LPL RESEARCH

BOND MARKET PERSPECTIVES

KEY TAKEAWAYS

Raising the debt ceiling is a major item on the agenda as Congress returns from their August recess today.

While debt ceiling debates can be contentious, history can help shed light on what markets are pricing in.

The bond market continues to price in a stalemate in the near term, though it ultimately appears to believe the ceiling will be raised.

September 5 2017

IS THE BOND MARKET EXPECTING A DEBT CEILING FIGHT?

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

Congress reconvenes today following its August recess and one of the major legislative topics that needs to be addressed is the debt ceiling. The debt ceiling refers to the legislatively mandated maximum amount of debt that the U.S. Treasury can have outstanding. The U.S. officially hit the debt ceiling (currently at $19.8 trillion) in March, and since that time the Treasury has been using "extraordinary measures," which include things like suspending the reinvestment of funds from certain Treasury securities, to allow the U.S. to pay its debts until Congress is able to raise the borrowing limit. Treasury Secretary Mnuchin has indicated that these extraordinary measures will be exhausted sometime toward the end of September, but has continually said that he is confident that the debt ceiling will be raised in time to avoid a default.

MARKET ASSUMES A DEAL, BUT IS HEDGING

Bond market participants normally demand more yield for holding longer-maturity bonds. One reason is that a longer time frame introduces more uncertainty, and may allow more time for financial problems to emerge that could make it harder for an issuer to pay principal and interest. Though this risk is generally thought of as remote for Treasury bonds, if the Treasury hits the debt limit and is unable to borrow additional funds, it could eventually end up impacting the Treasury's ability to pay investors.

Given this, one way to determine if the bond market is pricing in a debt ceiling fight is to look at the spread, or difference in yield, between short-term Treasury notes. If there is uncertainty among investors that the debt ceiling will be raised, we would expect that they would demand more yield for bonds maturing on or after the end of September. As we can see in Figure 1, the spread between 1-month and 3-month Treasury securities has declined in recent weeks. The fact that market participants are demanding more yield for 1-month Treasuries that mature near the end of September, relative to 3-month Treasuries, indicates that as a whole investors are at least somewhat concerned about a debt ceiling debate.

The fact that the spread between 1-and 3-month Treasuries increased slightly over the past week, could be a sign that fears are fading somewhat, perhaps on speculation that an increase in the debt ceiling could be tied to funding for relief efforts for Hurricane Harvey, making it more difficult for Congress

LPL Financial

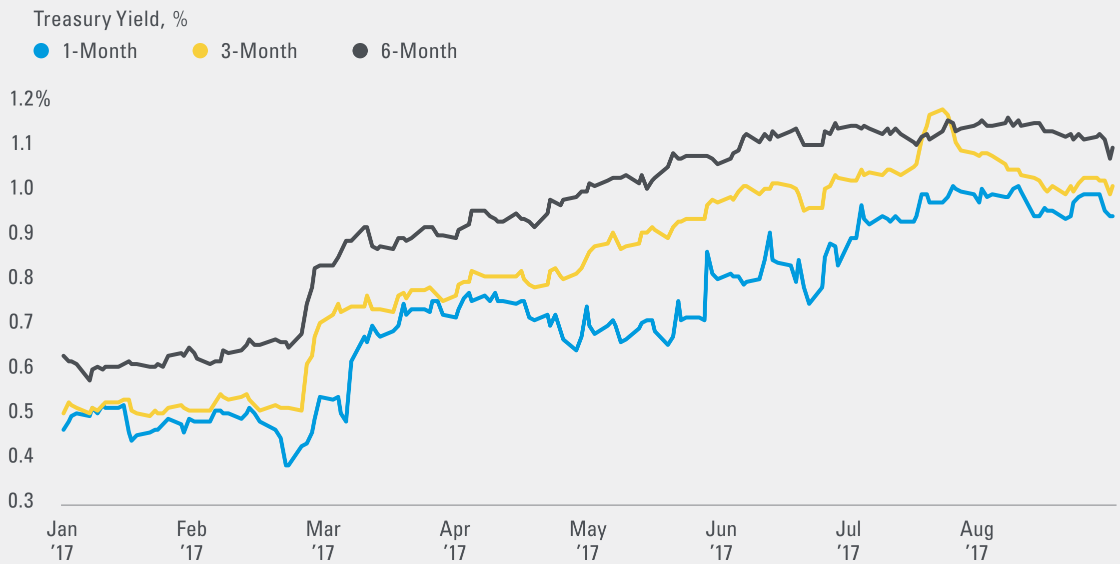
to allow a delay. However, even after this recent increase, the spread remains below its 1-year average indicating that the bond market is still flashing some caution signs.

There is one additional sign that markets aren't pricing in a long-term debt ceiling problem. In late July the yield on the 3-month Treasury bond (which would have matured in October at that time) moved higher as debt ceiling fears began increasing. However, since that time the yield has fallen, indicating that markets may view any potential debt ceiling impasse as temporary, and continue to expect that the debt ceiling will ultimately be raised.

PAST DEBATES HAVE SHOWN A SIMILAR PATTERN

Debt ceiling debates are nothing new for markets, and looking back at history, we can see that markets have reacted in a similar fashion as they are today. Past debt ceiling debates, both major (2011—which included a credit rating downgrade by S&P) and minor (2015), have caused the yield differential between 1-and 3-month Treasuries to decrease, and even invert (meaning that the 1-month yield is higher than the 3-month). However, as Figure 2 shows, this behavior generally doesn't last long.

1 SHORT-TERM TREASURY YIELDS HAVE SHOWN SOME SIGNS OF DEBT CEILING CONCERNS



Source: LPL Research, FactSet 09/01/17

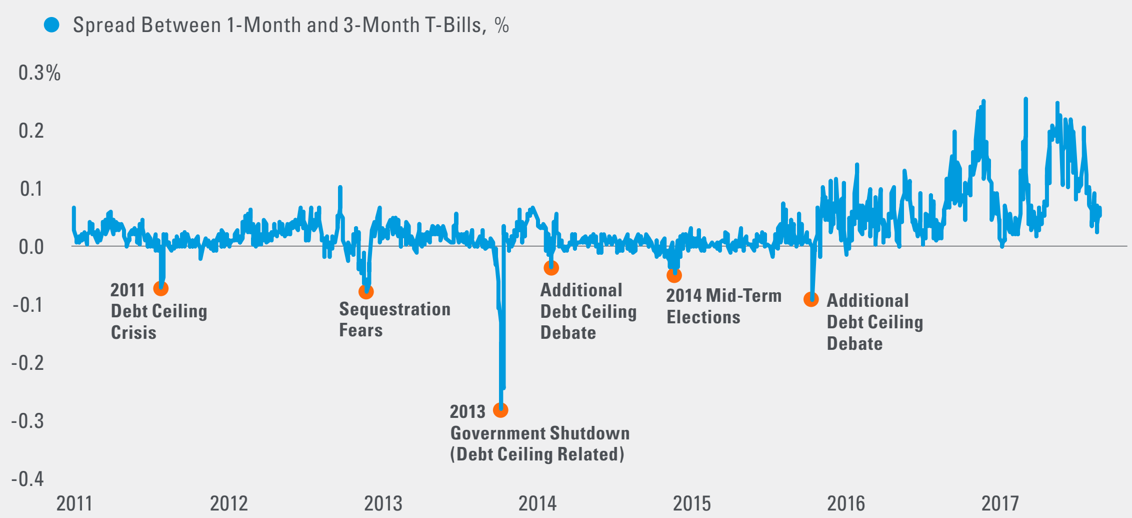
Performance is historical and no guarantee of future results.

Inversion already took place in the 3- to 6-month part of the yield curve in July, but it was short-lived, again indicating that markets aren't pricing in extended uncertainty. No inversion has taken place in the 1- to 3-month part of the curve so far, though it remains a possibility. It is also important to note that short-term yields are higher today than they were in 2011, 2013, or 2015, largely due to several Federal Reserve rate hikes since the last time the debt ceiling was debated. While it could be considered problematic that Congress has made a habit of politicizing the debt ceiling, we can take some comfort in the fact that markets have been here before and have made it through.

CONCLUSION

The current debt ceiling was hit in March 2017, and while the Treasury has been able to use extraordinary measures to avoid a default since that time, they have indicated that these measures will be exhausted sometime near the end of September. With Congress back in session, the topic of the debt ceiling is likely to be front and center. Though the Treasury seems confident that the limit will be raised and there will be no impact to their ability to pay back investors, the bond market is pricing in at least some chance of a stalemate in the short term. Ultimately though, the fact that yields on longer-dated Treasury securities haven't risen indicates that markets believe that a deal can get done, and that the Treasury is likely to be able to pay investors in a timely manner, a positive for both bond and stock markets.

2 **DEBT CEILING DEBATES HAVE HISTORICALLY CAUSED AN INVERSION IN THE T-BILL CURVE**



Source: LPL Research, FactSet, 09/01/17

Performance is historical and no guarantee of future results.

A negative spread (inversion) indicates the 1-month Treasury yield is higher than the 3-month.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

DEFINITIONS

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

RES 6044 0917 | Tracking #1-640778 (Exp. 09/18)