1 October 2021

RESEARCH NOTE

America (Probably) Won't Default, Although It's Not Yet Clear How

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What's Happening?

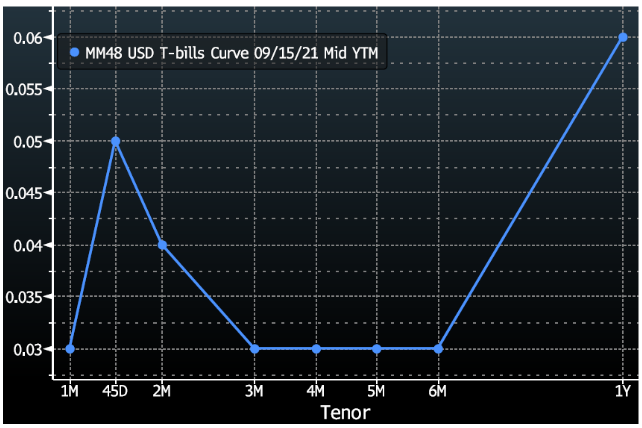
After July 31, the debt limit suspension expired. Some estimates suggest the Treasury's existing cash balances and other extraordinary measures can postpone default until October 18, according to the latest estimate from the Treasury. After that, if the debt ceiling is not raised, the U.S. risks defaulting on some of its obligations. While the odds of default are low, the bottom line for investors is that the risk of that outcome is the highest it has been since 2011, and there may be some turmoil ahead for the bond market.

How Would This Impact Liquidity?

Once the debt ceiling issue is resolved, liquidity is likely to contract on the margin as the Treasury General Account's balance is topped up, typically by issuing T-Bills. This, coupled with a substantial amount of net T-Bill supply forecasted for Q4 (given issuance has generally been very low so far YTD), could mean a larger than usual deterioration in liquidity conditions as we approach year-end. While Q4 is typically more volatile than other quarters for the front-end, the overall impact may only see front-end yields pick up a few basis points given the abundance of cash out there.

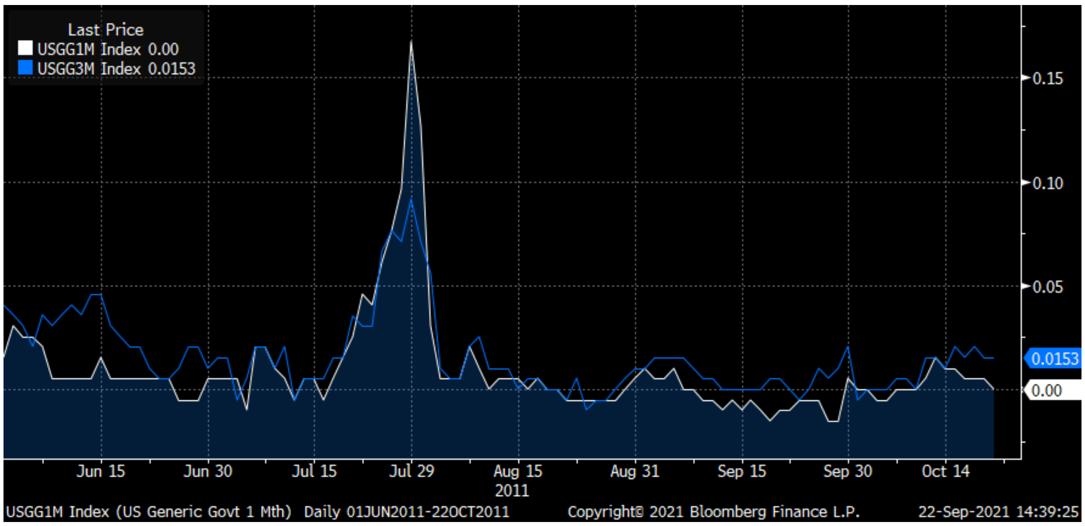
What's Priced In?

At least for now, there is little evidence that markets are concerned. Looking at the very short-end of the yield curve, we see a small kink in yields for T-Bills maturing in 45 days and two months. Because no Fed hikes are expected over this period, theoretically the only factor affecting these tenors should be default risk around the debt ceiling. Though T-Bills that mature in October and November have a higher yield than bills that mature before or after, the kink is very small—just about two basis points.



Bloomberg. As of September 15, 2021

For comparison, at the time of the last serious debt-ceiling confrontation in 2011, T-Bill yields rose almost 20 bps.

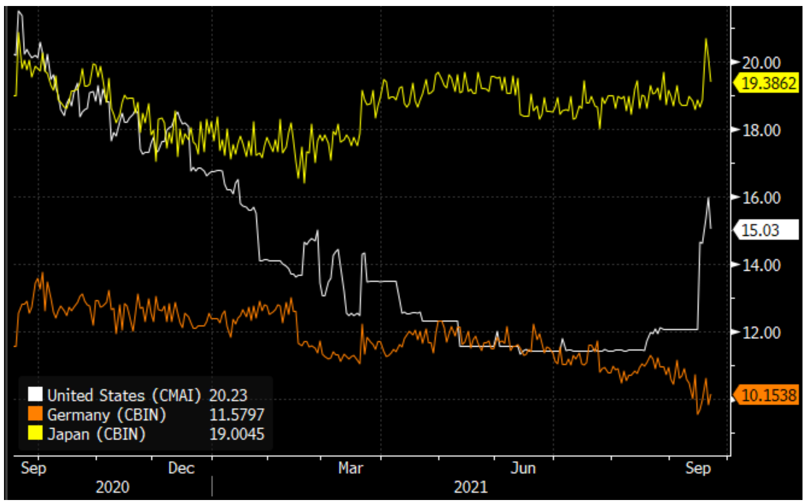


Bloomberg. As of September 22, 2021.

We can also gauge market anxiety by looking at the forward curve for 5-Year and 10-Year Treasuries. While yields for coupons around October and November (i.e. the one- and two-month forward rates) show a slight "bulge," pointing to some perception of risk, overall it is very small.

Bloomberg. As of September 17, 2021.

Finally, credit default swap (CDS) spreads on Treasury debt has only shown a slight increase of about five basis point in recent weeks. In 2011, CDS spreads rose over 20 basis points.

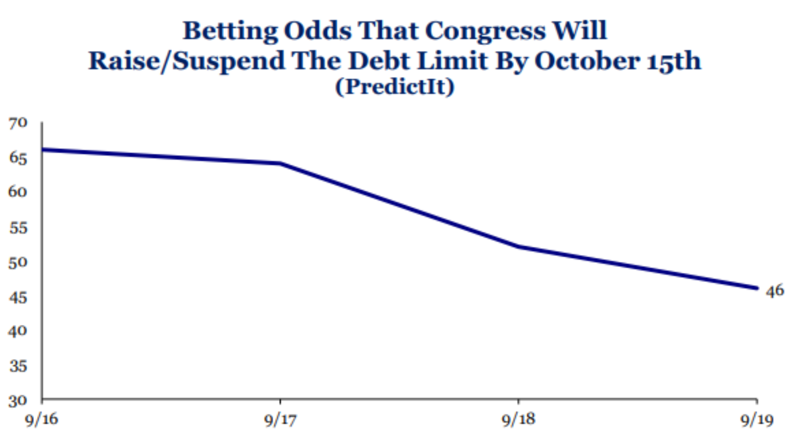


Bloomberg. As of September 17, 2021.

Overall, the market's perception of risk back in 2011 was likely higher given the novelty of the situation then. Given that experience, and others following it (e.g. 2013), markets are likely of the belief that lawmakers will do the right thing, but only after excusing all other options.

What About Non-Market Based Measures?

In recent days, betting odds fell below 50 percent that the debt ceiling will be lifted by October 15, implying consensus expects a last-minute deal is the likely outcome. This could raise noise in the coming weeks.



Strategas. As of September 20, 2021.

What Needs to be Done?
With Republicans having vowed not to vote to suspend the debt ceiling, it's still not clear what legislative vehicle raising the debt ceiling will take, or the timeline of when it may be passed. Democrats *can* raise the debt ceiling with their own votes, but they want a bipartisan vote because the debt limit is merely a recognition of all the spending and borrowing decisions of past votes by both parties.

Democrats' reluctance to go down a partisan route stems from the optics around taking the lion's share of blame for such a policy. In particular, voting to raise the debt ceiling could be a politically damaging vote for Democrats in swing districts. In addition, inserting the debt ceiling legislation in the reconciliation process will only raise it by a set dollar amount, rather than suspend it over a certain period of time. The latter has generally been less politically damaging than the former.

In any event, the fact that Democrats are pushing for a bipartisan solution suggests they do not have the votes in the Senate while negotiating the broader $3.5 trillion spending package.

How Could it be Resolved?
1. Republicans cave in and vote to suspend the debt ceiling in a bipartisan vote;
2. Democrats use reconciliation to include raising the debt ceiling in a partisan vote;
3. With the government set to partially shut down on October 1, Republicans and Democrats pass a Continuing Resolution with suspension of the debt ceiling included;
4. A compromise is reached between the Republicans and the Democrats, leading to a bipartisan vote.

What are the Key Dates to Consider?
- September 30 – End of fiscal year; partial government shutdown if a Continuing Resolution is not passed.
- October 18 – Treasury Secretary Janet Yellen's estimated "X-date" wherein the U.S. Treasury runs out of cash and other available extraordinary measures required to meet obligations.

What Does All of This Mean?
Markets so far are ignoring the risks around the debt ceiling showdown. If history is any guide, market perception of the associated risks may rise as we get closer to the deadline, when the Treasury runs out of extraordinary measures. Market volatility could also increase as a more precise date comes into view. While an accident is always possible, it's highly unlikely lawmakers intentionally go down the path of default.

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