Global Rates Notes: Debt Ceiling a Modest Tailwind to Funding Costs and Spreads

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- The start of 2025 brings the end of the debt limit suspension period. Treasury likely won't have to dip into its extraordinary measures until the middle of January, but from that point it will generally have to operate under the constraints of cash on hand plus available extraordinary measures until there is a resolution. The deadline for debt limit action is likely not until July or August 2025.
- Debt ceiling limitations mean that until there is a deal there will be less bill supply and higher levels of broad liquidity than would have been the case otherwise. The TGA is historically high compared to past instances when the debt ceiling has been reached. If there is no resolution in the first half of the year, we expect the TGA drawdown would more than fully offset the draining of liquidity via QT alongside meaningfully negative bill supply.
- Past debt limit impasses have more often than not corresponded to tighter swap spreads and dollar funding costs. Some of this likely reflects differences in TGA dynamics ahead of pre-pandemic experiences, however, with potential for a more favorable picture this time around. That said, the rates market appears to anticipate this in to a significant degree, pricing easier funding conditions in the first half of the year. We retain a long spread bias, but favor shifting from spot 3y into 2y3y UST-SOFR swap spread wideners.

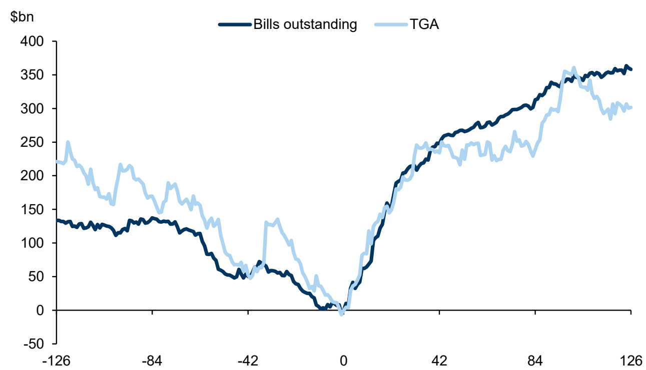
The start of 2025 brings with it the end of the debt limit suspension period on January 2, some 19-months after the suspension began. A last minute attempt to raise the debt limit preemptively alongside the year-end spending agreement fell short, though Republican leaders committed to raise the debt limit by $1.5tn as part of a 2025 reconciliation bill. While Congress may attempt to address the debt limit early in the year, the deadline for action is likely July or August 2025. Until there is a resolution, Treasury will generally have to operate under the constraints of cash on hand plus available extraordinary measures.

We estimate Treasury will start out with slightly more than $1tn in headroom, reflecting the sum of the Treasury's cash balance plus extraordinary measures available up front. As Treasury Secretary Yellen noted in a letter to Congress, it likely won't be until the middle of January that Treasury actually has to start dipping into its extraordinary measures thanks to redemptions of nonmarketable securities on January 2. In addition to the capacity available to begin with, we assume some incremental headroom will come available each month alongside a more sizeable boost at mid-year.

There is uncertainty as to how exactly Treasury will manage its available levers—i.e. the pace at which it draws down the TGA versus depleting extraordinary measures via higher net marketable borrowing. Still, the overall effect will be less bill supply and higher levels of broad liquidity (thanks to a lower TGA) in the system than the counterfactual of no constraint. Exhibit 1 illustrates the average change in T-bills outstanding and cash balances normalized to past debt-limit resolutions (using a sample since 2011). On average bill supply falls by about $130bn and the TGA drops roughly $225bn in the 6 months into an agreement. The subsequent rebuild tends to be somewhat faster—on average bills outstanding and the TGA both reverse that decline within the month or two following a resolution.

Exhibit 1: Typical declines in bill supply and the TGA tend to be more gradual than the eventual rebound following a debt ceiling resolution

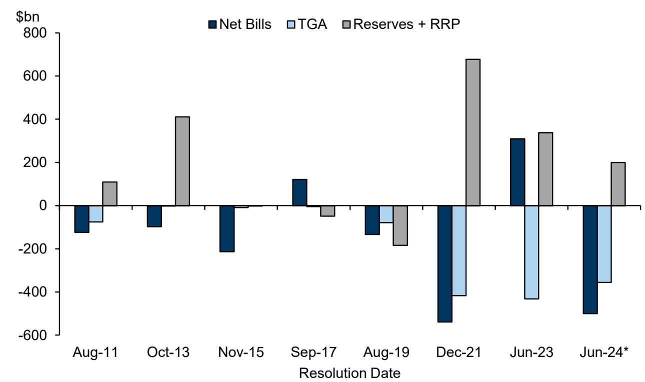
Average change in T-bills outstanding and TGA in 6m into/out of debt limit resolutions (2011-2023)



Source: Treasury, Goldman Sachs Global Investment Research

Exhibit 2: Even if the debt limit is resolved ahead of the x-date, the drop in bill supply and the TGA would likely be elevated by historical debt limit standards

Net bill supply and change in reserves plus RRP from when debt limit reached to point of resolution



*assumes end Q2 resolution for illustrative purposes

Source: Federal Reserve, Treasury, Goldman Sachs Global Investment Research

Compared to when Treasury has reached the debt ceiling in the past, the TGA will be starting off at a considerably higher level (the prior highs were around $450bn in both 2021 and 2023). Even under an end-Q2 resolution (somewhat ahead of our estimated x-date), we expect the TGA drawdown would be comparable to the 2021 and 2023 experiences when cash balances fell roughly $425bn in the window between reaching the debt ceiling and resolution (Exhibit 2). A process that drags into Q3 could see TGA fall significantly further still as July and August tend to be seasonally large deficit months. We estimate meaningful bill paydowns in the $400 to $600bn range over the first two quarters in this scenario, on par with the paydown observed in 2021 (also Exhibit 2).

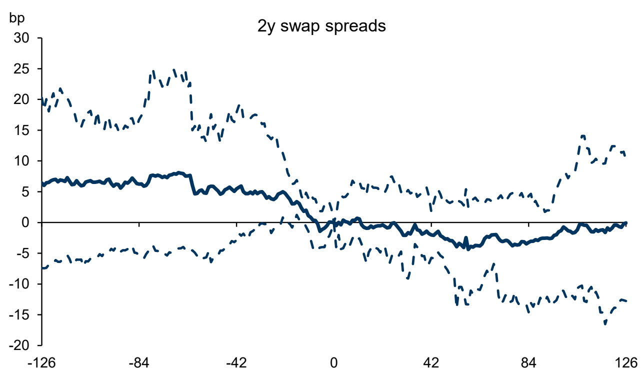
Balance sheet runoff means, however, that a given TGA drawdown is likely to translate to a smaller build in overall liquidity in the system (measured as reserves plus RRP)—we expect this would rise roughly $150-250bn through mid-year under our QT baseline assuming no resolution ahead of then. As with the scope for a larger TGA drawdown, a more protracted process that spills into the second half of the year could see a sharper rise in overall liquidity that exceeds what was seen in 2023 when injections from the Bank Term Funding Program also helped offset the impact of QT. Conversely, a later tapering and/or end to QT than our baseline would dampen any potential rise in liquidity.

Absent any debt limit constraint, we expect bill supply would be roughly flat alongside a roughly $350bn draining of overall liquidity from the system in the first half of the year.

Intuition would argue that backdrop of more liquidity and less collateral should be supportive of swap spreads and easier funding conditions. That has not necessarily been the case, however. 2y swap spreads have exhibited a tightening bias through past debt ceiling resolutions, compressing about 5bp on average in the months leading up to a deal (Exhibit 3). 2021 stands out as the instance in which swap spreads widened materially during the window when the debt limit posed a constraint, with that instance also corresponding to below-average pressure on measures of dollar funding costs as well (Exhibit 4). Still, for the most part, term dollar funding conditions in both repo and cross currency bases have tended to tighten during periods when the debt limit has been binding.

Exhibit 3: 2y swap spreads have tended to exhibit a tightening bias through past debt ceiling resolutions

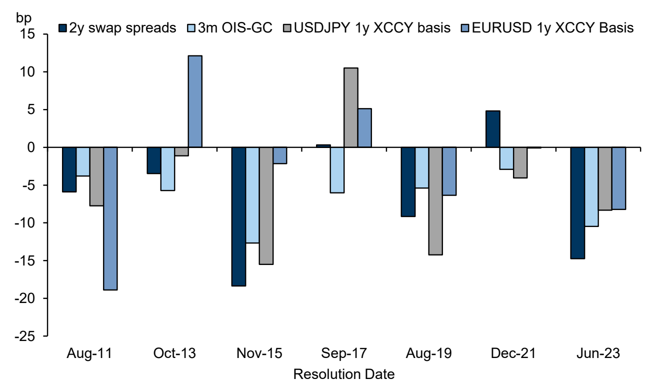
Average change in 2y UST-OIS swap spreads w/ max and min in 6m prior to and following debt limit resolution (2011-2023)



Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

Exhibit 4: Across spreads and measures of dollar funding cost the bias is towards tightening while debt ceiling measures are in effect

Change in swap spreads and USD funding costs (negative = tighter spreads, more expensive USD funding) from when debt limit reached to point of resolution



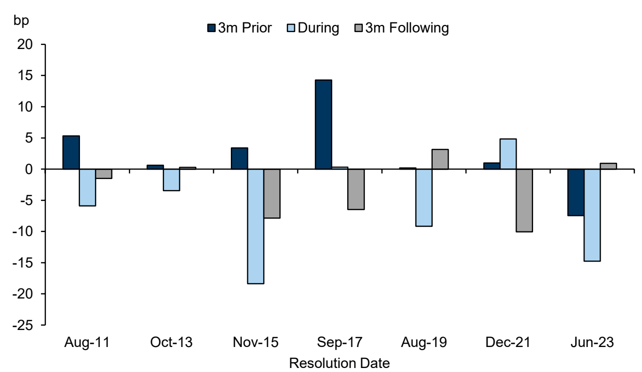
Source: Goldman Sachs Global Investment Research, Goldman Sachs Global Investment Research

The overarching evidence suggests that a debt limit impasse does not reliably support easier dollar funding conditions. Some of this, especially pre-Covid, is possibly attributable to the fact that TGA balances had to be quite low heading into the end of a debt limit suspension period, which may have front-loaded some of these effects, leaving dynamics somewhat more varied in the period after reaching the debt limit. For example, pre-Covid, 2013 was the only instance that saw a particularly significant rise in liquidity in the system, and that was due primarily to QE. Indeed, we observe that with the exception of 2023, swap spreads were flat to wider alongside stable to easier secured funding costs in the three months prior to reaching the debt limit (Exhibit 5). It's also possible that precautionary measures and/or anticipation of a rebuild in supply following a resolution tend to see a premium build in term funding costs heading into an eventual deal.

We think that the higher starting level for the TGA and magnitude of any potential bill paydown should at least support a more benign first half of the year in dollar funding conditions than would have been the case otherwise, dampening the tightening bias in swap spreads that have prevailed in prior debt ceiling episodes. Our rough rule of thumb is that a $100bn rise in liquidity from current levels is worth 0.5bp to SOFR-FF, while a $100bn drop in bills outstanding is worth about 0.1bp. That said, the market prices that in to a large degree, with most SOFR-FF tightening backloaded into the second half of the year (Exhibit 6); we think this leaves vulnerability to a faster resolution of the debt limit (or a later/slower ending of QT). It's also worth noting that balance sheet capacity constraints (rather than the overall level of liquidity) have played a greater role in driving volatility in funding markets over the last year—these may ease now that year-end is behind us, but not because of the debt limit.

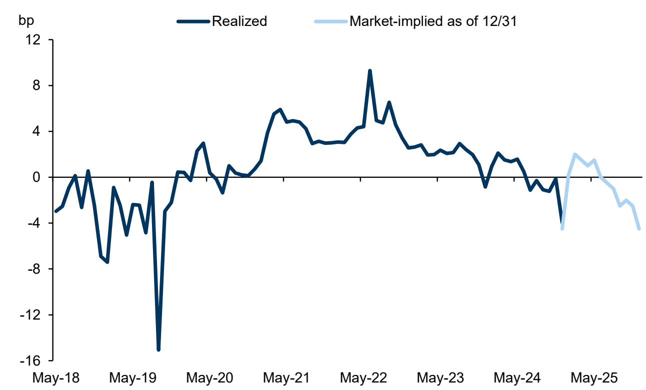
We've favored being long 3y swap spreads on account of our outlook for valuations, carry, and demand considerations. We remain comfortable retaining a long spread bias, but given the widening in spot swap spreads and easier funding conditions priced into the near-term already, we prefer shifting into forward space where recent outperformance has been less pronounced (both on an outright basis and versus our valuation framework). We close our 3y swap spread widener for a potential gain of 5bp and add a 2y3y swap spread widener (entry: -47bp, target: -37bp, stop: -52bp).

Exhibit 5: Widening in spreads has typically been more reliable prior to hitting the debt ceiling
Change in 2y swap spreads in 3m prior to reaching debt ceiling, between hitting it and resolution, and 3m following resolution



Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

Exhibit 6: The market prices easier funding conditions in the first half of the year before an eventual tightening
Realized and futures-implied spread between FF and SOFR



Source: Goldman Sachs FICC and Equities, Goldman Sachs Global Investment Research

As a final consideration, we noted previously that Treasury tends to rebuild the TGA fairly quickly upon resolution, suggesting risks of a swift undoing of any tailwinds in funding and spread markets. The intersection of this episode with the more mature phase of Fed QT may see Treasury proceed somewhat more cautiously in eventually returning the TGA to target, however, particularly with Treasury's "steady-state" TGA target somewhat higher than it was pre-pandemic. August-September 2019 is perhaps the closest point of comparison—QT had ended, and the mid-September jump in the TGA coincided with the surge in funding market volatility that prompted Fed liquidity injections. While the end point would ultimately be the same, a more gradual replenishing of Treasury's cash balance would reduce the risk of excessive volatility that could arise from quickly withdrawing liquidity from the system.

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