Here we go again! It's time for another debt ceiling crisis

The U.S. federal government has reached its debt ceiling. In the wake of this, the cost of insuring against a U.S. default has jumped. Can the U.S. actually default? With what consequences for the markets?

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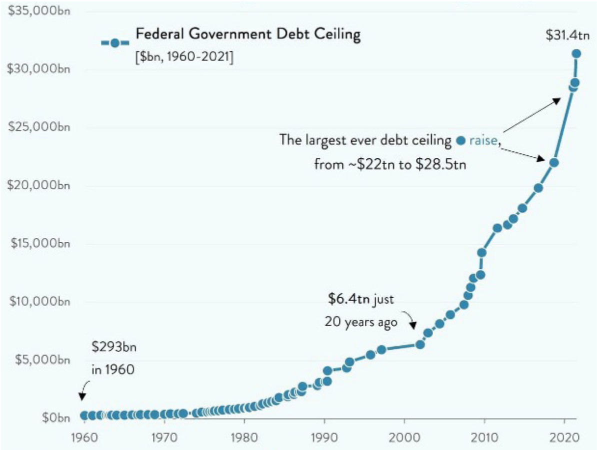
What is the debt ceiling?

Set by Congress, the debt ceiling is the maximum amount the federal government can borrow to finance the obligations that elected officials and presidents have already approved.

The ceiling, which currently stands at $31.4 trillion, was created over a century ago. Since 1960, Congress has raised or extended the debt ceiling 78 times, including 29 times under Democratic presidents and 49 times under Republican presidents.

A history of the US debt ceiling since 1960



Source: chartr

Prior to 1917, Congress authorized the issuance of individual bonds to supplement tax revenues to finance specific expenditures. But after World War I, Congress authorized the U.S. Treasury to issue bonds as it saw fit, although it was limited by a debt ceiling. The legislative branch thus ceased to micromanage the issuance of Treasury bonds that finance spending (leaving that function to the executive branch) but retained its authority to ensure the distribution of powers by limiting the total amount of debt issuance, and must still authorize federal spending (source: Lyn Alden).

Raising the debt ceiling itself does not authorize new spending; it simply allows the government to continue to pay its previously authorized spending obligations. Not raising the debt ceiling means that the government must either: 1) not pay previously authorized spending obligations or; 2) default on its national debt, which has accumulated over time.

In other words, the idea of a budget constraint is relevant when deciding new spending and tax plans, but it is not relevant in debt ceiling disputes over past spending plans.

Although originally designed to facilitate federal government borrowing, the ceiling has become a means for Congress to limit the growth of borrowing, making it a fiscal policy issue for the past few decades.

What happens if the US defaults on its debt?

The U.S. federal government is monetarily sovereign. In theory, it should never default on its debts, since it can print the currency in which its debts are denominated.

In the last century, when dollars were backed by gold, the United States could potentially run out of gold and default. But since the fiat currency era (1971), the U.S. government cannot run out of dollars that it prints itself.

However, the federal government can still default on its debt because of self-imposed legal constraints, which has happened once under the existing fiduciary system. In 1979, the Treasury experienced a brief default when it failed to make timely payments to bondholders due to a combination of political gridlock and computer systems failure. After a delay, these payments were actually made. So this was a relatively minor default.

The U.S. government has come close to similar technical failures on several occasions since then. In 2011, the S&P Global Ratings agency cut the U.S. government's credit rating from AAA to AA+. To this day, the U.S. remains lower rated than some countries (notably Switzerland).

In addition, when the debt ceiling is reached, the U.S. Treasury still has a few options. First, it has a primary cash balance that it holds at the Fed. They can reduce that balance to zero before they actually run out of money. They can also engage in inter-governmental borrowing, which means reshuffling the accounts. Another option is to invoke the 14th Amendment.

When it runs out of options and reaches the threshold of available cash, the U.S. Treasury must then prioritize what it wants to continue to pay on time and what it is delaying or defaulting on. In this case, tax revenues would continue to be collected, but they would not be sufficient to cover current spending without a new issue of Treasury securities. With the debt ceiling legally preventing them from issuing new net Treasury debt, defaults on various bonds would begin to pile up.

The implementation of extraordinary measures

In letters to House Speaker Kevin McCarthy, Treasury Secretary Janet Yellen wrote that she expects the extraordinary measures put in place to avoid default to last until early June, while noting that there is considerable uncertainty around that forecast.

Yellen plans to sell some investments and suspend reinvestments of some government funds that are included in the debt limit. These actions would reduce the amount of outstanding debt subject to the limit and continue to temporarily fund federal government operations.

Will Congress raise the debt ceiling?

Political conflicts have increased in the United States, especially after the mid-term elections, with both parties ending up with a slim majority in Congress (Republicans in the House and Democrats in the Senate).

Nevertheless, there is historical precedent for Congress to reach a "last minute" debt ceiling agreement, usually with concessions from both sides. Since 2001, the debt ceiling has been raised 20 times. The Treasury Department had to resort to extraordinary measures in six of these impasses before Congress reached an agreement.

Recent clashes in the Speaker of the House of Representatives election have raised concerns about McCarthy's ability to bring together the most hard-line Republicans (who see a potential default as a way to force the government to cut spending) and to negotiate a deal with Democrats, who oppose any cuts.

For now, Mr. McCarthy is leaning towards spending cuts and has rejected calls from Democrats for an outright increase in the debt ceiling without any conditions. The White House has countered that it will not offer any concessions and will not negotiate an increase in the debt ceiling. In the meantime, House Republicans are preparing contingency plans that would tell the Treasury Department which payments to prioritize if elected officials fail to agree on the debt ceiling.

While we can expect heated debates in the coming months, we believe that a solution on the debt ceiling will be found, most likely at the last minute around July.

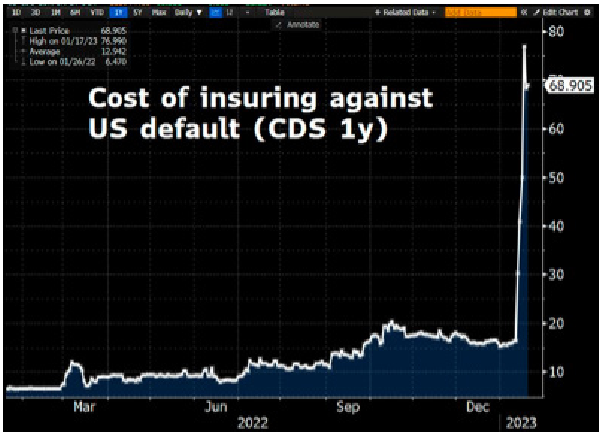
The $1 trillion platinum coin loophole

In addition to using extraordinary measures or invoking the 14th Amendment, the President may also direct the Secretary of the Treasury to mint a single platinum coin with a face value of $1 trillion and deposit it with the Federal Reserve. The Treasury would then be able to continue to meet its payment obligations. If the trillion dollar coin trick is used to avoid a default, the debt ceiling is then raised by Congress and debt is issued to finance the redemption and retirement of the coin, the financial system could return to normal.

What are the consequences for the financial markets?

On Thursday, when the U.S. debt ceiling was effectively hit, the cost of insuring against U.S. default jumped; the price of one-year CDS is now trading at 69 basis points.

1-year US Treasury CDS



Source: Bloomberg

From a market perspective, while previous debt ceiling events have always made headlines, they have never had a major impact on medium/long-term stock performance.

In recent, more serious episodes of debt ceiling debate, including 1995, 2011 and 2013, markets reached higher levels in the 12 months following the debt ceiling resolution. Market performance tends to be driven more by economic fundamentals and earnings than by the vagaries of U.S. politics.

S&P 500 performance 1 month and 12 months after previous debt ceiling events (1995-1996, 2011, 2013)

Event	Dates	Performance, During Standoff	Performance, 1 month after	Performance, 12 months after	Notes
1995 Debt Ceiling Standoff	Oct 1995 - Mar 1996	10.0%	1.3%	19.9%	Two periods of government shutdowns (5 and 21 days)
2011 Debt Ceiling Standoff	May 2011 - Aug 2011	(5.2%)	(6.9%)	10.4%	S&P downgrades U.S. credit rating from AAA to AA+
2013 Debt Ceiling Standoff	May 2013 - Oct 2013	3.2%	4.5%	8.2%	Government shutdown for 16 days
Average		2.7%	(0.4%)	12.8%	

Source: Edward Jones, Bloomberg

It is likely that if the U.S. government were to default on its debt obligations, significant market disruptions could occur, including a loss of confidence in U.S. bonds and the dollar, a sharp rise in yields, and an inability to perform essential functions such as maintaining national defense. From our perspective, the likelihood of such a scenario is extremely low.

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