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WASHINGTON POLICY STRATEGY

Potomac Perspective

There are still significant hurdles that need to be cleared before a debt ceiling deal can be reached, but mixed signals on the most recent round of talks lean to the positive. Equity markets seem to expect a deal. If the positive tone from Washington is misleading, or if talks break down, then equities could sell off. Investors should remain cautious pending more clarity on the progress of negotiations.

There is still no agreement on a debt ceiling bill or even on a framework for the legislation. However, on balance, the mixed signals now emanating from the principals have turned slightly more positive than negative.

THE POSITIVES

There were two notable positives on Tuesday:

1. The White House is tabbing Shalanda Young, the Director of the Office of Management and Budget, and Steve Ricchetti, Counselor to the President, to lead negotiations with Speaker Kevin McCarthy and his team. In our opinion, Director Young and Mr. Ricchetti both enjoy good relations with congressional Republicans, which could be beneficial in talks.
2. President Joe Biden is shortening his upcoming trip to Asia. This suggests that White House understands the time sensitive nature of the situation, and the president's early return is probably necessary to finalize an agreement.

THE NEGATIVES

1. Speaker McCarthy noted that the two sides are still far apart.
2. Relatedly, McCarthy noted that enhanced work requirements for some safety net programs are a line in the sand. Earlier, the White House had backed away from signals that the administration might be open to some changes in this area. This could be a sticking point for congressional Democrats who oppose any changes to safety net-related work rules.
3. While both sides have said they are open to energy permitting reforms, the devil will be in the details. Energy permitting is a complex issue that is not given to a simple legislative fix. Reaching an agreement could be difficult and might hold up a potential deal.

Investors should remain cautious as significant differences still separate the two sides. Time is of the essence as a possible X-date in early June draws closer. Some signs from Washington on Tuesday, however, indicate that the direction of talks is more positive than it has been in recent weeks.

If today's positive vibes turn negative and talks stall, equity markets could sell off. Current price action in the market seems to reflect the view that investors believe Washington will reach a deal and avert a default. If this confidence is misplaced, it could lead to a risk-off reaction.

We reiterate our view that **the chance of a default on U.S. Treasury debt is remote**, as the Treasury Department should be able to prioritize payments to bondholders. The status of other obligations (i.e., Social Security, government payrolls, and payments to contractors and vendors) is less certain and could cause economic disruptions even in the absence of a debt default.

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Depending on how much longer a debt ceiling negotiations take, **a downgrade in the credit rating for U.S. government debt by the credit rating agencies cannot be ruled out**.

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