Aegon Asset Management

Macro Research
May 2023

AEGON **INSIGHTS**

The US debt ceiling: Navigating a potential default

- *Prior US debt ceiling showdowns have been resolved in time to avoid a default, is this time different?*
- *We estimate a selective default is in the range of a 33%-50% chance of occurring.*
- *We think the US will avoid interruption of principal and interest, and presumably avoid a default event in US Treasurys.*

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Calvin Norris, CFA, is a rates strategist responsible for guiding the firm's interest rate strategy. He is also a portfolio manager responsible for the overall strategy, portfolio management, and trading of money market, short-term cash and ultra short duration portfolios, as well as a portfolio manager responsible for the overall strategy and portfolio management of short-term plus, government bond and US Treasury strips portfolios. Prior to his current role, Calvin held various responsibilities within the firm including managing and trading structured products, developing the money market and enhanced cash strategies, and securities financing activities. Calvin's experience also includes the development and evaluation of new insurance product initiatives, financial derivative applications, managing the public bond portfolios for several Transamerica business units, and the analysis of healthcare, pharmaceuticals and retail industries for the investment grade and high yield corporate bond portfolios. He has been in the industry since 1992 and started with the firm and its affiliates in 1992. Calvin received his BBA and his MBA from the University of Iowa. He is a CFA® charterholder.

US debt ceiling negotiations

The US Treasury is currently limited on how much debt it can issue due to a federal law capping that amount. Given persistent budget deficits, this debt limit must be periodically raised by Congress so the US Treasury can continue to fund ongoing government expenditures. At some point, without the ability to issue additional debt, the US would be unable to pay expenditures otherwise authorized by Congress, potentially including repayment of principal and interest on existing US Treasury debt. For over a decade, Republicans have sought to use the need to raise the debt limit as a bargaining chip to obtain spending cuts to the US budget. Democrats have historically been unwilling to make such spending concessions, instead daring Republicans to force a default by the US government; a classic game of "chicken".

In the past, Republicans have decided each time to raise the debt limit without obtaining any spending concessions, thereby avoiding a US default. Presumably, this is what will happen again. Although this time, the Republican Speaker of the House, Kevin McCarthy, has far less control over his caucus than past speakers. To obtain his gavel last year, he had to win over a large swath of far-right holdouts within his caucus. To do this, he agreed to allow any single member of his caucus to prompt a vote of "no confidence" challenging his speakership. Furthermore, because many in his caucus have never voted to raise the debt ceiling, the Speaker's ability to negotiate effectively is limited. Said another way, if Kevin McCarthy were to allow the debt ceiling to be raised without spending cuts, it very well could be the last thing he does as Speaker of the House of Representatives.

For this reason, we believe the odds of some form of selective default by the US government is much higher now versus previous occasions. Although difficult to handicap, we estimate a selective default is in the range of a 33%-50% chance of occurring.

When the US government will run out of money is a now a function of how much

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tax revenue it receives in the coming months. Recent estimates suggest the US government may be forced into some form of default as early as June with the potential to occur in July or August, or even as late as September, depending on how tax receipts evolve. Secretary of the Treasury recently sent a letter to Congress indicating there is a substantial risk this "X-Date" could come as early as June 1, although the exact timing of when the Treasury runs out of money remains unclear.

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Implications of selective default of US Treasury debt payments

As far as what a selective default would look like, there are a couple of factors in play here, the first of which is the 14th Amendment to the Constitution, which states: "The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned…"

We believe this would provide ample constitutional cover to allow/require the US Treasury to continue to pay principal and interest on existing US Treasury debt. However, the US Treasury could withhold all payments that are not debt related. These other payments would include Social Security benefit payments, Medicare/ Medicaid payments, wages to government employees (including members of Congress, TSA employees, members of the armed forces, etc.), tax refunds, and payments to government contractors. Because the US government would still be collecting taxes, it should have sufficient ability to cover interest payments and roll existing maturities, thereby avoiding any interruption of principal and interest, and presumably avoiding a default event in US Treasurys.

So even if the Biden administration does not explicitly attempt to invalidate the debt limit as unconstitutional based on the 14th amendment, our base case for any default by the US government is the Treasury would withhold payments on non-debt obligations. As a result, we view the risk of any interruption to scheduled payments of principal or interest on US Treasury securities as extremely low.

Given a large portion of outstanding US Treasurys is held by foreign governments, such an approach by the US Treasury also implies the US government will be paying foreign nations like China before it pays its own people. It's highly unlikely this will go over well with the average person in the US. This should, in turn, spur Congress to action and make such a selective default very short-lived.

Market implications

Treasury bills (T-bills) are often a canary in the coal mine for the rest of the market related to both risk and timing of a potential default. In past debt ceiling showdowns, investors have avoided T-bill maturities surrounding those periods with the highest risk of payment interruptions. Last week's US Treasury auction of 1-month T-bills maturing June 4, 2023, cleared at a yield of 5.84%, whereas 2-month T-bills cleared at 5.40%. This strongly suggests investors are growing increasingly worried about the potential for a default.

Historically, the possibility of a US default not only impacted T-bill maturities around potential default dates, but also prompted a modest flight to quality. This resulted in equities selling off, Treasury yields lower, and investment grade/high yield spreads wider. We expect something similar this time around, with volatility potentially higher than in the past, much more so if the US Treasury is forced into some type of selective default (i.e., halting non-debt expenditures).

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