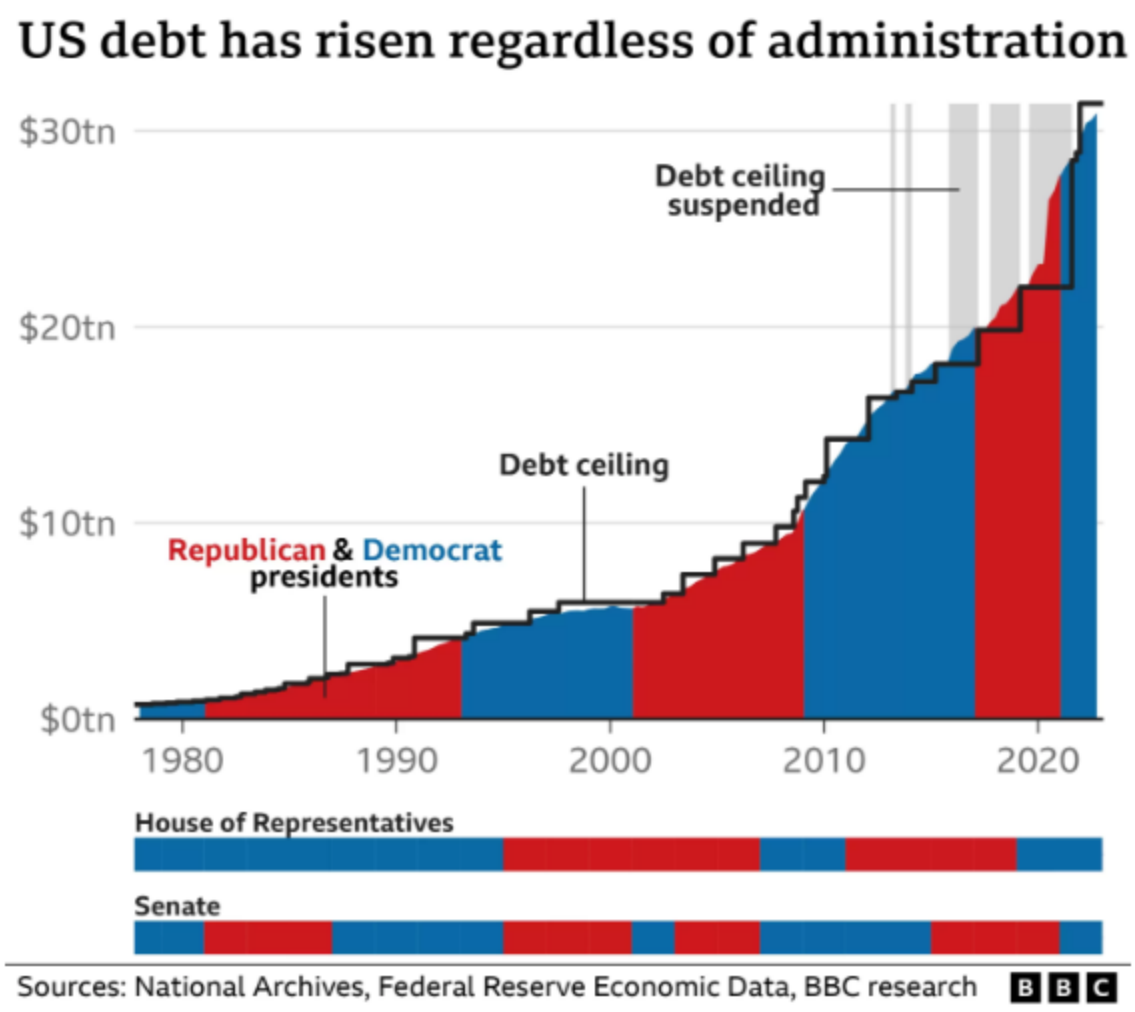

Chart Source: BBC

A handful of times in recent years, most notably in 2011, Congress has used the debt ceiling in order to pressure a presidential administration to either extract a bargain or for narrative gain, rather than to readily raise it.

Often, when politicians oppose raising the debt ceiling, they do so within the narrative of fiscal constraint, but like many things these days that is mostly political theater. The debt ceiling on its own is a separate concept from new spending authorization, although it can be combined into the same piece of legislation. Raising the debt ceiling itself doesn't authorize new spending; it merely allows the government to continue paying its previously-authorized spending obligations. To not raise the debt ceiling means the government either has to not pay previously-authorized spending obligations such as Social Security and Medicare, or must default on its national debt, which is accumulated over time from previously-authorized spending obligations.

In other words, logically-speaking, the idea of fiscal constraint is relevant when deciding on new spending and taxation plans, but not relevant during debt ceiling disputes, which are about honoring prior spending plans. To promote fiscal constraint, politicians can vote against increases in spending, or propose new legislation that reforms and reduces existing ongoing spending obligations, or propose changes to taxation and other revenue.

However, out of practicality, the debt ceiling is also a tool that can be used to extract concessions from the other party, even though it's technically only about whether the government will pay previously-authorized spending obligations and honor its debt. Politicians naturally use the tools available to them whenever possible, although they have to do political calculus to determine the risk-vs-reward regarding how their actions will be seen by the public and their donors. Politicians generally don't make an issue regarding the debt ceiling when their own party has the presidency, for example.

The Debt Ceiling Process

When the debt ceiling is not agreed to be increased as it normally is, the U.S. Treasury Department begins to take what they call "extraordinary measures". Tax revenue is still coming in, and expenditures are still going out, but since expenditures exceed taxes, they need to fill that gap.

Primarily, they begin drawing down their existing cash balance to fill the gap. Currently they target to maintain around $500 billion in their cash account, but during debt ceiling debates, they can draw that down to nearly zero, which allows them to keep spending without issuing new debt for several months. They also temporarily stop reinvesting soldier and federal civilian retirement holdings in Treasuries, which frees up another $300 billion or so.

When those types of measures eventually become tapped out, the risk of an actual default occurs, where a round of Treasury securities become due and, rather than cash being returned to the lenders, the securities are defaulted on due to an insufficient cash balance and an inability to issue new debt to refinance the maturing debt.

Treasuries are used as leveraged collateral by the Federal Reserve, by the commercial banking system, by foreign countries, and various other institutions. They are also held as savings assets by pensions, insurance companies, corporations, and individuals.

A small temporary default would negatively impact the country's credit worthiness and negatively impact some individual entities that are temporarily defaulted on, while a large permanent default would heavily disrupt the entire system, since Treasuries represent the leveraged foundation that the system is built upon. The latter scenario of a large permanent default is very unlikely, while the former scenario of a temporary default is reasonably possible, given how polarized politics have become and how large the debt and deficits are now.

We can already see some wacky results showing up in the Treasury market. There is a record yield gap between 1-month T-bills and 3-month T-bills, for example:

The 1-month T-bill will likely mature before the U.S. Treasury runs out of cash, whereas the 3-month T-bill faces a possibility of default unless Congress raises the debt ceiling by then. The Treasury market is taking the possibility of a temporary default somewhat seriously.

Part Two) The Aftermath

Okay, so a very polarized Legislation branch and Executive Branch have to figure out how to agree on a path forward, with a nonzero chance that they temporary default along the way before coming to some sort of reconciliation.

But one way or another, they'll raise the debt ceiling after that, whenever their political calculus (and/or their monetary donors) tells them it's necessary. However, financial markets aren't out of the woods then. At that point, the default problem turns into a liquidity problem.

The Post-Debt-Ceiling Liquidity Crunch

Since early 2022, the Federal Reserve has been doing quantitative tightening, meaning it is gradually destroying base money in an effort to rein in price inflation. This sucks liquidity out of the financial system and is usually negative for financial asset performance.

They hit a speed bump in March 2023 due to the banking crisis, where the Federal Reserve had to provide loans to banks even as the Federal Reserve continued to destroy base money. They gave liquidity to the financial system with one hand while continuing to pull it out with the other, and the result was a net increase in liquidity, at least for a while. As of this writing, they continue to perform quantitative tightening, although the total balance sheet remains higher than the low point it reached in March 2023.

However, since late September 2022, the Treasury General Account has been drawing down as well. Unlike the Federal Reserve balance sheet, a drawdown in the Treasury General Account is *positive* for financial system liquidity. When it draws down, it pushes liquidity back into the system that it had previously removed. They're now getting quite low compared to their desired target (absent a debt ceiling issue) of $500 billion:

Since September 2022, overall domestic liquidity has been rather flat, as the Federal Reserve and Treasury Department effectively offset each other. Risk assets have generally followed suit.

The dollar index (a measure of the U.S. dollar vs a basket of other developed market currencies) peaked at the end of September 2022, and fell sharply from there. Since a lot of foreign countries and corporations have dollar-denominated debt, a drop in the dollar is generally positive for global liquidity.

The cumulative result of this is that both domestic liquidity and global liquidity have been flat-to-positive from the end of September 2022 through this writing. During much of 2022, I had a negative view on liquidity, but once the debt ceiling impasse materialized in January 2023, I switched to a temporarily neutral view on liquidity and have been tracking that development:

> “ Going forward, this sideways liquidity situation is likely set to continue for the next few months. The Fed is still reducing its balance sheet (negative for liquidity) while the debt ceiling issue is likely to result in lower Treasury General Account balances (ironically positive for liquidity) until the debt ceiling is resolved, as described in the next section.
>
> When the debt ceiling is raised and the Treasury Department begins refilling its Treasury General Account with more bond issuance later this year, then that would likely be very negative for liquidity, assuming the Fed is still reducing their balance sheet at that point. That would be a negative double-whammy for liquidity.
>
> –January 22, 2023 Premium Report

We've indeed been in that sideways liquidity situation, and the bank failures actually gave us a mild boost in liquidity in March. In a couple months, however, we're set to enter that next phase: a potential negative double-whammy for liquidity. Once the debt ceiling is resolved, the Treasury will be legally able to increase its general account back to its target level (which is negative for liquidity when it happens) as the Federal Reserve continues to pull liquidity out of the system (which is also negative for liquidity).

The problem, however, is that bank cash levels as a percentage of bank assets are at pretty low levels in the post-2008 regulatory environment, especially for small banks. Sucking $500 billion of liquidity out of bank reserves to refill the Treasury General Account might not be tenable, and would likely be negative for financial assets.

A background problem is that the U.S. government is running very large deficits. The U.S. federal government ran a $1.1 trillion deficit over the past six months, and will continue to run large deficits going forward. The Federal Reserve is currently a net seller of Treasuries, most commercial banks aren’t buying Treasuries, and even the foreign sector in aggregate isn’t currently buying Treasuries.

This following chart from the U.S. Treasury's March 2023 Receipts and Outlays report, and shows the U.S. federal budget from October 2022 through March 2023 (the first six months of their fiscal year, which begins in October of each year). They humorously show it out of proportion; if it were proportional, the orange deficit bar would be the longest bar:

Policymaker Choices

Eventually, this post-debt ceiling liquidity cliff will likely be resolved by policy changes. However, none of them are easy. Someone needs to buy a lot of Treasuries, and the question is who.

Option 1) The Federal Reserve could capitulate, and begin buying Treasuries. This would mark the end of quantitative tightening and a shift towards quantitative easing, which if price inflation is still elevated would threaten Federal Reserve credibility. This is the path that the Federal Reserve had to turn to in the 1940s, which was the last time that federal debt-to-GDP levels were this high. This is what the Bank of Japan is doing currently (persistently printing money to buying bonds even with above-target price inflation), and what the Bank of England had to do temporarily in September 2022 (temporarily printing money and buying bonds amid 10% price inflation). The

Fed had to end quantitative tightening early in 2019 for similar reasons, although price inflation wasn't running hot then.

Option 2) The U.S. Treasury Department could issue a ton of T-bills to refill its general account, rather than issue long-duration bonds. This would reduce the average duration of government debt, and is currently the most expensive part of the Treasury curve to issue debt on, but it would likely suck cash out of reverse repos and allow the Treasury to refill its account without damaging commercial bank liquidity. There is about $2.3 trillion in reverse repos that could find a home in T-bills specifically. The Treasury Department could also keep its cash balance low for a while and try to refill it very gradually.

Option 3) If the dollar weakens enough, then foreign buyers might step back in to buy Treasuries with offshore dollars (accumulated trade surpluses). Combined with non-bank domestic buyers and large bank buyers (small banks are basically tapped out), this might be enough to avoid having the Federal Reserve or Treasury Department change their course. However, the foreign sector tends to buy Treasuries during weak dollar periods and sell Treasuries during strong dollar periods, and the problem is that liquidity-negative conditions usually result in a strong dollar.

The likelihood of going down one path or another is partially dependent on human choices by those in power, and thus is hard to predict. Will Congress suspend or raise the debt ceiling before or after a temporary default, and by what magnitude? After the debt ceiling is resolved, will Treasury Secretary Yellen seek to refill the cash account quickly, or try to draw the process out longer to reduce the near-term liquidity impacts? Will BRICS nations continue their current spurt of de-dollarization and reserve diversification, or take a break from that process for a bit and re-accumulate some Treasuries?

These are questions I'll be monitoring every couple weeks. In the meantime, the attractiveness of many large liquidity-driven equities is lackluster for the next few months unless or until we get more clarity on forward liquidity conditions. This is an environment where an investor should know what they own, be prepared for volatility, and avoid excessive leverage.

For the most part, I'm using a three-pillar portfolio strategy in this environment rather than a 60/40 stock/bond portfolio. The first pillar is profitable equities, with an emphasis on ones that pay rising dividends. The second pillar is commodities, commodity producers, and hard monies. The third pillar is cash and cash-equivalents.

Portfolio Updates

I have several investment accounts, and I provide updates on my asset allocation and investment selections for some of the portfolios in each newsletter issue every six weeks.

These portfolios include the model portfolio account specifically for this newsletter and my relatively passive indexed retirement account. Members of my premium research service also have access to three additional model portfolios and my other holdings, with more frequent updates.

M1 Finance Newsletter Portfolio

I started this account in September 2018 with $10k of new capital, and I put new money in regularly.

It's one of my smallest accounts, but the goal is for the portfolio to be accessible and to show newsletter readers my best representation of where I think value is in the market. It's a low-turnover multi-asset globally diversified portfolio that focuses on liquid investments and is scalable to virtually any size.

I chose M1 Finance because their platform allows for a combo of ETF and individual stock selection with automatic and/or manual rebalancing. It makes for a great model portfolio with high flexibility. (See my disclosure policy here regarding my affiliation with M1.)

And here’s the breakdown of the holdings in those slices:

Changes since the previous issue:

- No major changes.

Bitcoin Note:

I use small allocations to bitcoin price proxies such as MSTR and GBTC in some of my portfolios for lack of the ability to directly buy bitcoin in a brokerage environment, but compared to those types of securities, the real thing is ideal.

I recommend holding actual bitcoin for those that want exposure to it, and learning how to self-custody it. I buy mine through Swan.com.

I don't have a firm view on the bitcoin price over the next six months amid these unclear liquidity conditions, but I am bullish with a 2-year view and beyond.

Other Model Portfolios and Accounts

I have three other real-money model portfolios that I share within my premium research service, including:

- Fortress Income Portfolio

- ETF-Only Portfolio
- No Limits Portfolio

Plus I have larger personal accounts at Fidelity and Schwab, and I share those within the service as well.

Final Thoughts: The Forgotten Debt and Deficit

Over the past four decades, U.S. federal debt as a percentage of GDP has been structurally rising, but has been offset by lower and lower interest rates.

As a result, overall interest expense has been rather contained. People who were concerned about sustainability of the debt in the late 1980s and early 1990s were premature, and the resulting conclusion for many investors is that the debt doesn't really matter.

However, going forward, interest rates bumped into zero and are now trending structurally sideways-to-up, as the government continues to increase its total debt outstanding. This means that interest expense will become an increasingly relevant part of the budget. Due to the recent increase in interest

rates, the U.S. federal government's interest payments at $850 billion annualized have already exceeded what they spend on the military, and continue to increase:

Interest expense relative to GDP at 3.3% remains well below the high levels of 5% it reached in the 1980s, but is breaking out from a two-decade low point. This time there is likely no escape valve; there is not another four-decade period of steadily-declining interest rates in front of us to offset the rising debts and deficits, and demographics are far worse now.

During periods where inflation runs at a notably higher pace than interest rates, it helps the debt-to-GDP ratio go down. The debt holders are effectively getting partially defaulted on through inflation when that happens. On the other and, whenever the Federal Reserve tries to solidify the currency with positive inflation-adjusted rates, it'll notably increase the debt relative to GDP, and substantially increase the interest expense on the debt.

What compounds the problem is that hawkish monetary policy or improvements in the fiscal budget can dampen asset prices. The issue there is that U.S. federal tax receipts are highly correlated with asset prices. So as asset prices stagnate, tax receipts stagnate, and the deficit widens.

This is part of why the IMF found that attempts to rein in fiscal deficits usually do not reduce debt-to-GDP ratios.

–IMF April 2023 Report: A Rocky Recovery

Specifically, they found that certain types of fiscal consolidations can reduce debt-to-GDP ratios, but that the average fiscal consolidation historically fails to do so. Often GDP slows down when deficits are attempted to be improved, which reduces tax revenue and ironically keeps the deficit high, and so the resulting debt-to-GDP ratio keeps gradually grinding higher.

How did the United States and the rest of the world get out of their large 1940s public debt position? The answer is that, along with a period of strong growth, they ran inflation higher than interest rates on average over the next several decades:

“

High public debt often produces the drama of default and restructuring. But debt is also reduced through financial repression, a tax on bondholders and savers via negative or belowmarket real interest rates. After WWII, capital controls and regulatory restrictions created a captive audience for government debt, limiting tax-base erosion. Financial repression is most successful in liquidating debt when accompanied by inflation. For the advanced economies, real interest rates were negative ½ of the time during 1945–1980. Average annual interest expense savings for a 12—country sample range from about 1 to 5 percent of GDP for the full 1945–1980 period. We suggest that, once again, financial repression may be part of the toolkit deployed to cope with the most recent surge in public debt in advanced economies.

–The Liquidation of Government Debt, IMF Working paper 2015/007

The IMF's recent April 2023 reports further discussed this topic. The reports combined are hundreds of pages and touch on the role of inflation in multiple sections, so I'll just highlight some interesting snippets.

Snippets from Report #1:

> " An unexpected bout of inflation erodes the real (inflation-adjusted) value of public debt, at least in the near term, with bondholders bearing the loss. Likewise, deficit-to-GDP ratios decline because the nominal (current monetary) values of the economy's output and of tax bases will generally rise, generating more revenues, while spending—often set in nominal terms in the budget— initially fails to keep up. Without indexation, real incomes decline for civil servants, pensioners, and recipients of welfare transfers. The quality of public services may also suffer as nominal spending ceilings clash with higher costs of goods and services.
>
> […]
>
> Governments can influence how the costs of inflation are allocated, via indexation or discretionary policy decisions. They could choose, for example, to let inflation quietly increase taxation while eroding public pensions, wages, and transfers or instead seek to keep the real values of these variables unchanged. They could also make the tax or transfer more or less progressive by adjusting some items but not others. Further complicating policymakers' task, widespread indexation of public wages and other expenditure items would entrench inflation expectations and make inflation more persistent. Such anticipation of inflation makes price stability harder to achieve. Similarly, if untargeted support outlasts spikes in energy prices or other prices that originally motivated it, fiscal costs and contributions to aggregate demand would be unnecessarily prolonged (October 2022 Fiscal Monitor, Chapter 1). High inflation can lead to policy mistakes that may ultimately hamper investment

and economic growth, whereas price stability helps all individuals in the economy.

[…]

Inflation surprises often improve debt and budget balances in the near term, but are these gains maintained over the medium term? To answer this question, the chapter employs both quarterly and annual data.

[…]

Analysis using historical annual data (1962−2019) for 85 economies shows that, on average, spikes in the growth of the GDP deflator tend to reduce the debt-to-GDP ratio persistently (Figure 2.2). The drop in the debt-to-GDP ratio is larger in economies with higher initial debt, as expected, with an initial spike of 1 percentage point in the growth of the GDP deflator9 associated with a persistent cumulative decline in the debt ratio of 0.6 percentage point of GDP (see also Chapter 1 for recent developments on the relationship between inflation and debt). The reduction in the debt ratio is caused by a hike in the GDP denominator and an initial rise in fiscal balances.

[…]

The evidence presented in this chapter highlights the pattern that inflationary surprises are historically associated with an initial rise in fiscal balances in the short term and a fall in public debt that often persists into the medium term. However, expected inflation is not associated with a fall in debt ratios, stressing that inflating debt away is neither a desirable nor a sustainable strategy. Unexpected inflation may offer some breathing room for debt ratios, but attempts to keep surprising bondholders have historically proved futile or harmful. The impact on debt is more significant for countries with large amounts of debt, especially when it is

> denominated in local currency, long term, and unindexed. For countries with debt exceeding 50 percent of GDP, each 1 percentage point surprise increase in inflation is estimated to reduce public debt by 0.6 percentage point of GDP, with the effect lasting for several years.
>
> –IMF April 2023 Report: On the Path to Policy Normalization

Snippets from Report #2:

> “ Finally, both economic growth and inflation play an important role in reducing debt ratios. The results from this chapter complement the messages from related work (April 2023 Fiscal Monitor), including the importance of inflation and the scope of structural reforms to promote growth, which ultimately reduces debt ratios.
>
> […]
>
> Although the chapter documents the significance of inflation in reducing debt ratios, this does not suggest that high inflation is a desirable tool. High inflation, even if it is unanticipated, can become entrenched in higher expectations of price increases and exchange rate depreciations, raise the burden of future debt issuance, generate monetary instability, lead to loss of reputation, and in the end affect the credibility of institutions, including central banks.
>
> –IMF April 2023 Report: A Rocky Recovery

Some of the notable findings that I take away from the full reports are:

-Inflation above the rate of interest rates is a key part of sovereign debt reduction, but it only works if accompanied by prudent fiscal changes. In other words, debt gets restructured or partially inflated, but then needs a pivot in terms of better policy going forward.

-Bursts of surprise inflation can improve public finances over a multi-year timeframe, because bondholders get a surprise devaluation. However, persistent and entrenched inflation, or too many surprise bursts of inflation, can undermine credibility of financial institutions including the government and central bank.

-Inflation affects households differently, and it largely depends on whether peoples' incomes are indexed to inflation and whether they have long fixed-rate debts. For example, the reports find that inflation tends to benefit younger families with fixed-rate mortgages (their mortgage debt gets inflated away), while it hurts seniors who often live on fixed income and have less or no mortgage debt.

-Inflation gives the government significant abilities to determine who gets harmed by inflation by determining which types of incomes are indexed to inflation and which are not, and where the fiscal deficits are flowing towards. For some people inflation can cause poverty, while for other people it can alleviate poverty or enrichen them. Inflating away debt tends to be a messy process that is not very transparent for the public.

I wrote about the risks of inflation to bondholders back in 2019 by pointing towards the sovereign bond market as being in a bubble:

> "So far, central bank tools have not been inflationary because they have primarily benefited asset prices rather than middle class consumption. They printed money, but kept the money on the central bank balance sheets by buying bonds.
>
> If central bank actions get more aggressive, combine with fiscal policies, and start targeting the middle class, they have the power to override these various deflationary forces with sheer monetary expansion. They can issue helicopter money to pay off debts, boost inflation, build infrastructure, bail out unfunded pension systems, and prop up the middle class if that's what policymakers decide to do.

> I wouldn't want to be holding a 20-year or 30-year bond at super-low fixed yields in that kind of environment. Negative yields would be even more vulnerable.
>
> –July 2019: Are We in a Bond Bubble?

Since then, almost all of the $18 trillion in negative-yielding debt that was outstanding at the time has become positive-yielding, cash and bond yields underperformed inflation for a few years, and 2022 in particular was the worst year for nominal government bond returns in modern history.

After that 2020-2022 inflationary run, we've been in a disinflationary period from high levels for nearly a year. Attempts to rein in inflation by central banks have slowed demand and growth, contracted the money supply, and taken the edge off price increases.

However, I don't think we've seen the end of inflation, and I continue to view us as being early in the long-term process of debt devaluation. Inflation is likely to come in waves over time, and government bonds are likely to fail to accrue purchasing power through the course of the 2020s decade, even as they can make for occasionally good cyclical trades.

Best regards,

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