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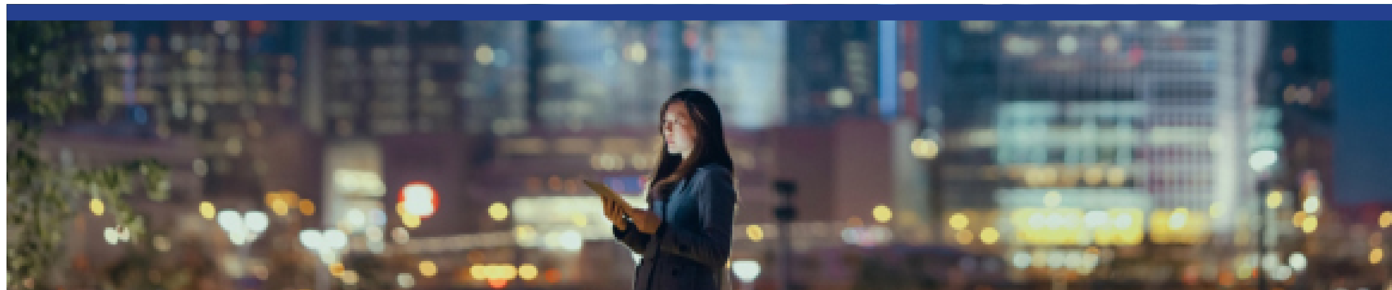

May 13, 2023

CIO Strategy Bulletin

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You Really Don't Want to Hit the Debt Ceiling

SUMMARY

- President Biden has ruled out debt default. Congressional Republicans have ruled out a US debt ceiling increase without spending cuts. While a last-minute compromise is most likely, we believe the US administration is willing to prioritize US debt payments (likely invoking the 14th Amendment), to avoid major financial consequences from missing Treasury bill redemptions and coupon payments.
- The most significant question is how much fiscal adjustment will be needed to get through this period? If the US had to live under the existing debt ceiling without new net Treasury issuance, it would have to cut non-interest spending by at least $150 billion immediately. If this was annualized, it would be a cut of nearly 7% of US GDP.
- Late payments of wages, contractor payments and Social Security benefits would generate a political backlash likely forcing a fast end to a standoff.
- The US has been raising or suspending its debt ceiling nearly annually since 1917. In 2011, the S&P 500 fell more than 15% intra-year after a particularly contentious, last-minute deal that resulted in fiscal tightening (the Budget Control Act of 2011). While not singularly responsible, federal spending fell in the next two years and rose just 3% (in nominal dollars) per year until the Covid spending explosion.
- Since the 2011 event, markets have been trained to see brinksmanship, warnings and last-minute compromises as the norm, limiting market reaction. This also may be emboldening the political theater.
- As the US Treasury bill market has been significantly distorted by the debt ceiling issue already, some market reaction is assured, with "relief" most likely. This may raise short-term interest rates as traders "price out" a possible financial shock and Fed easing in 3Q 2023. However, the extent of any fiscal tightening that may come from a debt ceiling agreement is the key impact for the economy and markets looking forward under the most probable outcomes.

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It’s US Debt Ceiling Time – Again

When the US Congress created the “debt ceiling” during World War I, its intent was to speed along government spending while maintaining a way to ensure responsible borrowing. The US debt ceiling has been raised or suspended nearly annually since 1917. A century later, the unintended consequences of having to pass legislation to borrow – separately from passing legislation to spend – were unimaginable.

The debt ceiling is unique to the United States. Congress passes a budget, the government spends the money and, when there is insufficient revenue, the Treasury borrows money to fully fund the expenditures. ***After*** the money is being spent – and just as the government’s borrowing is about to hit the previously approved ceiling – new debt ceiling legislation is required. This process is wholly unnecessary and allows partisans to interfere with earlier spending decisions under the threat of catastrophic default.

The US Treasury is the world’s largest sovereign borrower in its own currency. US government bonds serve as the most widely used form of collateral in global banking and comprise the slight majority of the foreign reserves of the world’s central banks. Failure to service and redeem US Treasury debt on time would indeed generate an unnecessary shock of severe and unpredictable size. The credibility of US government support for the banking system would be undermined. Numerous US spending commitments, including national defense spending, would be “unfunded.” Delayed payments would almost certainly trigger defaults from others dependent on Treasury interest payments and redemptions.

The repeated rounds of political theater over the debt ceiling have left markets numb to the nearly annual event. After a “close to the brink” set of compromises in 2011, several ratings agencies downgraded US Treasury debt and US equity markets fell more than 15%. Yet there were no lasting consequences for US borrowing costs and the stock market recovered in full. Despite this, in the current market context, we believe a repeat of the brinksmanship could add to the perceived riskiness of investing in US dollar assets. (see our latest Quadrant).

Agreeing to Disagree

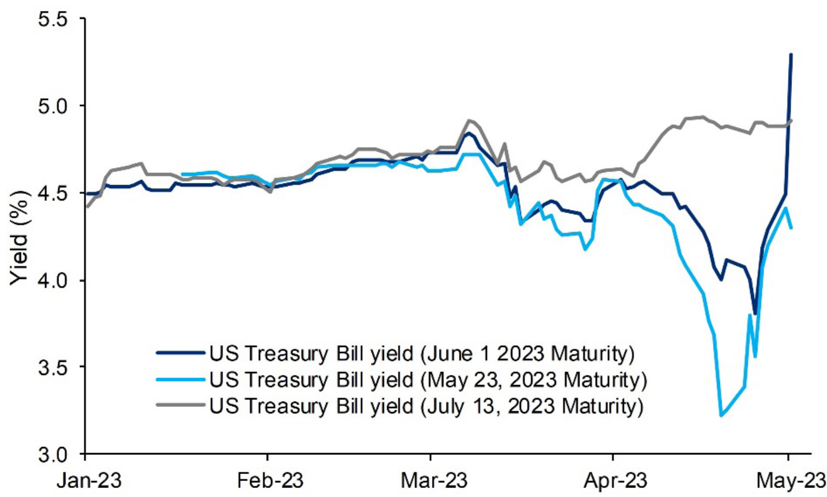
With this in mind, at a press Conference on Tuesday after meeting Congressional Leaders, President Biden said “the one thing I’m ruling out is default.” Congressional Republicans have also ruled out a US debt ceiling increase without spending cuts. The real questions are: *What sort of agreement will they reach, when and under what conditions?*

As of May 10, the US Treasury had $155 billion in cash in hand, having taken “extraordinary measures” to reduce borrowing to remain under the $31.4 trillion statutory debt limit since the start of 2023[1]. Operating cash is below two weeks of expenditures. In fact, Treasury Secretary Janet Yellen said the US may have no ability to pay all of its obligations in full as of June 1.

Interestingly, the fear over late redemption of Treasury bills has caused a large distortion at the front end of the US Treasury market (**Figure 1**). Bills that mature just before June 1 yield roughly 125 basis points *less* than those maturing after.

[1] Daily Treasury Statement, Department of the Treasury.

Figure 1: US Treasury bill market highly distorted by fears over debt ceiling



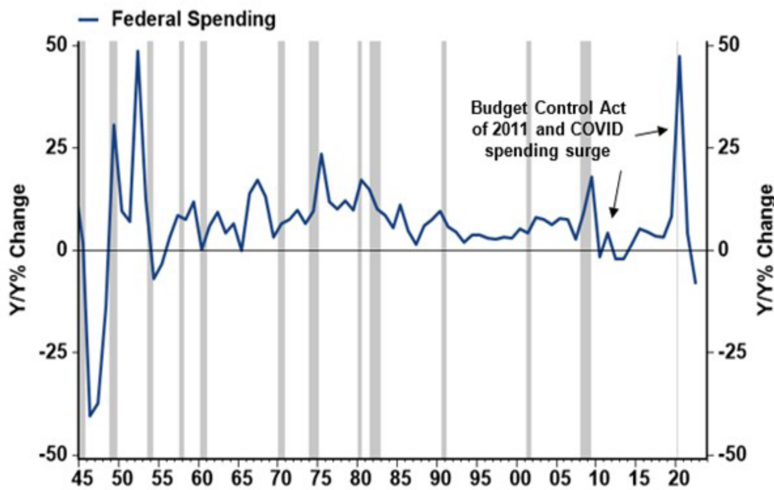
Source: Haver Analytics as of May 10, 2023. Past performance is not indicative of future returns. For illustrative purposes only.

Compromise Is Likely, but Not Assured

A last-minute compromise between the administration and Congress over the debt ceiling is quite likely, in our view. House Republicans demonstrated that they could raise the debt ceiling unilaterally in a vote taken on April 26. Far from draconian in overall scope, it slashes US spending by about 1.5 percentage points of GDP annually over the coming decade. However, it makes many cuts in areas prioritized by Biden and the Democrats that will make bipartisan agreement unlikely. It also includes areas where compromise is likely, such as unspent emergency Covid funding. (It's easy to un-spend what hasn't been spent.)

We believe that spending restraints similar to those reached after the rancorous 2011 debt ceiling battle are likely. With Biden negotiating for the Obama administration in 2011, the Budget Control Act of 2011 contributed to a small outright drop in federal spending in 2012 and 2013. But the whole debt equation changed with Covid expenditures in 2020 (**Figure 2**).

Figure 2: Federal spending year-over-year %



Source: Haver Analytics as of May 10, 2023. Grey areas note recession.

What if We Hit the Ceiling?

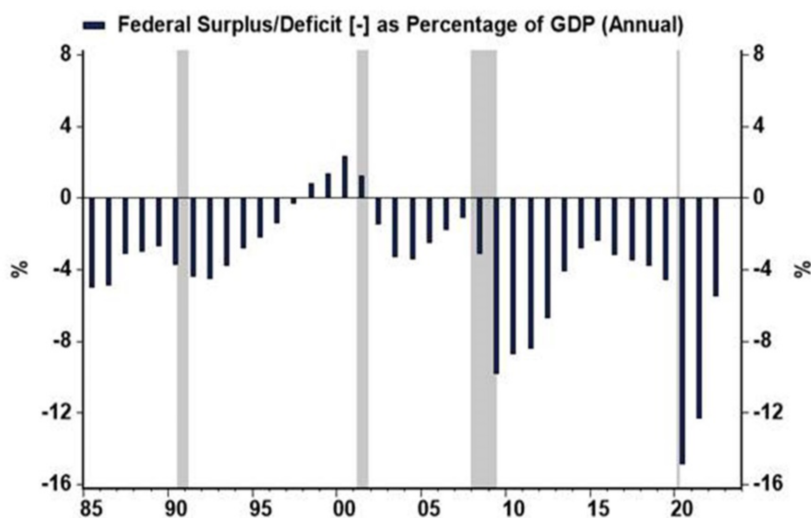
President Biden clearly does not want to drop his entire domestic spending agenda. House Speaker McCarthy may not have the votes to pass anything other than large cuts to Democrat priorities.

So, what might happen if the US Treasury were to run out of money? According to Treasury Secretary Yellen, who spoke to CNBC on May 8: “If Congress doesn’t raise the debt ceiling, the president will have to make some decisions about what to do with the resources that we do have.”

As Biden noted at a press conference on May 9 following a fruitless meeting with Congressional leaders: “I am considering the 14th Amendment.” This US Civil War era amendment states that “the validity of the public debt… shall not be questioned.” Biden believes it could be used as legal cover to prioritize continued servicing the US debt. Reports from 2011 suggest that no significant area of US government spending, aside from debt servicing, would be spared from “prioritization.”

It is not clear, is if Biden would – under the cover of the 14th Amendment – borrow in an attempt to make good on other US spending commitments. If the US were forced to cut spending to levels that would not expand federal debt – matching spending to receipts – non-interest spending would need to fall roughly $150 billion in the following month. This would create a default on some payments, but not others, depending on incoming receipts. If done over the course of a year, this type of spending reduction would amount to approximately 7% of GDP (**Figure 3**). It would almost certainly cause an immediate recession, which would lead US Treasury yields to plunge.

Figure 3: Gauge of the economic impact of a balanced budget with US deficit spending as % of GDP



Source: Haver Analytics as of May 10, 2023. Grey areas are recession.

Expect Outrage and Backlash

The political motivation to reach a compromise would skyrocket if payments were delayed to the many millions of Social Security recipients, doctors, federal employees, and private contractors who do business with the US government. Such a calamity would result in a surge in private defaults unless the situation was quickly remedied.

Markets are distorted by the debt ceiling impasse. As **Figure 4** shows, the probability of a late July rate cut by the Fed has reached 38%. The chance of a move by September has reached 63%. However, we believe these Fed easing expectations will *diminish* if a deal is reached. Without a debt ceiling crisis, the Fed is more likely to maintain higher rates for longer until real unemployment rates rise.

So far, equities and credit markets have been little impacted by the fiscal drama. However, investors in US equities must keep in mind that any fiscal compromise that reduced spending will likely come at the expense of medium-term US growth. It may affect the profits of some firms that have benefited directly or indirectly from deficit spending (**Figure 5**).

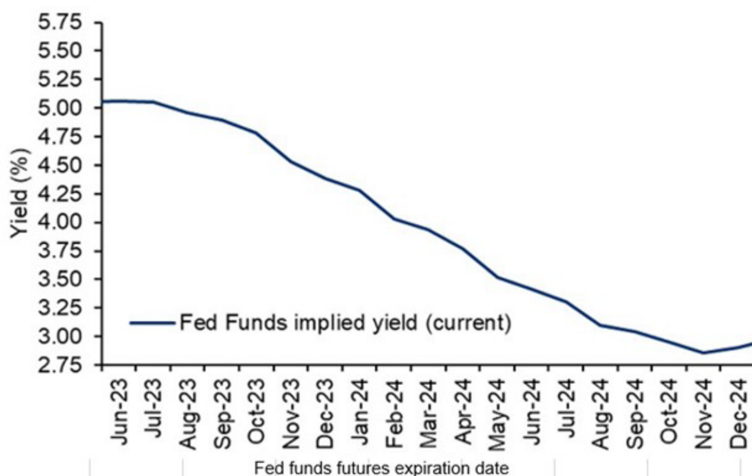
Conclusion

As we have seen dozens of times since WWII (see Outlook 2023 for examples), when markets are confronted by potential shocks and they don't occur, expectations swiftly adjust. Highly worrying threats of default in 2011 did not precede actual default. The market impact of the fear was therefore quite temporary.

With this in mind, US officials should not (and the vast majority don't) assume they can stretch their spending conflict beyond the brink without vastly more serious economic consequences. We do believe a spending compromise akin to the Budget Control Act of 2011 will be reached. But failing that, defaulting on non-interest obligations would still have severe economic consequences. Even if it lasts for a very short time – perhaps a week – it may set a bad precedent and hurt consumer confidence.

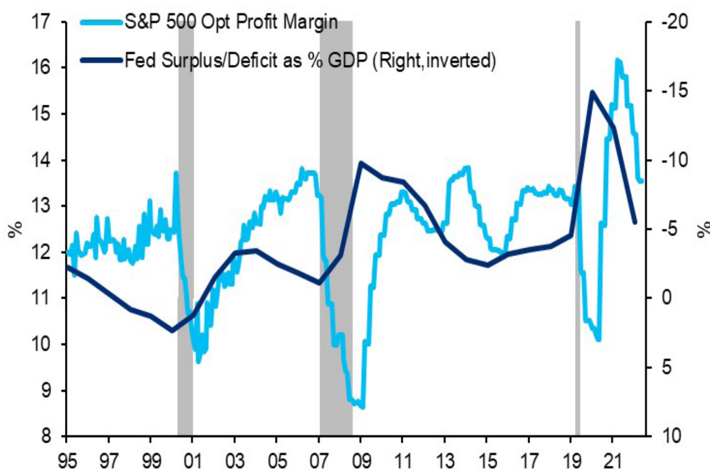
If a fiscal agreement comes before the debt ceiling is breached, the US bond market is likely to push out the possibility of rate cuts until late in 2023. Cyclical equities would likely rally, but interest-rate sensitive growth shares may fall. Yet beyond this immediate impact, the weakening in US bank lending we discussed in last week's CIO Bulletin will still be felt in time in the economy and cyclical industry shares. While the US economy has been somewhat more resilient than we expected in early 2023, more fiscal restraint is also likely to come in any budget agreement.

Figure 4: Fed funds Futures Imply Some Chance of Rate Cut as Soon as July



Source: Bloomberg as of May 10, 2023. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Figure 5: S&P 500 Profit margins vs US budget deficit as % of GDP



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Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
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