TAKING STOCK: THE X DATE – DARK CLOUDS OVERHEAD

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There is a storm brewing.

With negotiations around the debt ceiling at an impasse, investors are thinking of the unthinkable: a potential default by the United States of America on its debt obligations. If what was once considered improbable happens, there will be no place for investors to take shelter from this tempest.

The so-called X Date—a phrase, introduced by the Bipartisan Policy Center (BPC), which refers to the day the U.S. government will not be able to fully pay all of its bills—is fast approaching. The BPC estimates the U.S. may run out of funds between June and August, while Treasury Secretary Janet Yellen has informed Congress that the government may be unable to meet all of its financial obligations as early as June 1.

At NEPC, we believe there is no safe harbor to mitigate the potential market impact of a default by the U.S. government. The Treasury market is the foundation of the global financial system and there is no alternative global supply of government debt to take its place. Regardless of when a deal around the debt ceiling is reached—be it days, weeks or months—the U.S. dollar will remain the global reserve currency and Treasurys will continue to be the global standard for liquidity because there is no alternative to replace the depth and breadth of this market. However, if there are significant selloffs across equities and bonds in the days ahead of and following the X Date, we encourage investors to forcefully rebalance into oversold market segments.

At the same time, we do not see many viable options to adjust portfolio exposures beyond holding safe-haven fixed-income exposures to policy target while maintaining sufficient levels of liquidity. That said, as the X Date approaches, it may be prudent to hold greater levels of cash on hand in the form of bank deposits to cover specific liquidity needs in the weeks ahead.

To be sure, the most likely outcome is that the storm clouds dissipate and an agreement on the debt ceiling is reached in the days ahead or soon after the market turmoil that will follow should Treasury Secretary Janet Yellen announce that the U.S. has breached the X Date.

However, if no agreement is reached on the debt ceiling, the expectation is the Department of Treasury would prioritize interest and principal payments on Treasury securities to avoid default while also issuing new debt in the same amount of any maturing securities.

Payments on other federal obligations, for instance, Social Security and Medicare, would be withheld until funds are replenished by incoming government revenue. Under such a scenario, legal challenges will arise as federal courts will determine what constitutes a technical default and whether the Department of Treasury has the authority to prioritize payments on Treasury securities over other federal obligations.

Further complicating matters, the 14th Amendment states, "the validity of the public debt of the United States shall not be questioned," and the executive branch of the government could argue that it has the authority to issue debt above the debt ceiling level to pay for expenditures already approved by Congress.

Forecasting these different scenarios is inherently difficult. While we expect to see an agreement around the debt ceiling before the U.S. Treasury runs out of funds to meet its obligations, we cannot fully discount the prospect of a constitutional crisis and the impasse dragging out over many months. If you have any questions or concerns, please reach out to your NEPC consultant. Here is hoping for sunny skies ahead!

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

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