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Is a US debt ceiling crisis on the cards?

Negotiations are headed for a late resolution given the narrow Republican House majority, an emboldened Freedom Caucus and a split Congress. This could lead to higher market volatility as we near the X-date, but ultimately a resolution remains the most likely outcome.

Key Takeaways

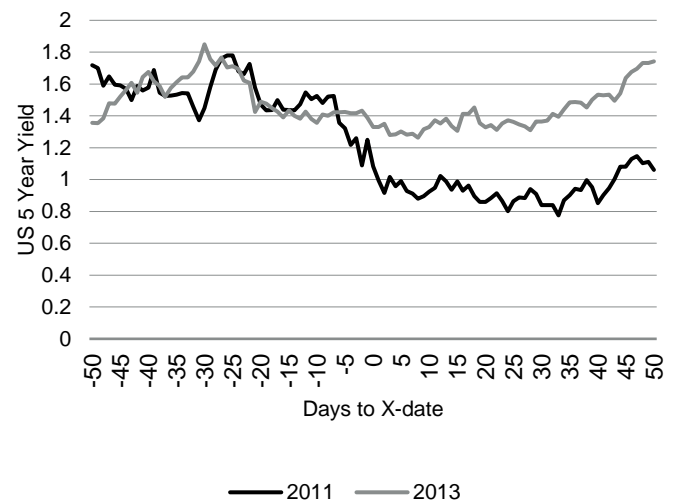
- Debt ceiling negotiations have become increasingly contentious, leading to higher market volatility.
- The narrow Republican House majority, an emboldened Freedom Caucus, and split control of Congress mean negotiations are likely going down to the wire.
- The economic impact of our base case will depend on the spending concessions made by the Democrats, but we do not see this significantly altering the outlook.
- If an agreement can't be found ahead of the X-date, this would likely lead to US debt downgrades, a large equity market correction and a deeper, more protracted US recession.
- A challenge to McCarthy's speakership, a clear deterioration in the state of the negotiations (including widespread 'X-date denial'), or an earlier X-date would increase the likelihood of a debt ceiling crisis.
- While investors should be cognisant of the possibility for higher volatility as we near the X-date, an eventual resolution should mean the impact on markets is short-lived.

What is the debt ceiling and why does it matter?

The debt ceiling sets a limit on the amount that the US Treasury can borrow, currently set to \$31.4 trillion. As the government approaches this ceiling, Congress needs to pass legislation to increase it, so Treasury can continue to meet its spending obligations via borrowing.

Prior to reaching the X-date, the point at which the government has exhausted its cash balances and cannot continue to borrow, the treasury secretary typically begins extraordinary measures which curtail spending to allow time for legislation to pass.

Figure 1: Debt ceiling crises have consequences for markets



Source: Bloomberg, abrdn, March 2023

Currently, the X-date is expected to fall between June and September. The tax season in April will help determine the exact date. The Treasury has already begun extraordinary measures following an announcement from Treasury Secretary Yellen on 13 January. However, these are not a solution to the debt ceiling issue.



Markets tend to be volatile around debt ceiling negotiations

Over recent history, debt ceiling crises have been flashpoints for market selloffs and increased volatility, with negotiations often going down to the wire.

During the 2011 debt ceiling negotiations, a deal wasn't found until 31 July, just ahead of the 2 August X-date. Equity markets declined around 6.5% in the week prior, and Treasury yields fell by a further 30bps, responding to the S&P downgrade to US debt.

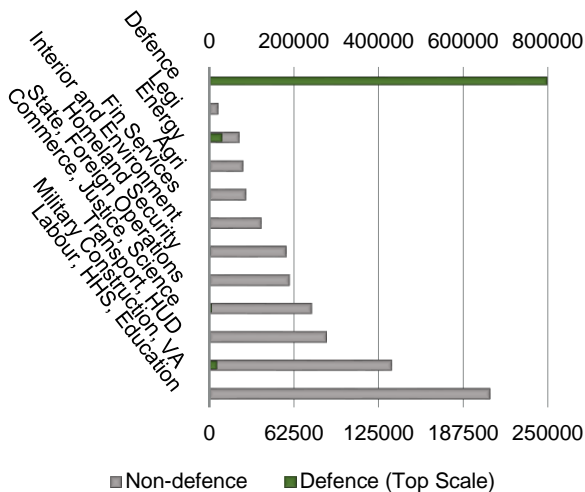
The market reaction in 2013 was much more muted. This may have been because issues in 2011 were ultimately resolved, or because continuing resolutions were used to push back the X-date.

Early signs point towards a late resolution

The current make-up of Congress raises the risks of a debt ceiling crisis. The Republicans have an extremely narrow majority of four in the House. Split control of Congress has historically indicated higher risks around fiscal events.

Traditionally, Republicans will try to reduce the spending of Democrat-controlled governments, using the debt ceiling as a point of leverage. A four seat Republican majority in the House has amplified the importance of the right of the party, loosely aligned to the Freedom Caucus. Estimated to number around 40, they are unlikely to support any increases to the debt ceiling without significant concessions.

Figure 2: Republicans will focus on cuts to discretionary non-defence spending



Source: Consolidated Appropriations Act 2023, abrdrn, March 2023

This group has utilised blocking tactics to amplify their influence. To win the speakership, McCarthy agreed to concessions on policy and process that undermine his ability to make bipartisan compromise.

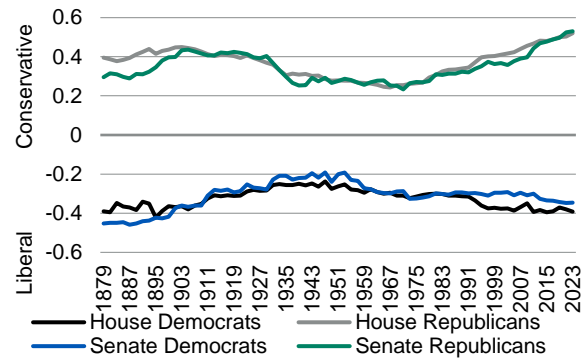
Voting patterns in Congress (Figure 3) demonstrate that Democrats and Republicans are now more ideologically

divided than ever. Republicans have yet to agree a set of key negotiating asks, but a suggested budget is being prepared containing \$150 billion in cuts, focusing on non-defence discretionary spending.

Democrats, meanwhile, are calling for a 'clean' debt ceiling increase without any funding cuts. Neither position is sustainable. However, Democrats have strong incentives to avoid early concessions – in debt ceiling negotiations where Democrat presidents avoid early talks, Republicans tend to compromise first.

There are also doubts over whether Republican proposals will be able to command a majority in the House. Even if a bill can pass in the House along party lines, it will be blocked in the Senate and vice versa. Bipartisan compromise is likely to be the only route to resolution. This, and the narrow majority, complicate the path to raising the debt ceiling on time.

Figure 3: Voting patterns show political polarisation has worsened since 2011



Source: Vote view, DW-NOMINATE, abrdrn, March 2023

A late resolution to raise the debt ceiling is the most likely scenario

With negotiations likely to begin in earnest after Congress returns from Easter recess, we have analysed three scenarios (see figure 6) to provide a framework to understand the political process.

In our base case, early opportunities to raise the debt ceiling are missed, principally due to a lack of cross-party consensus. Negative market consequences in advance of the X-date are required to incentivise compromise, with the most probable outcome being the passage of a bipartisan bill that does not require the support of the right of the Republican party.

Democrats will likely agree to some moderate cuts, focusing on remaining Covid related funding and minor areas of government spending. Social security and healthcare would likely be protected. Funding increases to border security and defence could hold bipartisan support. Biden may also include some form of commitment to reduce the budget deficit above his March budget proposal.



The extent to which a late resolution impacts the macroeconomic outlook will depend on the concessions made by the Democrats. But, with spending likely curtailed over time, the near-term outlook may not be significantly altered. The impact felt within financial markets is likely to be brief.

Waymarks will indicate the risk of a crisis

The earliest waymark of progress will be whether House Republicans fail to pass a proposed budget. This would demonstrate that Speaker McCarthy has not found a path to a majority within his own caucus, weakening the party’s negotiating position and decreasing the likelihood of an early resolution. We view this as likely based on current divisions.

Additional signs that would increase risk around the debt ceiling are a breakdown in negotiations, as well as a challenge to McCarthy’s leadership, both of which would take up valuable time.

In our base, there is little progress made until market pressure builds. Several failed votes are likely. Late in the process, we would consider a lack of momentum in the House towards bipartisan agreement, alongside continued denials of the importance of the X-date, as indicators of the possibility of a serious debt ceiling crisis.

Failure to act could be costly

With the debt ceiling binding and no resolution in place after the X-date, the US government would no longer be able to borrow. All spending commitments, including those to lenders, would have to be made from revenues alone. Given the CBO estimate that one-fifth of 2023 government payments will be debt-financed, and revenues volatile from month to month, such a position would be untenable.

Figure 4: Key dates

Date	Event	What to watch
9 March	Biden presents budget	Republican response to spending and deficit reduction plans
15 April	Target for publication of Republican budget proposal	Whether proposals can carry a republican majority
Early May	Data on April tax receipts	Strong tax collection would push X-date later
Late June- Early September	X-date	Greater clarity on date expected by late Q2

Source: abrdn, March 2023

Republicans have for some time touted prioritisation – the process by which Treasury would prioritise certain payments - as a solution to a debt ceiling breach.

Passing legislation to allow this wouldn’t address the issue, instead it likely makes the situation worse for those who aren’t prioritised in payments and could even act as a

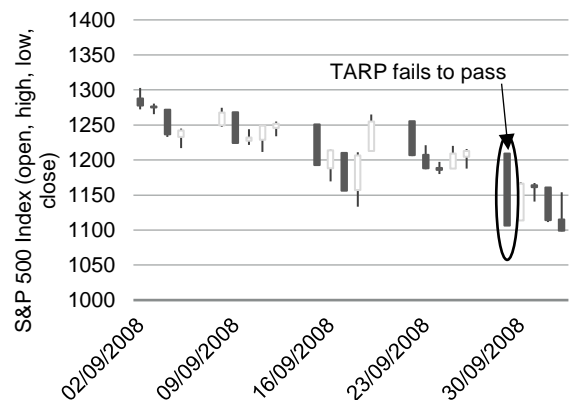
disincentive for lawmakers to reach a resolution ahead of time. It is also unclear whether the Treasury would be able to prioritise payments within the current system.

Even with prioritisation, failure to reach an agreement on the debt ceiling would have large macroeconomic and market consequences.

In 2013, the Federal Reserve modelled the impact of a one-month period of a binding debt ceiling. The modelling suggested a significant tightening in financial conditions - an 80bp increase in Treasury yields and a 30% decline in stock prices. The associated decline in consumer and business sentiment was estimated to cause a two-quarter recession and a 1.7ppt increase in unemployment over two years.

These impacts are similar to the reaction seen in markets when Congress failed to pass the critical TARP legislation in the wake of the Lehman Brothers collapse (see Figure 5). Here, even the expectation that Congress would ultimately pass the legislation did not avert a huge market reaction with lasting economic consequences.

Figure 5: Failure to pass TARP exemplifies potential market impact



Source: Bloomberg, abrdn, March 2023

Given we are anticipating a US recession this year, disruptive debt ceiling negotiations could pull forward the timing of this and increase the depth of the decline in activity.

The Fed is also in tightening mode, unlike in recent debt ceiling crises. Uncertainty could amplify the tightening in financial conditions. It is unlikely the Fed would want to intervene in a political crisis. However, in the event of severe market dislocation, it could attempt to smooth market functioning through various tools.

Investment implications:

- With negotiations expected to go down to the wire market participants should be cognisant of increased volatility due to the negotiations. Volatility trades around the anticipated X-date could therefore perform well.



- US assets tend to act as 'safe havens'. In the event of a pronounced market volatility as a result of debt ceiling uncertainty, it is plausible we – counterintuitively – see dollar strength and longer maturity treasury bonds performing well.

Figure 6: Negotiations going down to the wire is the most likely scenario

	Description	Waymarks	Impact
Down to the wire	Congress reaches an agreement extremely close to the X-date, after market consequences have become apparent. It either raises or suspends the debt ceiling.	<ul style="list-style-type: none"> • Early budget proposals cannot be brought to a vote or fail to pass. • Market reaction in the final days leading to the X-date incentivises Congress to compromise. • A last-minute bill is passed. Bipartisan support likely. 	<ul style="list-style-type: none"> • Risk of rolling disruption to markets if Congress engineers multiple X-dates to avoid default. • Downgrades to US credit rating possible. • Volatility in US bond yields ahead of an agreement. • Market volatility ends once deal becomes apparent. A relief rally is possible. • Economic impact will depend on spending reductions.
Early agreement	Congress agrees a resolution well in advance of the X-date.	<ul style="list-style-type: none"> • Republicans coalesce around a series of key asks. Both parties negotiate and compromise. 	<ul style="list-style-type: none"> • Debt ceiling raised without market consequences. • Economic impact will depend on spending reductions.
Debt ceiling crisis	Congress fails to reach an agreement. X-date is missed.	<ul style="list-style-type: none"> • No agreement on a landing zone for raising debt ceiling. No majority for bipartisan bill. • Market consequences in advance of the X-date do not incentivise deal. • Bill to suspend the debt ceiling to avoid missing the X-date fails. • Extreme market stress results from an agreement to raise the debt ceiling after the X-date. 	<ul style="list-style-type: none"> • Extreme disruption to markets. • Disruption will be focused on US bonds and the dollar, but there will likely still be volatility in equity market with a strong selloff. • US government unable to issue social security payments. • Deeper and more protracted US recession with a higher unemployment rate.

Source: abrdn, March 2023. Note: colours represent probabilities, with green the most likely and red the least.

Authors

Lizzy Galbraith, Abigail Watt, and James McCann



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