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Marketing material

That latest debt-ceiling drama

We remain confident that a small deal can get struck in time, paving the way for more deals later

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IN A NUTSHELL

– A U.S. default remains extremely unlikely. Strange as it may sound, recent political posturing provides confidence that the debt ceiling will be lifted in time.
– If the Treasury runs out of money before the debt ceiling is addressed, glitches in how to prioritize debt servicing costs over other spending could emerge.
– Given these uncertainties, investors are understandably cautious. Also note that if and when the debt ceiling woes pass, supply in Treasuries looks set to jump.

To market participants, the debt ceiling is one of those features of how the United States governs itself, that regularly strikes confusion, frustration and fear. Dating back to World War 1, the debt ceiling puts legal limits on the amount of borrowing the Treasury undertakes, without specific, additional Congressional approval.[1] If Congress fails to raise or suspend this borrowing limit, the potential consequences for markets, the economy and the standing of the United States could be catastrophic.[2] The current ceiling for gross debt is set at $31.4 trillion and the Treasury is swiftly running out of wiggle room to stay below it. Treasury Secretary Janet Yellen has indicated that they currently "expect to be unable to pay all of our bills in early June, and possibly as soon as June 1st."[3] In this note, we go through some of the basic questions, facts and possible scenarios investors need to consider, in assessing how negotiations progress day by day.

Default or no default?

"There is one person on planet earth with the power to ensure that we don't have a default," Republican Senator Ted Cruz declared on Fox News on Sunday, referring to President Joe Biden. Senator Cruz added that, "A responsible President would have said (…) the United States of America will never, ever default on our debts."[4] After all, the president could "simply" prioritize payments on interest and principal from maturing bonds over other spending.

Like most market participants, we expect and sincerely hope that this proposition will not be tested in the coming days and weeks. At the time of writing, negotiations between the White House and Congressional leaders appear to be going reasonably well, indeed better than seemed likely a few months or even weeks ago. In terms of politically and legally plausible scenarios, getting to a technical default on government bonds probably requires a whole series of things going wrong in the coming weeks.

Specifically, one would need to imagine that Congress fails to act prior to the day when the Treasury runs out of wiggle room. That day itself is a moving target given uncertainty on expenses and tax revenues. This would need to be followed by the Administration failing to take unilateral action(s) to continue servicing financial debts.

[1] What is the federal debt ceiling? (brookings.edu)
[2] How worried should we be if the debt ceiling isn't lifted? (brookings.edu)
[3] Meet the Press - May 21, 2023 (nbcnews.com)
[4] Sen. Ted Cruz rips Biden wanting to 'tank the economy' with debt ceiling stalemate | Fox News Video

What are the options if the Treasury runs out of money before the debt ceiling is lifted or suspended? Could we see a government shutdown in June?

Reportedly, the Treasury has already been putting together “unofficial” plans of how to prioritize debt servicing costs over other spending.[5] These plans would presumably include decisions on which payments to delay similar to what we saw in previous government shutdowns. There are several additional options to avoid or reduce the need to borrow from public markets and/or challenge the debt ceiling’s constitutionality that have been floated in recent years.[6]

At this stage of the negotiations, though, we view these options more in terms of shaping bargaining, as both sides appear keen to reach a resolution on the debt ceiling. A deal both sides can describe as a success would also augur well for negotiations after the summer on government funding, i.e. avoid government shutdowns later this year, too.

That said, for investors feeling uncomfortable to take the progress so far at face value, it is worth explaining what Sen. Cruz, a constitutional lawyer by training, was presumably hinting at. The U.S. constitution is not a suicide pact. During periods of crisis, the President has ample authority to do what it takes to minimize harm. And courts have plenty of pathways to avoid triggering economically catastrophic consequences, while considering the legal merits of various steps the Administration might take.

If time runs out, the most plausible way of getting to default is that the Administration tries to take unilateral action to continue servicing financial debts but fails because of technical glitches within the payment process. If that were to happen, pressure on the House would be immense. But a similar logic holds without a default on financial debts, too: if payments to, say, U.S. retirees are at risk, while foreign central banks, including China’s, get paid on their bonds.[7]

What could be the economic implications of a default and/or government shutdown?

The economic implications could be far reaching depending on the ultimate outcome.[8] A rule of thumb remains that each week of government shutdown most likely costs 0.2% of gross domestic product (GDP) but this figure is likely to increase the longer a government shutdown lasts. In this episode we should keep in mind the deterioration of sentiment following a potential default compared to government shutdowns triggered by a failure to pass appropriations. Therefore, we assign a somewhat higher initial impact at around 0.3-0.4% of GDP. The longer the crisis lasts the more severe the impact on GDP from sentiment and less government spending would get. Should the U.S. default de facto (missed payments) on its debts and no solution can be found, the overall economic fall-out is extremely hard to predict.

What could a failure to arrive at a speedy deal mean for the Fed balance sheet / Fed policy rates?

The U.S. Federal Reserve (Fed) will not act pre-emptively and has to avoid any impression of monetizing U.S. debt, e.g. government financing by printing money, and even secondary market purchases could be challenged as they potentially lower the cost of funding. We should keep in mind that the current monetary-policy setup differs from 2013 as a standing repo facility as part of the new ample reserves framework[9] is in place and the discount window as well as the Bank Term Funding Program[10] accepts U.S. Treasuries at par already. Also, one could argue that the prevailing stigma from 2013 – solid banks don’t borrow from the Fed - has lost its weight. From that perspective, a lot of what has been discussed in the past is already in place and the Fed seems prepared. In general, the Fed most likely will follow the mantra “when the economic outlook changes, our reaction will change.” Outright purchases, given the issues above, might be further down on the list of possible reactions.

[5] What happens if America defaults on its debt? (economist.com)
[6] Biden could end the debt ceiling all by himself - Vox
[7] Who Americans Usually Blame After Showdowns Over Federal Spending | FiveThirtyEight
[8] See, for example, The Potential Economic Impacts of Various Debt Ceiling Scenarios | CEA | The White House
[9] In the limited-reserves framework, the Federal Reserve sells or buys U.S. Treasury securities in the open market to in- or decrease the supply of reserves, which moves the FFR higher or lower.
[10] The Bank Term Funding Program (BTFP) was created to support American businesses and households by making additional funding available to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors.

Asset-class implications

Given these uncertainties, investors are understandably cautious. And while we would expect a small deal to potentially pave the way to a more constructive relationship between Congress and the Administration for the rest of Joe Biden's first term, we would caution that it is still too early to rule out further problems after the summer when Congress goes through the appropriations process to keep the government funded.

For fixed-income assets, it should also be noted that if and when the debt-ceiling woes pass, supply in Treasuries looks set to jump. Potentially, that could drive up yields and have spill-over effects to other parts of the market, notably investment grade (IG) bonds. Overall, however, we would expect relief over any of the worst-case scenarios being avoided to boost risk sentiment. If the U.S. instead edges closer to default, we expect a flight to safety ironically benefitting longer-dated Treasuries. On riskier assets, credit spreads would widen significantly, especially if political events were to reinforce the impression of chaos in Washington, with no clear end in sight.

Similarly, for equities, we think that our expectation of face-saving political compromises is already priced in. Any delays into early June would probably weigh down markets, with investors getting increasingly nervous with every additional day. That said, a lot will depend on the eventual resolution, as well as the implications of current events on other potential market drivers, notably Fed policy.

In short, we would stress that now is an odd moment to assess how different political outcomes are likely to shape the longer-term attractiveness of U.S. assets, partly because it is rarely the case that good things or bad things necessarily come all together in neat packages. Consider, for example, the following three scenarios, which are among the more plausible ones we are discussing internally in our investment decisions:

1. By June 1st, Congress passes a Suspension of the Debt-Ceiling until September, but with no binding agreement beyond that.
2. Congress raises the debt ceiling to a level sufficient to likely last until the end of 2024, but only in the first half of June, after the Treasury has had to prioritize debt servicing costs over other spending for a couple of days. These prioritized payments are implemented without glitches. Moreover, the outcome from the negotiations includes some key elements to shape future government funding negotiations for at least the next two years.
3. Congress fails to act. The administration uses what critics deride as a legal gimmick to effectively side-step the debt ceiling. The courts do not intervene to stop this, but House Republicans are furious and promise to "make Biden pay" in upcoming funding fights.

Now, consider, how one might rank these in terms of the attractiveness of riskier U.S. assets, say over the next 12 months? If our internal discussions are any guide, that question is far from trivial with a lot depending on the implicit assumptions investors tend to make when assessing such scenarios in the abstract.

Glossary

Default is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

Part of monetary policy, the discount window allows eligible institutions to borrow, on a short-term basis, money from the central bank to meet temporary liquidity shortages

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The United States House of Representatives is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A repurchase agreement (repo) is a form of short-term borrowing, whereby a dealer commits to repurchase the security shortly after it is sold. The dealer pays the repo interest as remuneration.

The Republican Party (Republicans), also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

The United States Congress is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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