

Impact of Debt Limit Concerns on Financial Market Conditions¹

October 11, 2013

Financial markets have responded in material ways to concern about the statutory debt limit (DL), while showing minimal reaction to the government shutdown. Over the period from September 20 through October 10, markets showed some pockets of stress, particularly in shorter-dated U.S. Treasury securities and U.S. dollar funding markets, although widespread market stresses were not evident.² DL concerns also weighed slightly on risk sentiment. Outflows of Treasury securities from money funds were notable, however, and occurred earlier relative to the projected DL breach date (of October 17) than they did in 2011. The marked reaction to the announcement on October 10 of a possible deal to increase the DL highlights the continued sensitivity of financial markets to political developments.

Broad Asset Market Developments

- **Financial conditions** were little changed to slightly tighter in the weeks leading up to the DL. Prior to signs of political progress towards a short-term solution to the DL, U.S. equities and longer-dated Treasury yields were lower by 3 percent and 7 basis points through October 9, respectively. High yield credit spreads widened by 11 basis points, while investment grade spreads were little changed over the same period. Movements in these markets largely reversed on October 10 as signs of political progress emerged. Over the entire period, option-adjust spreads on current coupon mortgage-backed securities tightened and the U.S. dollar was little changed.
 - Trends in U.S. equity markets were broadly similar to those seen around the 2011 DL deadline (Figure 1).
- **Implied volatility** across markets was mixed. Equity market implied volatility (the VIX), increased to near its highest levels in 2013 but subsequently retraced much of the increase on October 10. Fixed income and currency market implied volatilities were little changed over the period.
 - Trends in the VIX were similar to those seen in 2011 (Figure 2).
- **U.S. sovereign CDS** spreads increased sharply with 1- and 5-year CDS spreads higher by 65 and 19 basis points, respectively, through October 10. The U.S. CDS term structure inverted, suggesting greater concern over a near-term U.S. sovereign credit event. Although the market for U.S. sovereign CDS is very illiquid with wide bid/offer spreads and small net notional outstanding, market participants reported increased focus in the product during the period.
 - U.S. sovereign CDS widened earlier than in 2011 (Figures 3 and 4).

¹ Fabio Natalucci (Board) and Kevin Stiroh (Federal Reserve Bank of New York).

² September 20 was chosen because it was after the September FOMC meeting and before concerns over the debt limit appear to have affected financial markets.

Treasury Securities

- **Treasury bill yields** increased sharply, with yields on bills maturing in mid- to late-October higher by up to 47 basis points through October 9.³ Market participants focused on these issues and noted deteriorating liquidity conditions, which were driven largely by liquidations by money funds concerned with potential delayed payment risks. On October 10, yields on these bills declined somewhat, while those on bills maturing in early- to mid-November remained flat. As the possibility of a 6-week DL extension emerged, bill yields with maturities in late-November through December increased.
 - Trends in bill yields deteriorated earlier than in 2011 (Figure 5).
- **Liquidity conditions** for Treasury securities with potentially delayed *principal* payments were reportedly challenging. However, liquidity metrics for securities with potentially delayed *interest* payments were little changed, as reflected in bid-ask spreads and overall trading volumes.
 - Trends in Treasury liquidity conditions were similar to those seen in 2011.

Funding Markets

- **Overnight Treasury GC repo** rates increased up to 18 basis points through October 9 before retracing somewhat. Contacts noted that some accounts were exploring ways to apply changes to repo agreements in order to exclude securities at risk of delayed payments. Despite this, traders described the overnight GC repo market as remaining liquid. Market participants attributed the rise in overnight rates to investor psychology and aversion to headline risk, rather than to an increase in investors' perceptions of counterparty default risk. **Overnight agency and agency MBS GC repo** rates followed Treasury GC rates higher, in part because Treasuries generally can be pledged into these repo transactions.
 - Trends in overnight GCF repo showed slightly earlier deterioration than in 2011 (Figure 7).
 - The October Treasury GCF futures contract is implying an average repo rate of 16 basis points for the remainder of October, compared to an average of 6.5 basis points in September. Treasury GCF futures for November and December are implying average repo rates of 14 basis points (Figure 8).
- **Term Treasury GC repo** rates increased with mid-November and year-end tenors rising 10 to 18 basis points. Term repo rates rose in part because cash investors became less willing to lend since, without the ability to modify collateral eligibility schedules over the term of the contract, they could receive at-risk securities. These concerns also reportedly made dealers less willing to provide term funding to their customers. Market participants reported a deterioration in the liquidity of term GC repo markets, though they noted trading activity was subdued prior to DL concerns.
 - Trends in term Treasury GC repo showed an earlier deterioration than in 2011.

³ Treasury Secretary Lew stated that extraordinary measures would be exhausted no later than October 17, 2013, and bill yields for surrounding maturities increased the most sharply.

- **Unsecured funding market rates** remained relatively stable. Implied rates on front-end Eurodollar futures increased up to 4 basis points. LIBOR fixings were little changed and remained near historic lows.
 - Trends in unsecured funding markets were similar to those seen in 2011.

Institutional Impacts and Flows

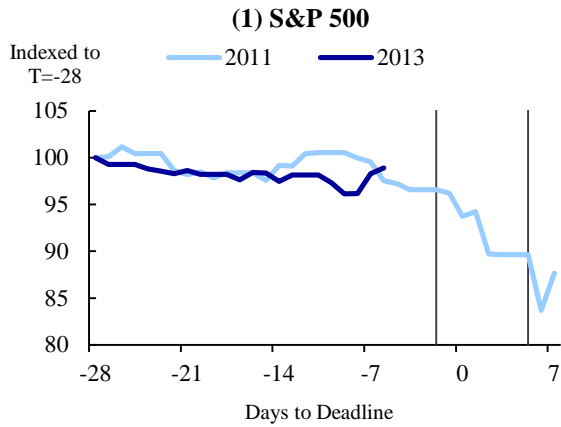
- **Dealer funding** did not show any signs of dislocation. The Desk dealer repo survey showed the amount of securities financed in overnight repo was little changed.
 - Trends in dealer funding were similar to those seen in 2011.
- **Institutional government funds** had outflows of \$25 billion (3 percent of assets) from October 3 to October 10. Several large money fund complexes indicated that their money fund business had sold or announced they had no exposure to holdings of U.S. Treasury debt maturing from mid-October to early November. Many reported taking proceeds from their maturing October bills and placing them in overnight repo or leaving cash uninvested.
 - Weekly data through 10/8 show larger declines in money fund holdings of U.S. Treasuries than those seen in 2011 over a comparable period (Figure 9).
- **Foreign and international monetary authority (FIMA) holdings of bills at FRBNY** increased by \$3.4 billion in the week ahead of the DL deadline, or less than 1 percent of total bill holdings of FIMA customers. Some customers appeared to reduce positions in bills that could potentially be affected by the DL, while others purchased these same securities in even greater quantities.
 - Trends in FIMA bill holdings indicated less concern than in 2011, when there were sales of \$20 billion or around 6 percent of FIMA bill holdings.

Other Developments

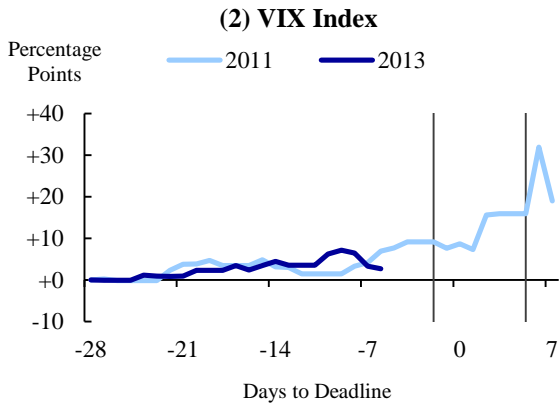
- **Collateral eligibility questions** received by the Desk regarding repo transactions increased sharply in recent days. To date, DTCC has not announced any changes in their eligibility schedule for GCF. These questions were received amidst reports that some market participants were amending documentation to exclude certain securities from repo eligibility. Related questions focused on the treatment of securities with delayed payments at the discount window or with CCPs, and the treatment of securities on Fedwire. The Desk has been keeping a log of market participant inquiries and categorizing the concerns expressed since 10/02/13 (Figure 10).
 - The Desk received similar questions in 2011.

Market Conditions Charts

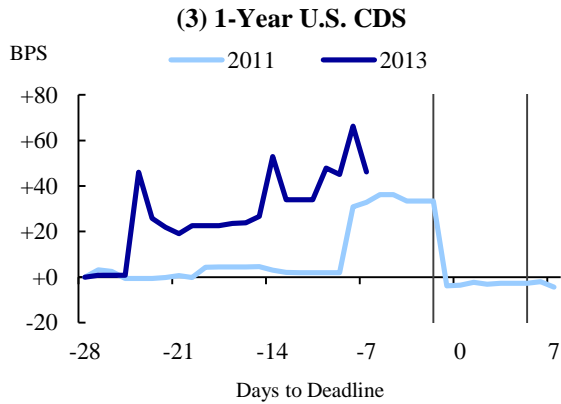
Unless otherwise indicated, the first vertical line represents two days prior to the debt limit deadline: 07/31/11 and 10/15/13. The second vertical line represents S&P's downgrade of the U.S. sovereign credit rating on 08/08/11.



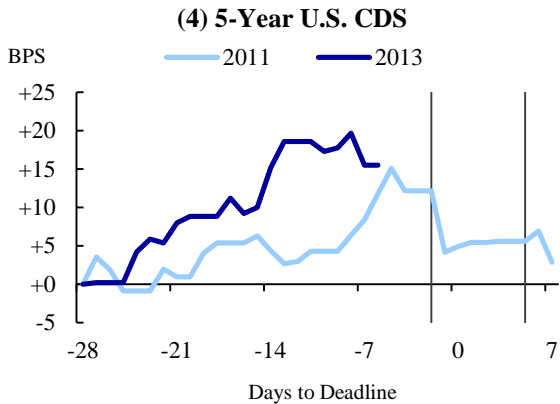
Source: Bloomberg



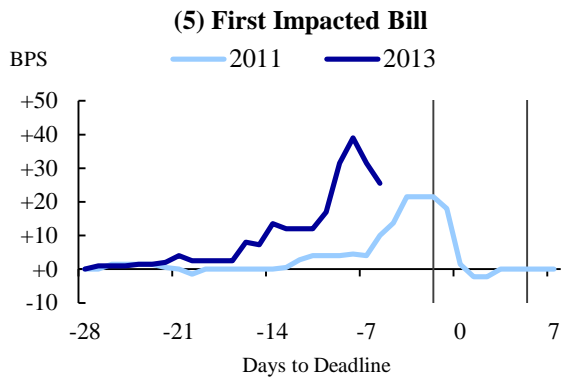
*Cumulative change starting 4 weeks before deadline.
Source: Bloomberg



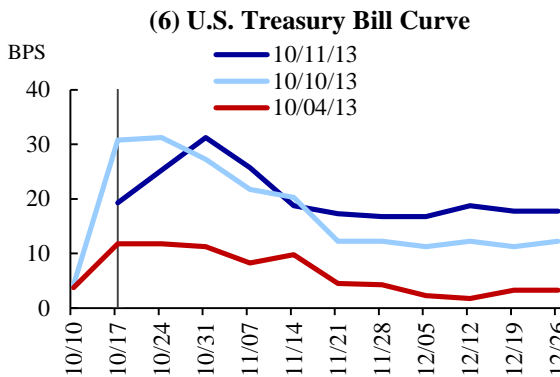
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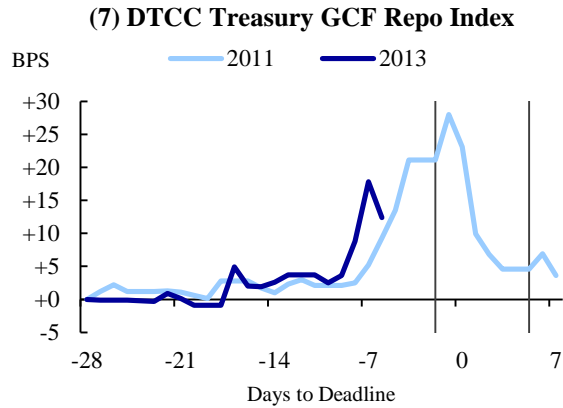
*Cumulative change starting 4 weeks before deadline.
Source: Bloomberg



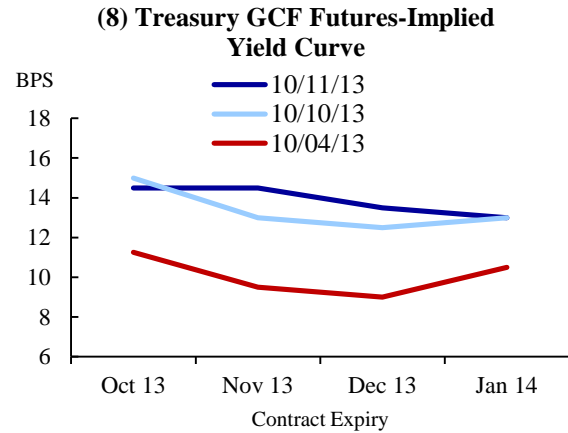
* Bills used are 08/04/11 and 10/24/13. Cumulative change starting 4 weeks before deadline.
Source: Bloomberg



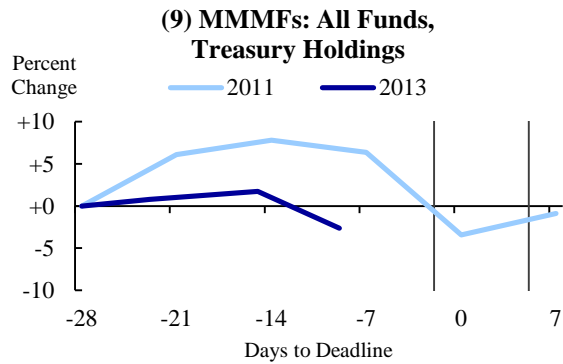
*Vertical line represents date when extraordinary measures are expected to be exhausted, as indicated by Secretary Lew.
Source: Bloomberg



*Cumulative change starting 4 weeks before deadline.
Source: Bloomberg



Source: Bloomberg



*Weekly data. Cumulative change starting 4 weeks before deadline. Includes Treasury Only, Treasury & Repo and Treasury & Agency, and Prime funds.
Source: iMoneyNet



*From 10/02/13 through 10/11/13.
Source: Federal Reserve Bank of New York