



Insigneo Weekly Dispatch

# The Debt Ceiling: at the edge of brinksmanship

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## The Debt Ceiling: at the edge of brinksmanship

As expected, and as this goes to print, debt ceiling discussions are still underway and gaining importance as the 'x-date' nears. The odds of a US technical default, which we place subjectively between 10 and 15%, are not immaterial and could soon be reflected in many financial assets beyond just short-term Treasuries and Credit Default Swaps.

At the start of last week, Treasury Secretary Janet Yellen continued to express her worries about the US being able to pay its bills after June 1 unless Congress acts. Since then, Congress has held talks, but representatives from both ends of the spectrum stated that the two sides are still far apart. Fortunately, both Republican and Democratic leaders have publicly stated that a default is out of the question. But the real concerns are not emanating from the leadership or center of both parties but from their fringes. Far-right Republicans are not accepting anything less than their full demands, and far-left Progressive Democrats do not want to compromise any part of their agenda. In this age of polarization, both fringes punch above their weight.

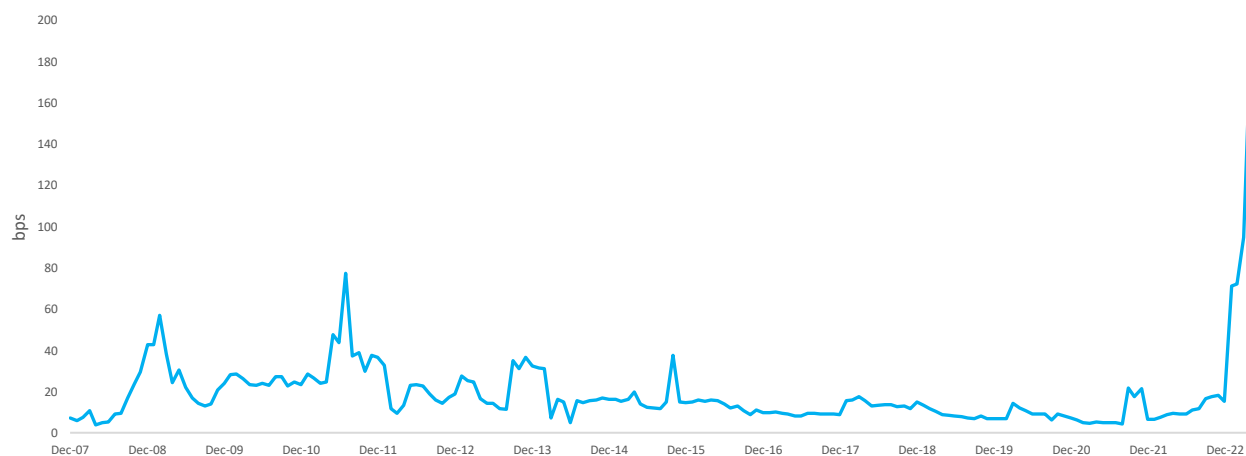
Wall Street's nervousness is seeping into Corporations. More than 140 leaders from major US companies, Pfizer and Goldman Sachs included, have written a letter to Congress warning of the disastrous consequences of a default, per a report of the New York Times. To better understand the situation, we should go back to 2011 – the last time that the government and Congress were at odds

because of the debt ceiling. Back then, an agreement was reached 72 hours before the US defaulted on its debt. The outcome of those negotiations was the Budget Control Act, which initially increased the debt ceiling by USD 900bn while guaranteeing a similar amount in long-term savings across different expenditures. However, the US did not exit these negotiations unscathed: among other consequences, S&P downgraded the US's credit rating after signaling that the brinkmanship observed in the discussions decreased the debt's safety level and that such events reduced trust in the US economy.

Meanwhile, and as [we mentioned on previous occasions](#), the equity market plunged due to the potential ceiling breach, with the S&P 500 experiencing its steepest decline between July 21 and August 8, after the S&P downgrade, days after the Treasury was unable to fulfill some payments. Even if Congressional leaders seem to be saying all the right things, some segments of the market are beginning to discount the possibility of a technical

default. For example, the yield on short-term bills has increased in such a manner that the T-bills maturing on the x-date are yielding more than 6%, above corporate debt, and close to reaching 30-year highs.

Moreover, the shortest tenors of the US Treasury curve have been the quickest to price in this risk. The one-month bill saw a rise in its yield of ~20bps since last Friday. To put things into perspective: if we review the one-month yield changes across the Treasury curve, the one-month tenor has increased by over 200bps, a stark contrast to an average increase of ~40bps of the remaining tenors. On another note, the government's cash balance has been falling starkly daily, a fact that adds to the worries of the government running out of funds before the x-date and increases the pressure to resolve the debt standoff. Those worries have also been visible via the one-year CDS for US government debt, which has risen to its highest level in over a decade, as can be seen in the following chart:



Source: Bloomberg. Data as of May 24, 2023

If history serves as a guide, and as we have discussed on previous occasions, the debt impasse should be resolved before the x-date, in a manner that will not leave all sides satisfied, but which will bring a sigh of relief to markets. This, amid the recent statements of Fitch Ratings, in which the agency said it could downgrade the US's credit rating to reflect worsening political capital that is preventing a debt deal, thus bringing additional volatility to an already troubled environment. Our base-case scenario is that the government will be able to avoid default at the brink of reaching the x-date, as well as a starker spike in the shortest end of the Treasury curve. Still – party egos aside – the market and the American population would like to believe that the country's best interest is still what is driving the debt ceiling negotiations. The latter, considering a recent poll by Monmouth University that revealed that “more than half of almost 1,000 people polled stated that the debt limit should be raised with no strings attached, whereas

only 25% of those polled considered that it should be tied to spending cuts – what the GOP is requesting.”

We hope June 1 will arrive with a clean debt ceiling increase and without the need to invoke the 14th amendment or to mint a platinum coin – two alternatives some have entertained before and that would allow the government to meet its financial obligations, albeit in a very disruptive and heterodox manner.



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