Markets in a Minute:
The Federal Debt Ceiling Debacle

While today's debt ceiling debates seem to mark a new level of acrimony and discord in Washington, they are not unlike debates our founding fathers once had. Alexander Hamilton, charged with tackling debt of $80 million from the Revolutionary War with just $4.4 million in revenues, argued that this was an opportunity for our young country. "A national debt," he argued, "if it is not excessive, will be to us a national blessing."

With a series of measures, sometimes painful, sometimes remarkably forward-looking, he made the U.S. government a credible borrower and that creditworthiness quickly became a bedrock of the American economy.

Could this be the first time in history that the U.S. defaults on its payments and challenges Hamilton's legacy? How does the economic landscape shift if we default? Let's find out in this edition of *Markets in a Minute*.

If you're unsure of what the debt ceiling is and why it's an issue, be sure to check out our previous article on the debt ceiling from February 13, 2023 to set the stage for our current conditions. The article can be found at:
https://www.viaggiowealth.com/market-update/markets-minute-debt-ceiling

Where We Are Now

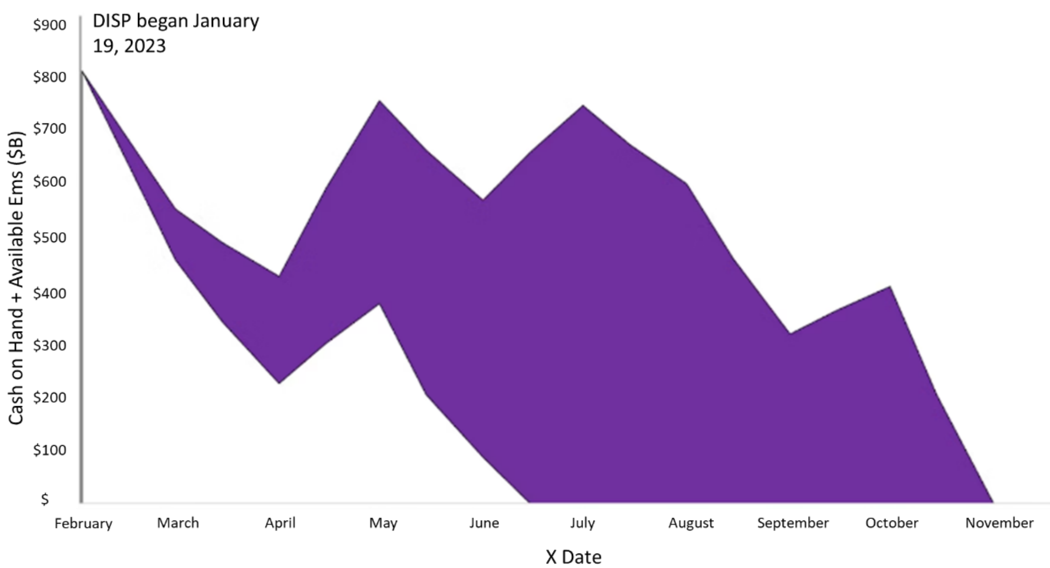
Back in January 2023, the US government officially hit its debt ceiling, meaning it could not increase the amount of debt it takes on. Since then, the Treasury Department has been using "extraordinary measures" to keep the government running – carefully issuing just enough debt to offset bonds that are maturing to remain below that proscribed ceiling. In the meantime, there has been very little progress toward resolving the political impasse, leaving the U.S. on the brink of default.

Sometime in the next few months, the US government will officially exhaust its extraordinary measures and run out of funds to continue paying its obligations, which include outstanding debt as well as payments like Social Security checks. That "cliff", also known as the "X date", depends partly on the size of tax payments made by individuals and corporations which can vary significantly from year to year. US Treasury Secretary Janet Yellen recently announced we could approach that impasse as soon as June 1.

Other estimates of the "X date" vary somewhat. The Bipartisan Policy Center, for instance, estimates the government will run out of funds sometime in the summer or early fall of this year, absent Congressional action - though even they admit a wide range of possible outcomes.

Possible X Dates

Range of possible days on which the federal government will run out of money to pay its obligations, based on projected government cash flows.



Source: [Bipartisan Policy Center]

While Republicans did introduce and pass a bill in the House that would raise the debt ceiling—that bill also mandated $4.8 trillion in spending cuts. Republicans have good reason to pursue this tactic: back in 2011, they successfully got Democrats to agree to budget cuts just three days before the U.S. was expected to default. Democrats, on the other hand, are attempting to stand their ground and have refused to link spending cuts with raising the debt ceiling.

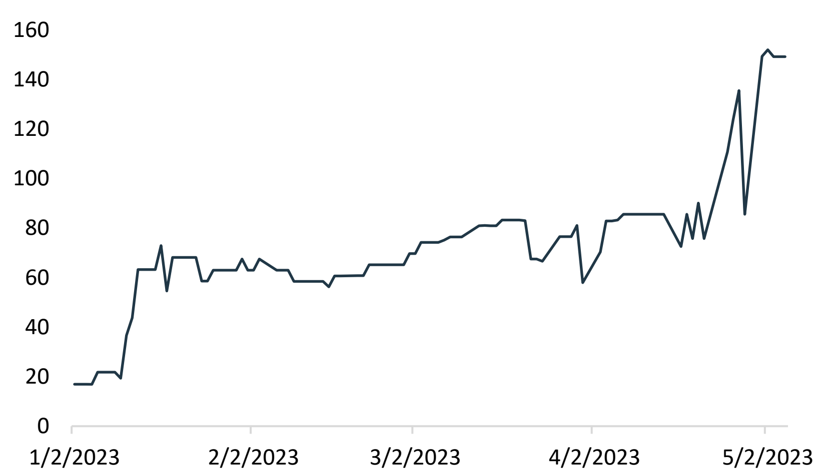
What Happens If the Debt Ceiling is Not Raised?

Quite simply, if the two sides of the aisle are unable to reach an agreement, the debt ceiling would not get raised and the U.S. government would default on its debt. We've already seen evidence of market stress correlated with debt ceiling tensions, both now and previously when the debt ceiling was being approached.

Yields on Treasury bills with maturity dates around the "X-date" have increased noticeably – directly increasing the cost of borrowing for the government and thus the cost to taxpayers. Since the middle of April, yields on short-duration Treasury bills around the expected "X-date" have increased by nearly 1 percentage point, or roughly 20%.

The cost of insuring U.S. debt has also risen substantially and is now at an all-time high, reflecting increased worries about a U.S. default. In fact, credit default swaps (CDS) spreads – the insurance premiums that must be paid to insure U.S. debt – started to increase dramatically in April.

One-Year U.S. Government Bond Insurance Premiums



Source: Kestra Investment Management, with data from FactSet. Index: United States 1 Year Sovereign CDS Spread USD. Data as of May 5, 2023.

Moody’s Analytics provides a detailed analysis of five possible outcomes to the debt ceiling debate, which range from a straightforward increase of the debt ceiling to a prolonged breach in which government spending needs to be slashed by $350 billion, sending the economy into a tailspin.

The more onerous paths highlight that not raising the ceiling would be so undesirable that neither Republicans nor Democrats will want to be blamed for the fallout. Like a game of chicken - where two participants hurtle toward each other - it’s in both players’ best interests to swerve away and avoid a head-on collision - yet you can only win by not swerving.

Despite some stress in the market, most professional investors believe that legislators will come to a resolution in time. According to one survey by research firm 22V, a full 88% of professional investors polled believe that the US government will not default on its debt. One likely outcome is that Congress agrees to a one- to two-year extension of the debt ceiling, meaning we get past this current situation but can look forward to another round in the not-too-distant future.

While Washington, DC may seem more acrimonious than ever, rest assured that debt ceiling showdowns are well-trodden territory. As Aaron Burr sings in the musical Hamilton, “no one really knows how the parties get to yes,” but 78 times in the last 63 years Congress has been able to come to a resolution. And even on the most difficult of those occasions, financial market impacts have been short-lived.

(see the next page for important disclosures)

Important Disclosures

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