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CIO Office Viewpoint

US threatens to put debt ceiling through breakpoint test

Investment Solutions

8 May 2023

The US Treasury could not have been clearer. Political brinkmanship over new US debt issues "can cause serious harm" to the American economy. The date by which the Treasury may have to start deciding which creditors to honour and which payments to postpone, may arrive on 1 June, months sooner than calculated in early 2023. We look at three scenarios and the stakes for a US government default.

The US breached its USD 31.4 trillion debt ceiling in January, and the nation now owes more than USD 31.7 trillion, and counting. On 27 April, Republican lawmakers in the House of Representatives used their majority to try to impose limits on an already-passed budget. With a two-vote majority, they passed legislation to raise the debt ceiling by USD 1.5 trillion, on condition that the Biden administration scrap industrial subsidies and tax credits designed to support the US transition to cleaner energy and infrastructure. The Republican plans, rejected by Democrats, also include tighter criteria for the poorest to qualify for healthcare and food stamps.

On 1 May, US Treasury Secretary Janet Yellen surprised Congress by saying that the so-called 'X-date' – when the US Treasury runs out of cash to honour its obligations – may fall as early as 1 June. The exact date is uncertain, because it depends on the amount the government collects in income taxes; year to date, the Treasury reports that revenues are lower in 2023 than a year ago (see chart 1). In the meantime, the Treasury has already started taking "extraordinary measures," including no longer issuing securities that help US states and municipalities manage their budgets, since they count towards the debt ceiling. Once such steps are exhausted, the Treasury can move to shut down parts of government, and postpone payments to government employees.

The predicament matters because US Treasury bills provide the risk-free benchmark rate for financial assets worldwide. Treasury bonds are treated as the safest, 'risk-free' financial assets in the world. It follows then that every other monetary asset is dependent on this benchmark. Any threat to that status would trigger a re-pricing of every other asset, from sovereign debt to corporate credit and housing. It would also undermine the US's economic credibility. "It's Congress's job to do this," Ms Yellen said on 7 May. "If they fail to do it, we will have an economic and financial catastrophe that will be of our own making."

Last week the White House set out its own estimates for the economic impact of the US failing to pay its bills in the third quarter of 2023. They range from a 'brinkmanship' scenario that would cost 200,000 jobs and take an annualised 0.3% of real growth from national GDP, to a 'protracted default' that could strike 8.3 million jobs and cost more than 6% of GDP.

Key takeaways

- A Congressional impasse over authorising new US debt could trigger a technical default unless a compromise is reached within weeks
- US Treasury debt provides the financial world with its 'risk-free' rate. A threat to its status would spill over into a re-pricing of every other asset
- We believe the most likely outcome is a last minute deal to lift the debt ceiling, given the severity of the consequences if the US runs out of cash
- In 2011, a last-minute agreement sparked market volatility: stock prices and bond yields fell, credit spreads widened, gold surged and the dollar strengthened. Still, if a deal is found, the subject will fade quietly away. We maintain our overweight allocation to US Treasuries.

Still 'AA+'

Markets have historically shrugged off the regular political brinkmanship that surrounds the US debt ceiling, and for sound reasons. Congress has agreed to lift the ceiling 78 times since 1960, three-fifths of those occasions under Republican presidents (see chart 2). The most recent raise was in December 2021, by USD 2.5 trillion. In 2011, however, an agreement was only reached at the last moment. That late deal was followed by a first-ever downgrade in the US's credit rating. Standard & Poor's cut the US rating by one step, from 'AAA' or 'outstanding,' to 'AA+' or 'excellent,' The country's rating has not recovered to its former level. In 2011, the US ceiling was just over half today's level, at USD 16.4 trillion, and the country had negative real interest rates and a debt to GDP ratio of 90%.

Tighter monetary policy since March 2022 has increased the stakes for servicing higher levels of national debt. Following the most recent hike, the Fed's benchmark interest rate is 5%-to-5.25%, while outstanding debt is the equivalent of 120% of GDP. However, we believe that rates are unlikely to be cut in 2023, unless further stresses in the banking system, or a severe recession, drive the central bank to reduce borrowing costs sooner.

Today's polarised US politics mean that the possibility of a technical default can't be ruled out. Any solution has to begin with a meeting between House of Representative's speaker, Republican Congressman Kevin McCarthy, and President Joe Biden. A first meeting is scheduled for 9 May. Mr McCarthy was appointed by the Republicans in January 2023, after a lengthy, 15-ballot deal-making process. Support for his position within his own party depends on him demonstrating fiscal thrift to a hard-line minority of Republicans in the House.

Alternative scenarios

Workaround solutions abound, but there are doubts about their political feasibility and associated legal and financial uncertainties. One solution is to simply ignore the debt limit by invoking section 4 of the 14th Amendment of the Constitution, which says "the validity of the public debt of the United States... shall not be questioned." That dates from the American Civil War, and was an attempt to absolve the northern union states from honouring the southern states' debt.

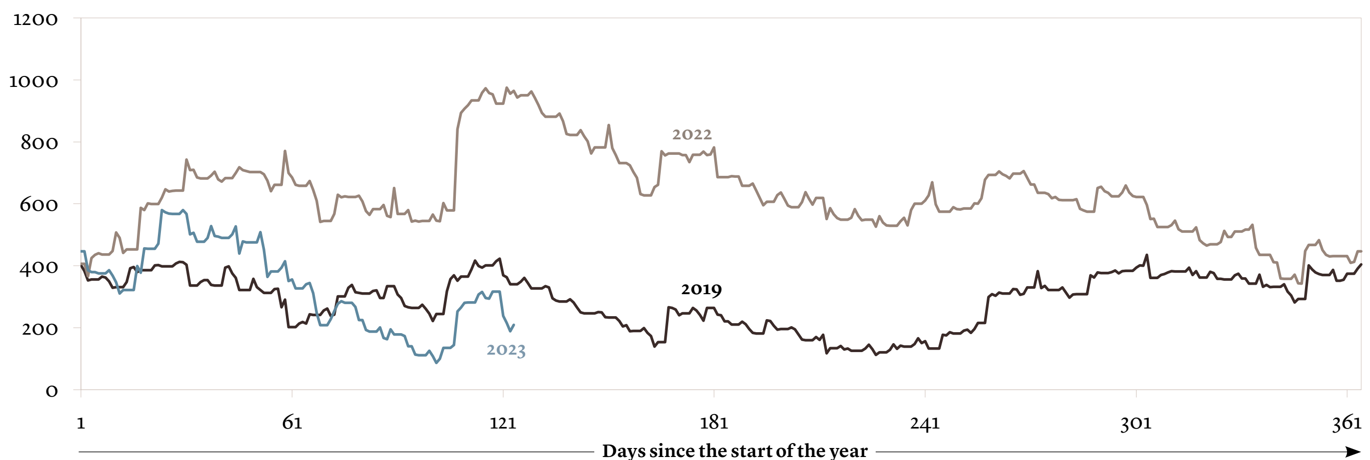
Another last-resort possibility is to mint a one-trillion-dollar platinum coin under a 1997 law giving the US Treasury Secretary broad discretion to create coins of any denomination. In this scenario, the US government would continue its financing activities by depositing a newly-created USD 1 trillion coin, or coins, at the Fed in exchange for corresponding amounts of cash to use for interest payments or other obligations. To prevent the outright monetary financing of the deficit, the Fed would then have to 'sterilise' the coins using quantitative tightening measures, such as the selling bonds held on its balance sheet.

A third solution would be to issue US Treasuries at coupon rates higher than market yields. That would allow the US government to issue bonds at above-par prices, creating a gap between the cash it receives from investors and the par-value of debt that it tracks for debt ceiling accounting.

In these scenarios, the Biden administration would likely face an immediate legal challenge that could only be settled by the Supreme Court, where conservatives outnumber liberals by six to three. That would effectively dare the Court to either trigger a catastrophic technical default, or end the debt limit with a legal precedent that permanently neutralises it. Even if the administration succeeded, markets would face a period of uncertainty over the US debt instruments that underpin the entire financial system. Some investors would surely interpret these acts as a default in all but name.

1. The US government is low on cash

US Treasury operating cash balance, USD billion



Source: Bloomberg, Lombard Odier

Base case

We estimate that the most likely scenario remains a last-minute agreement to lift the debt ceiling (60%), and avoid the Treasury having to take steps to prioritise payments. Still, there is perhaps a 30% chance that lawmakers agree to short-term fixes, extending the Treasury's authority to issue debt through July, or September. Finally, we cannot exclude a roughly one-in-ten chance that there is no deal, forcing the Treasury to start prioritising principal or interest payments on US obligations over other claims.

There is also a geopolitical angle to the debt dispute. It's "almost a certainty" that China would leverage any default to deride the US political system as dysfunctional, US Director of National Intelligence Avril Haines told a Senate committee on 4 May. A threat from China is currently one of the few topics on which Democrats and Republicans agree.

To unpack the possible implications for financial assets, we can look at how markets reacted to the 2011 debt ceiling crisis. Unlike other years of political haggling over the ceiling, this was the only occasion in which the country came comparably close to its X-date. Equity markets declined sharply and credit spreads widened, gold prices surged and the dollar strengthened, while bond yields fell despite the US credit rating downgrade. This said, it is difficult to attribute these moves solely to the debt ceiling crisis because at the time the eurozone was experiencing a sovereign debt crisis. In other debt ceiling episodes, market reaction was much more muted. In every case, the present day included, we see investors paying a premium for short-dated Treasury bills maturing just before the X-date, and a discount for those showing a settlement date shortly after.

The rising risk of a default would also increase the pressures on the US dollar, which is weakening as America's economy slows. We expect the dollar to depreciate against the euro, Swiss franc and Japanese yen, reaching EURUSD 1.12, USDCHF 0.87, USDJPY 120 a year from now. Nevertheless, we see the US currency proving more resilient against other major economies, such as the Canadian, Australian or New Zealand dollars, and North Asian currencies including the Chinese yuan.

Market volatility around this issue is likely to stay limited to short-dated US Treasuries. The case for longer-dated bonds remains unaffected and we therefore maintain our overweight allocation to US Treasuries. If, as we still expect and hope, the latest debt ceiling dispute is resolved without forcing the Treasury to determine a hierarchy of its debts, the subject will fade away quietly. Nevertheless, in such a politically divided environment, we cannot fail to at least consider the most extreme scenario, since without a compromise, financial assets would face at least a short-term pricing dilemma.

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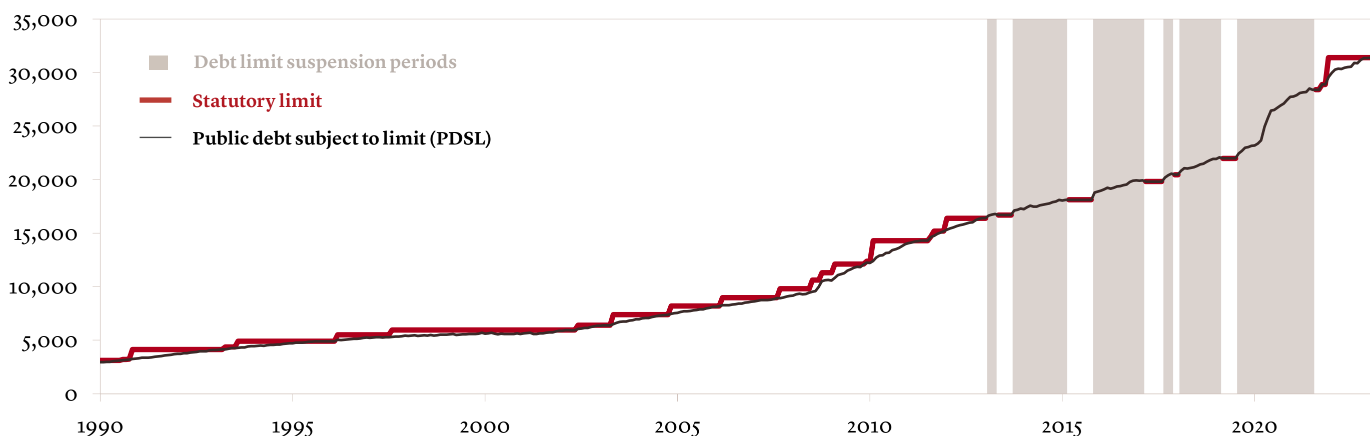
2. Last minute debt limit disputes, and raises, have become common



Source: CEIC, Lombard Odier

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