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US debt ceiling standoff nearing climax May 2023

- The debt ceiling is the maximum amount of debt that the US government can take on and is set by the US Congress. This limit means the US government may soon run out of cash to spend, indeed Treasury Secretary Yellen stated this may happen as early as 1 June.
- Market volatility has risen in recent days as negotiations for a deal to increase the ceiling stalled. If a deal to increase the limit is not agreed soon, this could increase the risk of the US government defaulting on their debt.
- While short-term volatility may persist, the highly probable scenario is that a deal is reached in the next few weeks with limited long-term impact on asset prices.

What is the US debt ceiling?

The debt ceiling is the total amount that the US Federal government can borrow to pay its obligations such as social security and healthcare spending or its employees' wages, but also to service its debt. Congress is responsible for setting and raising the debt limit which is currently at \$31.4tn and is normally increased every few years. This means that whenever Congress and the Presidency are controlled by different political parties there tends to be a standoff and a high level of brinkmanship as the two parties seek to agree spending concessions.

The \$31.4tn figure was breached in January this year, which means that since then the government has resorted to various "extraordinary measures"1 to make payments. Initial estimates from the Congressional Budget Office (CBO) projected these measures would last until the third quarter of this year, but the CBO and Treasury Secretary Janet Yellen now expect the US could run out of funding by early June due to smaller-than-expected April tax receipts.

What could happen next?

The expectation is that after a series of political wranglings, a deal between the Republicans and Democrats is reached and Congress votes to increase the debt ceiling. However, if the debt ceiling is reached, and other spending measures exhausted, the US government will have to limit spending. In the past, this has meant a government shutdown where Federal employees are asked not to come to work. Other spending such as social security payments could also be suspended. It is likely that debt and interest payments on Treasury bonds will be prioritised, however there is a small possibility of a default on either coupon payments or the principal on short-dated bonds that are due to mature within the next few months.

Other more left-field options for the government, if a deal cannot be reached in time, include the Treasury minting a \$1 trillion coin and depositing it at the Federal Reserve or President Biden enacting an untested legal fiddle by using the 14th amendment which may deem the debt ceiling unconstitutional. Both options are untested and are therefore unlikely to be used.

^{1 -}Extraordinary measures are accounting manoeuvres on the government's books and records that have little to no impact on fiscal policy or economic growth. The use of extraordinary measures is part of the Treasury department's "playbook" for debt ceiling episodes. They allow for issuance to continue but can only create a finite amount of capacity that will eventually be exhausted." (Source: Northern Trust).



How are markets reacting?

The US government bond market is the world's largest debt market and is used heavily throughout the global financial system in a variety of ways whether as a safe store of spare cash, as a benchmark yield for lending rates or as collateral to back loans. A political misjudgement leading to a default would have serious implications going as far as threatening the dollar's positions as the global reserve currency.

Although investors' expectations are still that a deal should be reached, the uncertainty around this has had an impact on markets. On 24th May a short-dated US government bond, or Treasury Bill, due to expire on 30th May this year was yielding 3.12%. Another bond, maturing two weeks later, on 15th June, but importantly after the crucial 1st June date,



and therefore at risk of default, was yielding 6.21% (higher yields means lower prices). Looking a bit further out to bonds maturing in two months' time and the yield is back down to around 5%. Investors are clearly trying to avoid holding bonds that mature around a possible debt ceiling date and piling into bonds that mature beforehand (see chart).

If the worst were to happen i.e. a default, the fallout could be widespread with large drops in equity markets likely. The fate of US Treasury bonds is less clear. Despite being the assets at risk of default, Treasuries' status as the ultimate safe haven asset could lead to a rally in the price of these bonds alongside the dollar. However, it is important to remember that default is still deemed to be a low probability event. We expect market volatility to be heightened over the next couple of weeks until this is resolved, but our expectation is that a last-minute deal is struck and the impact on financial markets is short-lived.

What does this mean for HRIS portfolios?

We are not making any portfolio changes due to the US debt ceiling stand-off. We are long-term strategic investors and we adopt a portfolio construction process which includes portfolios being scenario tested against a broad range of economic scenarios. This testing, along with our qualitative assessment from our experienced investment team, gives us confidence that our investment strategies are robust, and portfolios should offer positive outcomes for investors over the long-term.



Jack Richards Investment Manager

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HYMANS ROBERTSON INVESTMENT SERVICES

London | Birmingham | Glasgow | Edinburgh

T 020 7082 6000 | hymansinvestmentservices.co.uk

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