political debate with each party using the threat of default as a means of negotiation for alternative – and often unrelated – policy directives. While both sides have been guilty of utilizing this practice, Republicans are leading the debt ceiling challenge this time around. President Biden and top Democrats have called for a "clean" debt limit increase, while House Republicans want any increase to be linked to spending cuts.

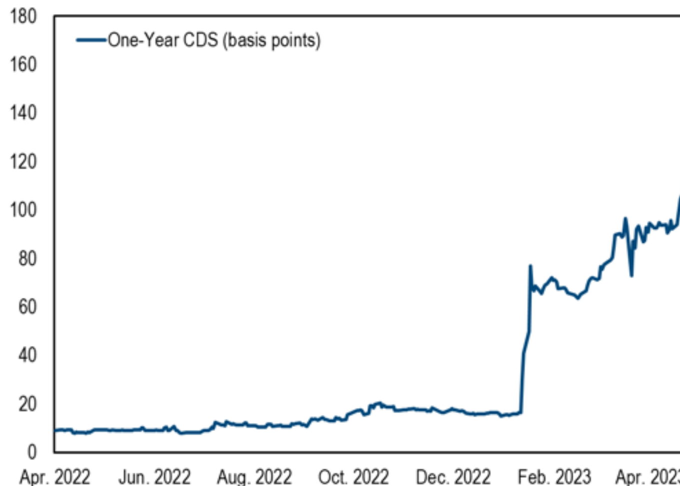
WHAT REPUBLICANS PROPOSE

On April 19, House Speaker Kevin McCarthy introduced legislation that would allow for an increase if certain conditions related to curtailing long-term debt and reducing the administration's climate change agenda were met. According to reports, in exchange for agreeing to raise the debt limit, Republicans demand that any unspent – but approved – COVID-19 funding be recalled. McCarthy's debt-ceiling increase legislation also aims to ease the Biden administration's energy regulations and clean-energy tax breaks, as well as implement work requirements on adults without children who receive food stamps and Medicaid.

The proposal would furthermore limit growth in – particular areas of – government spending from 2022 levels, thus arguably reducing future government outlays and deficits. However, given the massive size of the government's balance sheet, while a welcome step for those seeking fiscal order, any single statute can hardly be expected to have a material impact on the longer-run trajectory of the nation's debt.

AT RISK?

The clock is ticking for officials in Washington to reach an agreement on the debt ceiling, but according to market metrics, despite the dwindling timeline, investors remain convinced a deal will be met. Even with the "hype" and political theater, market participants appear largely immune to partisan showdowns involving the debt ceiling, taxes, or other spending-related issues.



Source: Bloomberg

That being said, some investors are growing – at least somewhat – more concerned that this time things may play out differently than in the past. According to Bloomberg data, the 3-month Treasury bill yield hit a new 22-year peak of 5.32% on April 20, currently trading at 5.11% as of 9:09 a.m. ET. While reflective of a rapidly rising federal funds target rate as the Federal Reserve seeks to tame inflation, the premium may also be an indication of an elevated default risk.

Additionally, credit default swaps (CDSs), a form of insurance against a borrower not making full or on-time payments on their debt, rose to the highest level since the financial crisis. Up 141 basis points (bps) since the start of the year, the cost of insuring U.S. debt against default is over 150 bps, according to Bloomberg data. Spreads on five-year CDSs have also widened more than 30 bps since the start of the year.

GLOSSARY

CDS – Credit Default Swaps

EOP– End of Period

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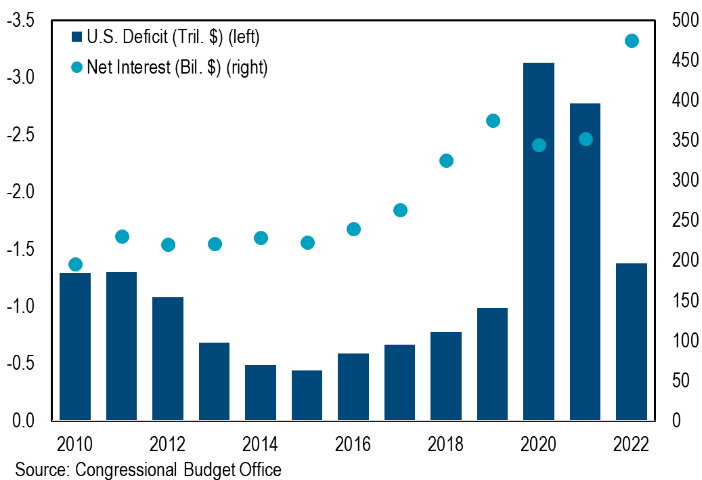
END GAME

If the United States defaults, it would struggle to restructure its debt. Investors may have to wait longer than expected or agreed upon to receive full payment, or they may be forced to take a partial payment with some loss of interest or principle. That being said, default is still a highly unlikely scenario. The consequences of a default would have significant – negative – implications for future Treasury issuance and the government's ability to function properly, an outcome officials on both sides of the aisle should want to avoid.

Under the scenario of default, the U.S. government would still need to run the country, and subsequently would need additional funds. However, amid declining or an outright loss of confidence, buyers of U.S. debt would require additional compensation. Higher rates, of course, make it increasingly more expensive for the government to operate even at a reduced capacity. A default of any kind would also likely lead to a rating downgrade, or at least negatively impact the country's credit rating. Recall in 2011, amid a fierce showdown between Republicans and the Obama administration, Standard & Poor's downgraded the government's credit rating for the first time in history from AAA to AA+.



Source: Congressional Budget Office

Additionally, a failure to reach an agreement to raise the debt ceiling could send shockwaves through an already fragile financial system, still reeling from the recent collapse of Silicon Valley Bank and others. Banks, in particular, are large purchasers of U.S. bills and bonds. A delay in payment or only partial payment could spark insolvency issues, potentially leading to additional failures of individual institutions or worse, a systemic breakdown.

RESOLUTION

While the endgame agreement is likely to be made in the eleventh hour behind closed doors, an agreement for all intents and purposes will be made. There is simply too much at stake. Despite the difference in politics, both Republicans and Democrats agree the U.S. government must 1) be allowed to continue to function properly, and 2) repay its debts. Without confidence in – and evidence of – the government's ability to meet these goals, the safety and soundness of the nation's debt is undermined.

Of course, stringing along the process with both sides issuing ultimatums and proclamations, the mere threat of default – even if not ultimately realized – can have lasting implications. Prolonging the process with a consistent warning of potentially no deal can act to undermine the – global – perception of dollar assets and destabilize the flight to quality trade, particularly in today's environment of international uncertainty and war, as well as amid a growing movement to overthrow the U.S. dollar.

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[1] *Estimates vary widely with some suggesting the deadline could be as far off as November.*

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