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60-second summary

US debt ceiling debacle: scope for heightened yield volatility and worse

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As US debt levels reach the ceiling of $31.4trn, a potential default by the US on its government debt is an increasing concern. While a US default may still be unlikely, the ongoing political impasse between Democrats and Republicans could increase market volatility, particularly in sovereign bond markets.

Background

The US technically breached its $31.4trn debt limit in January, which means the government cannot technically issue any new debt. Since then, the Treasury has been using various ‘extraordinary’ measures to pay the government’s obligations on time. The exact date at which the US will run out of funds is highly uncertain, as it’s dependent on the timing and amount of incoming federal tax receipts. Treasury Secretary, Janet Yellen, suggests a technical default could occur as soon as early June, while the Congressional Budget Office has suggested that extraordinary measures would likely be exhausted sometime between July and September.

The US has only technically defaulted once, in 1979, due to a word-processing backlog delaying the payment of US Treasury bills. In total, the debt ceiling has been raised by Congress 78 times since 1960. However, due to the partisan impasse, it looks like the raising of the debt ceiling could go down to the wire, something seen in 2011, 2013 and 2021. In each of these instances, a default was averted by Congress voting to raise the ceiling.

Democrats want to raise the debt ceiling without any conditions imposed in order to pay for fiscal decisions previously made by lawmakers. Republicans, meanwhile, are insisting on spending curbs and other conditions being attached to any debt limit increase. The current ultra-partisan nature of US politics has seen the market starting to reflect concerns that a political compromise might not be reached. One-year US credit default swaps (CDS) spreads have widened to 155 bps as of 5 May 2023, versus 18 bps on December 31, 2022. Spreads on 3-year and 5-year US CDS spreads have widened by 70 bps and 42 bps, respectively, during the same time period. On 14 May, credit rating agency, Fitch, placed the US’s AAA sovereign credit rating on a negative outlook due to “increased political partisanship” hindering talks to resolve the looming fiscal crisis.

What options do the US Federal Reserve and Treasury have?

If the debt ceiling is not raised, many market commentators expect the US Federal Reserve (the Fed) to follow the protocol drafted in 2011, where debt and interest payments were prioritised over federal employee salaries, social security and military benefits, unemployment insurance, and other federal obligations.

The Fed also has contingency plans in place, via money-market operations, to deal with market disruptions in the event of default. It has also been suggested that the Treasury could avoid default by selling gold, issuing new debt, or by minting a large denomination coin, which would then be deposited at the Fed and used to pay federal obligations until the debt ceiling is raised.

However, even if any of these options avoided default, they'd have an adverse impact on the economy and markets.

The market impact

A default on US Treasury Bond payments would have a severe impact on markets and dramatically increase volatility. It's likely that Congress would be forced into action to resolve such a situation, but the US economy and markets would not escape unscathed, and the payment prioritisation protocol outlined above would also have a material impact on the US economy.

The impact on yields is potentially ambiguous, at least initially. A default would probably cause a degree of forced selling, placing upwards pressure on yields, which may lead to upwards pressure on the yields of other major advanced economies. However, breaching the debt ceiling would necessitate massive cuts in government expenditure (with some estimates expecting as much as a 25% cut). The negative impact on the US economy and the deep recession that would follow, and the subsequent impact on the global economy and markets, would lead to risk aversion. This, alongside expectations of slowing growth and inflation could, paradoxically, drive longer-dated yields lower.

Concerns over a default have been mostly reflected in short-term treasury yields, so far: 1-month treasury yields have risen over 2% pa over the last few weeks – far in excess of any move explainable by changes in the anticipated path of monetary policy. Longer-term treasury yields have been largely unscathed, probably owing to the assumption that an actual default would prompt swift action from politicians to resolve the situation. However, as treasuries are extensively used as collateral by traders and company treasurers, a government default could cause companies to miss payments to each other and cause a wide variety of financial contracts to collapse. Yield and currency volatility and plunging risk asset prices would both have scope to negatively impact funding levels, at least in the short-term.

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