The Debt Shilling

When I start to think about the debt ceiling debate, I have to start with one premise:

- **Politicians love the debt ceiling!**

If politicians didn't like the debt ceiling:

- They would just adjust the debt ceiling when they passed policies that would likely push us above the debt ceiling in a few years (or sooner).
- The debt ceiling would only become an issue every 7 to 10 years when a confluence of events (and unexpected circumstances) pushed the country through the debt ceiling.

Politicians love the debt ceiling

- If you get to start a sentence with "default" you instantly capture the attention of the audience. That attention is amplified when the sentence starts with "the U.S. government is defaulting". So, politicians of all stripes know that there will be almost insatiable media demand for soundbites that the politicians can use in fundraising and campaign ads.
- Inevitably, when one side is asking for something, the other side will try and get something in return. It is an opportunity to stick your hand in the cookie jar (even if you don't get anything, you get some nice soundbites for your next set of campaign ads).

My apologies if this is too cynical, but I cannot stop thinking about "shilling" for something when I think about the debt ceiling. If that disqualifies me from further thoughts on how this set of debt ceiling negotiations will play out, so be it. But, sadly, it is actually a realistic starting point when thinking about what is next.

The Usual Positions

As far as I can tell, the debt ceiling issue plays out along these lines:

- **The party in charge argues** that it would be wrong on every level not to pay the obligations. More often than not, recent policies (put in place by the party in charge) push the country through the debt ceiling. Alternatively, they need a bigger buffer for policies they want to pass (again, why the debt ceiling isn't negotiated at the time that policies are passed seems silly).
- **The party not in charge argues** that the debt ceiling is the fault of ABC and that XYZ needs to be addressed as part of the debt ceiling negotiation.

I'm sure that we could poke holes in that generalization, but it seems defensible to me.

The Usual Positions on Steroids

Right now, we seem to have dug into the usual positions:

- We want to pass a clean bill in exchange for budget negotiations down the road.
- We won't pass a clean bill because some people don't trust the negotiation process and have more power now (vs later).

The exact make-up of the various constituents (including friction within parties) seems to be amplifying the rhetoric.

Who Will Take the Blame?

This is the crucial question. Actually, the crucial question is "who does each party think will take the blame."

- **Democrats seem to believe** that any default will be blamed on the Republicans for not supporting payments of obligations that are the legal responsibility of the U.S. to pay. Despite all the soundbites, the voters will see through any "shenanigans" played by the Republicans and blame them, which will take a toll on the Republicans in the next election.
- **Republicans seems to believe** that there is so much angst at the apparent lack of concern about rising debt/deficits, inflation due to government largesse, and the rapidly increasing cost of debt service that they have the support of the public to exact changes now as part of the negotiation process. They also seem to believe that supporters of change are concerned that once the debt ceiling is lifted, there will be limited opportunities to get material victories. So, by forcing a default to get concessions, they think that the Democrats will take the blame and be hurt in upcoming elections.

The first party to flinch will likely do so because they fear that their side will take the blame and be hurt despite their best efforts to put the blame on the other side.

What if Both Sides are Right?

Here is my biggest concern about "why this time might be different".

What if:

- The Democrats are correct and a big chunk of the population (say 50%) will blame the Republicans for unnecessarily forcing us into failing to pay our obligations.

But at the same time:

- The Republicans are correct and a big chunk of the population (say 50%) will blame the Democrats for unnecessarily forcing us into failing to pay our obligations.

Who flinches first in this case?

In a world where I'm not convinced that political parties could agree on the color of the sky, **I see it as being plausible that both parties think that they can blame the other side in the event of a default (and they both may be correct).**

The risk that neither party flinches is real.

The Credit Default Swap Market Seems About Right

Here is my biggest concern about "why this time might be different".

The 1 Year U.S. CDS contract (Euro denominated) trades at a cost of ~1.75% of par (it is more nuanced than that since it isn't a one-time up-front payment, but that is close enough for now).

The U.S. 1.25% bond due May 2050 trades at 58% of par.

So, if you get a failure to pay event, you should be able to settle up against that bond and earn 42%.

So, at its most simplistic, you are paying 1.75% for a chance to win 42%.

That implies a 4.2% chance that we experience a failure to pay event. In other words, paying 1.75% for

something that can pay 0% or 42% has only a 4.2% probability of a 0 expected value.

The 5-year CDS contract trades at only 70 bps (a lower annual rate, but potentially a higher total cost) because the bet isn't about longer-term concerns regarding the ability of the U.S. to pay the debt. It is all about the odds of getting a credit event that lets the cheapest to deliver option kick in on a CDS contract.

What Few Are Discussing, But Some Are Thinking – So What if We Default?

I can quickly find any number of articles about the "Armageddon-like" nature of what it would mean if the U.S. were to default on its debt. Yet, I see very few details on how or why it would be Armageddon. **It's almost as though "it is so obviously horrific that we have no need to explain why it is horrific".**

Is it catastrophic on day 1? Day 5? Day 30? Day 90?

When it becomes catastrophic (which it will) could be important to the calculus of what party flinches first (assuming high math has a place in political posturing).

Let's Play a Failure to Pay Game – T-Bills

Let's say that as of June 1, the U.S. is current on every obligation it owes. It paid all recent redemptions, interest, etc. and business moves along as usual as we wake up on June 2nd.

There is a T-Bill that expires on June 6th.

Let us assume that we wake up on the morning of the 6th and the Treasury announces that it cannot raise the funds to pay that T-Bill back (the failure to pay event).

Before jumping to broader market implications, let's stay focused on that particular T-Bill.

The worst case scenario for holders of that T-Bill is that they need the cash to pay bills the next day. That could be bad, but this bill already trades at 5.3% versus 3.6% (for the bill maturing on May 30th), so we can assume that those who might "need" the cash on the 6th have already moved out of that particular bill. This would result in giving up some yield, but it avoids the "disaster" scenario of a failure to pay (which would trigger their own inability to pay).

So, on June 6th, imagine you are a market maker and asked to "bid" on this (in my best Darth Vader voice) "DEFAULTED" bill.

Imagine the fear coursing through the veins of this trader being asked to bid on a bill that the government just defaulted on!

Sweat dripping from their brow, a shaky hand, as they type **99.6**.

They offer to pay $99,600,000 for $100,000,000 of maturing debt, which would be the price if they thought that they should "earn" 10% for 14 days to "only" get back par.

I would argue that 10% seems like an extreme penalty rate with SOFR at 5.06%.

14 days might seem long. We will see that an initial "failure to pay" might not be catastrophic (which is why it could happen). It will come down to how long the failure to pay situation would last.

It would be easy to conceive me that the T-bill would be paid back at more than par because some sort of "penalty interest" is included in the final payment (I have not read the bill documents closely enough on this).

If anything, 99.6% of par seems like a low-ball bid!

So, before we go all "hell in a handbasket" over a default, it seems worth thinking about the price of the obligation that was defaulted on.

We have a mindset that Default = Bad = 40% on the dollar (or some variation of that), so we should step back and reflect.

If the value of the defaulted obligation is close to par, then what does that mean for the rest of curve?

If you disagree with the rough assessment of where the defaulted T-Bill would trade in the event of default, you can stop reading now.

I would expect that other T-Bills near that expiration date would get a bit cheaper, but they are already cheap, and if expectations are that it will get fully paid in a matter of days or weeks, it is difficult to crater the price.

The Failure to Pay Game – Long Bond

This is a bit trickier and my conviction level isn't as high as it is on the T-Bill side of the equation. We jump straight to the 30-year bond (rather than other points on the curve) as the analysis should be similar and more extreme, making the arguments more entertaining (and saving us a bunch of time).

The long bond closed at 3.8% on May 10th.

On the morning of June 6th, when we learn that the U.S. government is about to default on a T-Bill, what happens to the long bond? Without a doubt there will be volatility as it will be more reactionary to flows compared to T-Bills.

- **"Immediate" forced sellers?** Will there be entities that need to sell the long bond because they cannot hold debt in an entity that has defaulted? That is possible, but I suspect that it includes very few entities in the real world.
    - **Treasuries** are often given separate limits and guidelines for portfolios compared to other assets (like investment grade corporates). If a corporation defaults, I could envision a world of forced selling where managers need to hold "performing" assets, however:
        1. Does documentation consider "non-performance" as a risk for Treasuries?
        2. Is it even "non-performing" if no payment is expected to be missed on that bond?
- I am not arguing that (over time) it will reduce the amount of demand for Treasuries, but is there an immediate selling impact? I'm dubious on that front.
- **What is the economic impact of a default?** Even while playing devil's advocate, it is difficult to think of a scenario where economists (and corporate leaders) think that defaulting on the debt is going to boost the economy. So, at best, it will create some level of anxiety about the economy. I believe that **even after any defaults are cured, there will be a lingering overhang regarding the economic outlook**. In any case, I'm reminded of that moment at the end of ***Planet of the Apes*** when he realizes that he has been stuck on earth the whole time and that they had finally destroyed themselves.
- **Positioning in longer-term Treasuries seems heavily skewed to bearishness.** The contrarian in me sees this as a set-up to spark a rally.

I'd be patient on the morning of the default. We could see some initial selling and 4% (if we were at 3.8%) wouldn't be out of the question. I'd be a buyer on any widening. I wouldn't aggressively buy at or near 3.7% because although we could see a short squeeze, there will be ongoing hesitation to commit to duration until we learn how it truly impacts demand. This could take time, but it is also worth pointing out that the long bond is the playground of insurance companies and pension funds. These entities likely won't reduce their buying needs and central banks/foreign entities tend to be more focused on the 5-year and in part of the curve.

Certainly, on June 6th, I'm not sounding the alarm.

In Come the NRSROs

At some point (and maybe it occurs before default) the Nationally Recognized Statistical Rating Organizations will weigh in.

The headline generation machines will kick in!

It will be the "story of all stories" when the U.S. is no longer rated AAA! Except that the U.S. is currently rated Aaa/AA+u/AAAu.

I honestly cannot remember what the "u" means – largely because I don't think that many people invest in Treasuries based on their ratings!

But it is useful to remember that Standard & Poor's had the U.S. as AAA from 1991 until February 2011 when it was changed to AAAu. They put the rating on negative watch in July and on August 5th (my first time ever on Bloomberg TV with Pimm Fox) they downgraded the rating. So, the U.S. has not been Aaa/AAA/AAA for a long time and it didn't stop the long bond from trading at 0.997% yield during COVID.

Fannie Mae debt rated Aaa/AA+/AAA could be impacted by ratings changes to Treasury debt (it would be consistent with prior treatment of "agency" debt by NRSROs). It is difficult (if not impossible) for NRSROs to rate a potentially related or linked entity higher than the hypothetical parent.

In the case of Standard and Poor's they have JNJ and MSFT at AAA (both "piercing the sovereign ceiling" on ratings) which may be **yet another indication that the sovereign ratings, at least in the case of the U.S., are more symbolic than anything else.**

I could see a small impact on agency debt (unlike in Treasuries where I see no impact) due to a ratings change. In bond index land, FNMA for example is AAA since 2 of 3 ratings are AAA. For those who care, it could slip to AA+ or something on downgrades to the U.S. government. **I don't think that there would be a material impact on spreads/prices here because most investors invest in them because of "who they are" not what their rating is.**

The Sun Rises on June 7th

On the day after the U.S. does not pay its debt, the sun still rises. Bond yields (despite the default) have barely budged.

Workers getting furloughed are being told that they will be paid back wages once the crisis is resolved.

Social Security payments will be a major concern.

Stocks could be down 3% or so. They had to move, especially since they will follow the longer-term economic impact vs the short-term price gyrations in the bond market.

- We will start to see blame apportioned to each party, which may cause one side to flinch.
- We may find that if I'm correct and bonds don't respond, those talking about cataclysmic failure and the "woe of a downgrade" have to backtrack.
- We may hear about various means to overcome this failure to pay that for some reason weren't enacted earlier (high coupon, high initial price bond offerings, and "minting the coin", among others).

I suspect that June 7th will be closer to business as usual than is widely anticipated.

Things will Get Worse

June 15th (a big coupon and maturity date for bonds) will start throwing a larger wrench into the system.

At that point, I'm not sure any Social Security checks will have been missed, but some bi-weekly paid employees may not get paid on the 15th.

By July 1, I'd expect problems to mount in the economy. I might not be at "Armageddon" by July 1st, but I'm getting closer as more and more government obligations aren't met which will hit individuals, corporations, and the economy as a whole.

It we made it to July 1st without some settlement, the divisiveness in D.C. would be beyond our wildest expectations! I can only imagine the rhetoric spewing out of D.C. if we get to this date without a resolution. I'd be scared if this happens and the U.S. would be mocked by most of the world.

Bottom Line

There is less incentive than usual to compromise. The chance of a failure to pay is non-trivial (the CDS model of 5% seems about right).

The world will not end on a failure to pay event.

It will get worse the longer we go without resolution (even if we get one).

I don't see shorting bonds as a useful "hedge" against a debt ceiling driven default (if anything that could backfire).

I am reluctant to be bullish on risk assets ahead of such a potential outcome as I expect that they will bear the brunt of any consequences both in the near-term and after it is resolved.

There are so many things that we need to do to remain at the top of the heap in terms of global competitiveness that it would be nice to get this debt ceiling thing behind us!

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