SPECIAL REPORT

Marcus & Millichap

IMPACT OF DEBT CEILING IMPASSE ON COMMERCIAL REAL ESTATE

MAY 2023

Delayed Debt Ceiling Negotiations Increase The Likelihood of Structural Ramifications

Debt ceiling impasse has moved into troubling territory. On January 19, the United States reached the national debt ceiling of $31.38 trillion. At that point, the Treasury Department was no longer allowed to borrow money to finance previously-made spending decisions. Instead, the Treasury began pulling from a reserve of federal funds originally allocated for other expenses, in order to maintain government operations and service the nation's outstanding debt. Paying interest to the various holders of U.S. debt is critical to maintaining the nation's status as a reliable borrower and allowing the country to continue to access capital in the future. U.S. debt is also a benchmark for many financial instruments, and a default would likely send major shocks through capital markets. However, the Treasury's reserves are quickly dwindling and may expire as soon as early June. At that point, the Treasury will not be able to fully fund the government, as federal expenses exceed incoming revenues. Congress and the president are negotiating a deal, but as the impasse moves up against that early June date, consequences are possible.

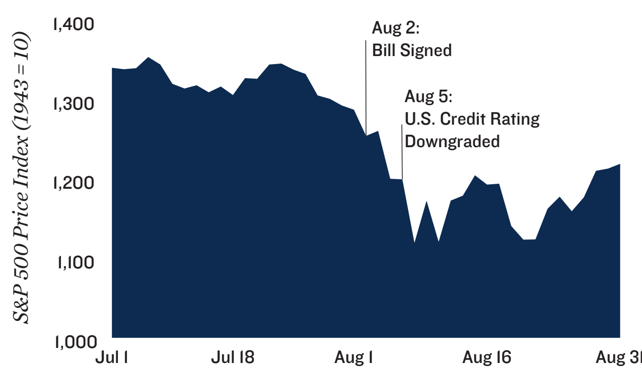
Close-call agreements are not unusual for the country. The U.S. has never experienced a major default in recent decades, but lawmakers have reached last-minute resolutions on several occasions. In 2011, the standoff persisted right up to the estimated date in which Treasury reserves were to be depleted, potentially serving as a guide for the current situation. That close-call triggered the most turbulent week for capital markets since the Global Financial Crisis, as Standard & Poor's downgraded the U.S. government's credit rating for the first time in history. The byproduct of this caused the U.S. government's borrowing costs to rise by an estimated $1.3 billion during that year. A contingency plan was also created to avoid default if reserves dried up, likely providing foresight for the path forward today if a resolution is not reached in time. The plan called for the Treasury to continue paying interest and principal on maturing debt, while cutting costs on all other obligations.

Government-funded programs may be cut if needed. The Treasury is likely to continue making debt payments, even if it exhausts funds to pay for other expenses. Veterans benefits, as well as social welfare programs, may be suspended, while federal employees could see a delay in their paychecks. The interruption may in turn prompt some agencies to scale back operations. In this way, a debt default would act like a government shutdown. A key difference is that a shutdown does not impede the nation's ability to pay its debts; the very risk of which could increase lending costs not only for public debt instruments like Treasury Notes, but also the financial vehicles based on those benchmarks.

A Timeline of the 2011 Close-Call

- On July 31, House Republicans and former President Barack Obama reached an agreement to raise the debt ceiling. On August 2, the measure was approved and signed — the estimated date in which the Treasury would exhaust reserve funds, narrowly avoiding the need to utilize a contingency plan to circumvent a default by cutting costs elsewhere.
- General uncertainty surrounding the outcome produced the most volatile period for financial markets since the 2007-2009 Global Financial Crisis. Between July 22 and August 8, the S&P 500 price index fell by 16 percent, the fastest drop over an equivalent interval since November 2008.
- Despite resolving the crisis by passing the Budget Control Act of 2011, Standard & Poor's downgraded the U.S. government's credit rating from AAA to AA+ on August 5. Moody's and Fitch also considered a downgrade but did not.
- Mortgage rates increased by about 70 to 80 basis points and remained elevated for about two months.
- The Government Accountability Office later estimated that the credit downgrade, among other byproducts of the last-minute resolution, caused the U.S. government's borrowing costs to rise by an additional $1.3 billion that year.

Near-Default in 2011 Created Stock Volatility



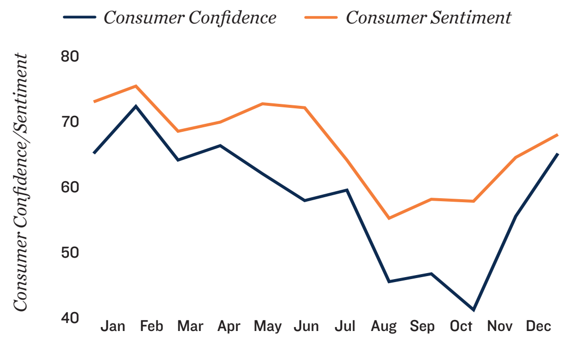
Sources: Marcus & Millichap Research Services; Federal Reserve; Moody's Analytics

Avoiding a Default Could Still Create Headwinds for Commercial Real Estate

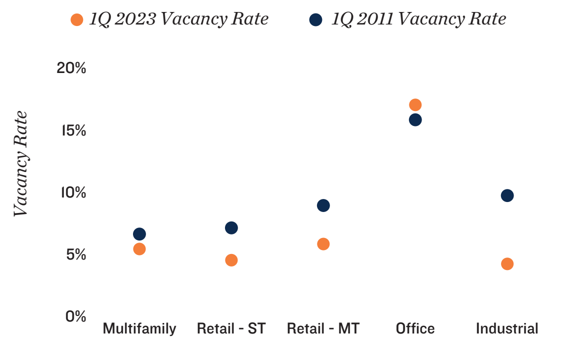
Consumer and business sentiment may be eroded. Under the scenario that the Treasury's reserve funds become exhausted, and they prioritize making debt-service payments while reducing expenses elsewhere, government programs are at risk of being suspended. It has been estimated that these other obligations would need to be cut by about 25 percent in an average month. As a result, federal employees will likely not receive pay, and recipients of social welfare programs may not have those benefits. This could translate into a loss of spending at retailers, including historically sturdier categories like drug stores, as well as hotels and even medical office. Interruptions to pay and benefits could also impact household formation, extending as far as senior housing. The 2011 last-minute resolution weighed on consumer sentiment and confidence, potentially foreshadowing the impacts of the current impasse. That close-call agreement was announced on July 31 and consumer sentiment plummeted from 63.8 in July to 54.9 in August, falling below the Global Financial Crisis trough. Consumer confidence, which is correlated to forward-looking expectations, meanwhile descended across several months, declining from 59.2 in July to 40.9 in October 2011, reaching the lowest measure since 2009.

Near-default could reverberate to real estate. Even if the country steers clear of a default, there may be some lending implications as seen in 2011. During that year, the U.S. government's borrowing costs increased significantly, due to the perceived demotion of their creditworthiness. It is estimated that the historic safety and liquidity of the Treasury's market grants the U.S. a 25-basis-point discount relative to interest on debt of other sovereign nations. The U.S. credit rating has already been placed under negative watch by Fitch, indicating it is at risk of a downgrade. The squandering of that advantage would generate an economic cost. Broad investor fears of a financial contagion event transpiring could put upward pressure on Treasury rates. During 2011, however, stock market volatility actually encouraged a flight-to-safety that pushed down on Treasury rates. In the past few weeks, Treasury rates have been climbing across the board as concerns grow, with the 10-year yield surpassing 3.7 percent in late May. As a result, commercial real estate lending could tighten further, or at the very least, financiers may raise rates. This could also spill over into real estate construction. Nevertheless, most property types are in much stronger positions than they were in 2011, granting a safety net to overcome some turbulence. The shock to financial markets and consumer confidence could take time to recover, however.

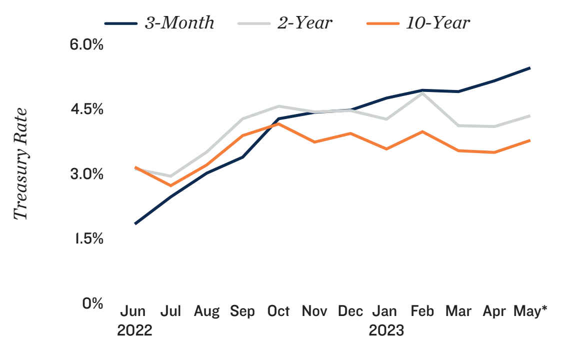
July 2011 Close-Call had Steep, Short Impact



Property Types Better Positioned Than in 2011



Treasury Rates May Face More Upward Pressure



** As of May 22*

Sources: Marcus & Millichap Research Services; CoStar Group, Inc.; Federal Reserve; Moody's Analytics; RealPage, Inc.; The Conference Board; University of Michigan

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