Equity Research;
US debt default?

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

Report Date

11th May 2023

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Key Risks to Price Target

Not applicable

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US national debt; the context

On a flight to America a few weeks ago, I had a conversation with an American who described the country's problems as caused by "Baby boomers in control of the US government.... all America's problems are because no US President yet has come from the post Baby Boom generation and provided a fresh perspective". This pearl of wisdom was given to explain why successive US governments regardless of their political colour, have consistently presided over increasing debt levels, passing this debt 'birthright' to future generations.

It is worth reflecting how precisely the US has gone from being the world's largest creditor (supplier of finance) in 1979 to becoming the world's largest debtor (user of finance). It was President Ronald Reagan who convinced the political classes and capital markets, that '*deficits don't matter'* in the words of former US Vice President Dick Cheney. Reagan's two terms increased US debt to US$1.8trn – which pales by today's standards. The justification used in the 1990's for Reagan's spending spree was America winning the Cold War.

President Bill Clinton who balanced the US budget, closed with $5.8trn. His successor, President George W Bush added $5.85trn doubling the US national debt. President Barrack Obama spent heavily in the aftermath of the 2008 financial crisis adding US$8.6trn. In just one term President Donald Trump added US$6.7trn or 33% to the national debt.

For the last 23 years the US has accumulated debt because it employed tax cuts as a panacea to every issue, post September 11th 2001, post 2008-2009, to buy votes post the 2016 election and in response to C-19 in 2020. Since 2008-2009 the US national debt has almost tripled.

Recent events have reminded us, that whilst a given debt load may be affordable and even desirable with interest rates at 1.5%, how should existing debt and new borrowings be approached with market interest rates over 5%? What is right and wrong in this context? Both sides of the US Congress are concerned that America's ability to service debt will be problematic if the current debt trajectory continues, however what is also clear is the deficit brinkmanship and threats of default is the wrong way to deal with the issue.

US national debt US$31.4trn in 2023

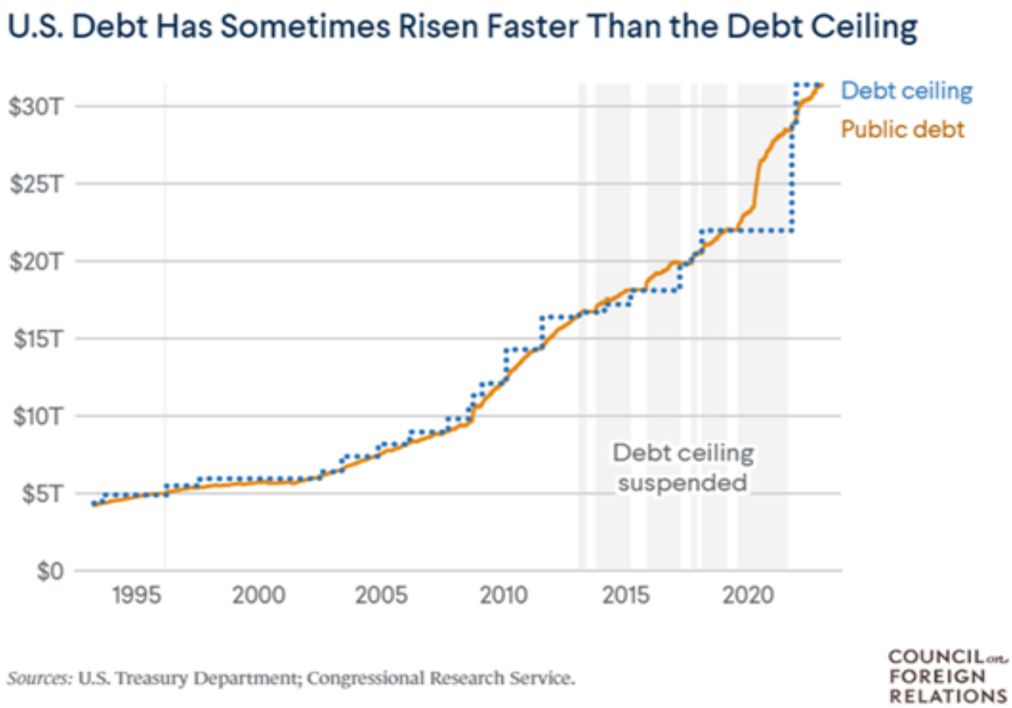
The US national debt hit its 'ceiling' ('the maximum 'legislative' debt permitted by Congress of US$31.4trn) in January 2023 due to the American Rescue Plan which distributed cash to US households in the form of pandemic stimulus cheques, extra unemployment payments and child tax credits worth US$1.9trn by 2031.

President Biden's infrastructure bill, which provides cash for motorways, railways and broadband will also add about $390bn to the US national debt, over ten years. A similar cost $330bn, results from Biden forgiving $10k of student loan debt per borrower. The legality of Biden's debt forgiveness plan which was granted by executive order, is currently being debated in the US Supreme Court.

The US President needs Congressional support for his Administration's budget. The Republican controlled House of Representatives *is refusing to sign off on any increase in the US$31.4trn debt limit*. This is rich given that it is mainly Republican Presidents that have accumulated America's vast debt.

But such is the polarity of US politics that the Republican Party is seeking to use the debt limit and threats of a US default to disrupt the US government and damage Joe Biden politically and the credibility of US fiscal policy.

The US Congress can vote to either suspend or raise the debt limit. Suspension of the debt limit, which has occurred seven times since 2013, is when the US Congress decides that for a period of time that the debt ceiling is not operative. Whilst suspended, the absence of legislative constraint on debt accumulation, has led unsurprisingly, to increased debt.



Lawmakers are right to seek savings and hold the US government's feet to the fire given the US debt trajectory and the current market context. However the brinkmanship around the debt ceiling and risks involved raises the stakes and increases the risk of very costly mistakes. Does America lack the political spine to address its debt? Probably. The underlying debt problems are not going away, regardless of debt ceilings etc.

US default brinkmanship, what does it cost?

The serious political haggling has started given the 1st June 2023 deadline when the US Treasury Secretary Janet Yellen has advised the US will run out of cash to pay its bills. On the Democratic side advisers to Biden have suggested he refuse offers for a one year debt reprieve as this would mean the debt ceiling debate would then occur in 2024, an election year.

Will a deal be reached? It has been in the past and most likely will be reached now. But post Brexit/ Donald Trump/ Russia/ Ukraine it is worth examining the worst case scenario. What if no deal is reached?

If there is no deal then President Biden could invoke section 4 of the 14th Amendment which states that….”the public debt of the US government shall not be questioned”. According to some legal scholars the US debt limit would then be viewed as unconstitutional and hence would not be applied. This would lead to a legal vacuum and is considered an unattractive option that would then require the support of the US Supreme Court.

A US debt default, even if it were brief, is not priced into capital markets now. The implications would be very negative, very far reaching and deserve a separate article!

JP Morgan CEO Jamie Dimon, America’s most senior banker has said the ‘congressional standoff over the US debt ceiling and a potential US default could create a financial panic’ and ‘when you see people panic that’s 08,09 again’ according to a Punchbowl News interview published on the 10th May 2023.

It is likely a US debt default would lead to dollar crisis, a US recession (according to Moody’s a 4% drop in US GDP), it could finish off the US regional banking sector, and possibly the loss of the dollar’s status as world reserve currency.

What is being slowly priced in, is the cost of brinkmanship, what spending will Biden have to shelve to get the votes he needs, how does this embolden America’s rivals, what are the very short term implications for US debt?

US bond yields have not reacted to the debt ceiling issue. Over the last month US 2 year and US 5 year Treasury yields have fallen by 10 and 13 basis points respectively. Nor has the problem impacted the US dollar’s external value much. So far investors have assumed whatever the political posturing, it will not result in a US default in June 2023.

Conclusion

US investors’ reaction to political problems are usually short lived. A good example is the JFK assassination which led to a 3.3% drop that was recouped the following week. Shock events, (c.14 since WW2) have led to an average drop of 5.3% with US markets recovering on average 14 working days later. There is wide dispersion so the median numbers are not good pointers.

As deadlines approach, the political wrangling will become important and we expect a political resolution only at the last minute. Volatility and market volumes are expected to rise. The issue will be a major talking point this month and given the US regional banking crisis it is bad time for problems. However no point in panicking early, we leave that until we have to.

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