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The macro and market outlook under debt ceiling scenarios

We expect Congress to reach a late agreement on the debt ceiling. But a failure to do so would trigger severe market disruptions.

Key Takeaways

- We think Congress will reach a deal on the debt ceiling that avoids technical default, but building market stress (weaker equities/USD and widening credit spreads) could be part of the incentive to get the job done.
- An eventual agreement is likely to deliver cuts to government spending. While Democrats are attempting to minimise these, some tightening in fiscal policy supports our call for a recession later this year.
- A short breach of the x-date would trigger very sharp market reactions, even if the Treasury prioritises payments to bond holders. Drops in equities of perhaps 10%, severe stress in other risk assets, dollar depreciation and a looming downturn would likely push Congress to raise the ceiling rapidly.
- In the very unlikely scenario in which Congress does not act for weeks or even months following a technical default, we expect very large shocks to economic activity and much deeper adjustments in markets.
- President Biden could bypass Congress and avoid a default, by using the 14th Amendment or minting a \$1tn coin. But these actions come with significant costs and are only likely in the case of extreme stress.

A debt ceiling standoff

In our [previous note](#), we predicted a narrow GOP majority in the House, and political polarisation, had increased the risks around the debt ceiling. With the x-date fast approaching, we look in more detail at the economic and

market consequences of our scenarios, with help from investment colleagues.

Where do we stand now?

With a week until the estimated 1 June x-date, Republicans and Democrats remain some way apart. The former are seeking to ensure 2024 spending is below 2023 levels, while allowing for an increase in defence spending. This would deliver steep cuts on Democrat non-defence priorities. In contrast, Democrats are aiming to keep 2024 spending flat, arguing this represents a real-terms cut.

The other major area of disagreement is over the size and duration of spending caps, which echoes the 2011 debt ceiling negotiations. The Budget Control Act that came out of that dispute introduced spending caps over a ten-year period but was modified repeatedly to allow for more discretionary spending. This would likely occur again if caps were introduced.

The short negotiating window increases the likelihood of an extension

We still believe the most likely outcome is that the debt ceiling is raised in advance of a technical default. However, given the absence of demonstrable progress, and with this deadline nearing, we have now included the option to pass a short-term extension in our scenarios (see Figure 3).

Congress has been surprised by an early x-date, which has compressed negotiations into a one-month timeframe. House Speaker McCarthy's promise to give representatives 72 hours to scrutinise legislation before any vote makes timeframes even tighter.

We think there is in aggregate a 90% probability the debt ceiling is raised ahead of a default.



This consists of a 35% chance a deal is done by 1 June, and a 55% chance it is achieved after a short-term extension to the debt ceiling that shifts the x-date later.

A late deal may not be pain free

A very late agreement could involve market stress as investors are forced to price a higher risk of a mistake.

Conversations with our investment teams suggest that, as negotiations go right to the wire, equities could fall up to 5%, the dollar weaken up to 2%, credit spreads widen by as much as 100bps for HY and 20bps for IG, and the 10yr UST rally around 20bps if we go right down to the wire. Much of this volatility could dissipate upon a deal being reached.

The economic implications of a debt ceiling deal could still be material. The bill passed by House Republicans implied steep cuts to aggregate government expenditure in FY24, of around \$150bn. This would equate to a drag of around 0.5ppts on GDP growth, with further hits in subsequent fiscal years (see Figure 1).

Figure 1: Republican bill would reduce government spending by \$4.5tn over 10 years

Policy	Ten year savings estimate
Return discretionary spending to FY 2022 level in FY 2024, then grow 1 percent annually for a decade	\$3.2 trillion
Prevent student debt cancellation and IDR expansion	\$500 billion
Repeal energy tax credits and rescind unused COVID relief funds	\$300 billion
Expand work requirements in Medicaid, SNAP and TANF	\$100 billion
Repeal mandatory IRS funding for enforcement, operations and customer services	-\$100 billion
Enact reforms related to energy, regulation and permitting	Unknown
Total policy savings	\$4 trillion
Interest	\$500 billion
Total savings	\$4.5 trillion

Source: Congressional Budget Office, May 2023

Democrats will negotiate spending up from this starting point, but we still expect a fiscal tightening versus current baseline legislation. This adds to the likelihood that the recession we anticipate materialises, dragging interest rates significantly lower next year.

Another TARP-style mistake would be painful – even if quickly reversed

We see around a 10% probability that there is no deal or extension ahead of the 1 June x-date. This might be because Republicans are sceptical the Treasury will run out of cash after this point, or that Congress underestimates the negative consequences of missing the x-date.

Most likely is that this leads to a 'TARP 2.0' style scenario (9% odds), reminiscent of the initial failure to pass the bailout in 2008, triggering widespread market stress that forced lawmakers to then pass the legislation within days.

In this scenario, the Treasury could not meet all its obligations and would most likely prioritise payments to

bondholders to avoid a full-blown default. The flipside is that this would delay other domestic spending commitments.

The consensus among investment colleagues was that even a short x-date breach would deliver severe market stress. Equities could fall up to 10% in two days, IG and HY spreads increase by 100bps and 350bps respectively and the dollar depreciate around 5%. US government bonds would be expected to rally by around 40bps at the 10yr point despite the default risk, helped by safe haven flows and a lower expected path for Fed policy.

A large fiscal contraction, severe market stress and public uproar should force Congress to rapidly raise the debt ceiling. However, even in the case of a 48-hour reversal, we think some of the short-term macro and market damage would be lingering especially if aspects of the financial 'plumbing' become compromised. The longer-term fiscal credibility of the US would also be damaged.

A prolonged default is very unlikely

We think that a prolonged x-date breach of weeks or months is very unlikely and attach just a 1% probability to this outcome.

Payment prioritisation would become increasingly challenging if Congress drifted further past the x-date, raising the likelihood that bondholders are defaulted on alongside continued missed domestic obligations. This combination would spark very severe and reinforcing economic and market stress.

Modelling by the Council of Economic Advisers, the Fed and Moody's suggest a deep recession, comparable to the shock during the Global Financial Crisis.

Our investment colleagues expect equities would decline around 30%, with some estimates even larger. Credit spreads would explode, increasing by around 550bps for high yield and 200bps for investment grade. The dollar could sink by 10% in trade-weighted terms.

Longer dated Treasuries would be expected to rally, even in the face of some missed coupons and redemptions. This would be driven by the radically lower path for the Fed Funds Rate, and potentially dramatic action by the Fed in terms of balance sheet expansion, liquidity support and other operations to shore up the financial sector. It is possible that the Fed itself buys those bonds at risk of default and holds these on its balance sheet to minimise the fallout.

Alternatives to finding congressional support for raising the debt ceiling are impractical

Speculation has built that President Biden could circumvent Congress and effectively bypass the debt ceiling. Figure 2 outlines some of these alternatives, which would avert a default.



However, all are controversial and come with significant costs. This means they are unlikely to be used unless we slide into a full-blown crisis.

Figure 2: There are creative solutions to a debt ceiling crisis but these are unlikely to be invoked

Proposal	On the table?	Workable?
Using a discharge petition to force a vote	<u>Endorsed</u> by House Democrat leadership.	Unlikely. Requires Republicans to vote against their party leadership.
Invoke the 14 th amendment	Popular among progressives. Would be strongly opposed by Republicans and moderate Democrats.	Unlikely, absent a severe crisis. This may avert default, but the Constitution states that Congress has authority over tax and spending decisions, making the risk of the Supreme Court overturning the decision high.
Using premium bonds to raise government funds.	Not endorsed by the Treasury or either party.	Has largely been dismissed as a budget gimmick and would not solve the political impasse. Could become more palatable in case of extended default.
Mint a trillion dollar coin	Not endorsed by the Treasury or either party.	Potentially effective and has long been part of public debate, but would harm the Federal Reserve's independence.

Source: abrdn, May 2023



Figure 3: Debt ceiling scenarios

	Description	Indicative probability	Waymarks	Impact
Down to the wire	Congress reaches an agreement close to the x-date, incentivised by rising market stress.	35%	<ul style="list-style-type: none"> Negotiations are fractious but both parties remain at the table. A high level agreement is reached in advance of the x-date with time for Congress to act. Market stress close to the x-date incentivises compromise. A last-minute bill is passed. Bipartisan support likely. 	<ul style="list-style-type: none"> Markets may remain unmoved by debt ceiling concerns if a deal is done with a few days to spare. It's equally likely that building stress is the incentive lawmakers need to reach a deal. Investment colleagues saw a possible draw down of 5% for equities, the dollar weakening 2%, credit spreads increasing by 100bps for HY and 20bps for IG, and the 10yr UST rallying around 20bps. Markets may reverse most of these moves on an eventual deal. Downgrades to US credit rating possible. Caps on government spending will exacerbate recession risks.
	Congress runs out of time and passes a short-term suspension of the debt ceiling to allow the process to be completed.	55%	<ul style="list-style-type: none"> There is a large gap between negotiating positions, but talks continue amid signs of incremental progress. Congress runs out of time and quickly pivots to a suspension of the debt ceiling to avoid the x-date. A short suspension would indicate that negotiations are largely concluded and the extension is to allow the voting process to take place. A longer extension of 1-3 months would indicate more substantive negotiations still need to happen. 	
TARP 2.0	Congress fails to reach an agreement. x-date is missed. Extreme market stress results in a rapid policy correction and a deal is passed within 48 hours.	9%	<ul style="list-style-type: none"> No progress towards a landing zone for raising debt ceiling. 'Debt ceiling denialism' means market stress in advance of the x-date does not incentivise a deal as policy makers believe they have more time, or can move slightly beyond the x-date absent severe consequences. x-date is missed, resulting in a negative market reaction. Congress rapidly corrects, suspending or increasing the debt ceiling almost immediately. 	<ul style="list-style-type: none"> Equities could fall around 10% in two days, IG and HY spreads increase by 100bps and 350bps respectively and the dollar depreciate 5%. US government bonds would be expected to rally by around 40bps at the 10yr point. Deeper and more protracted US recession with a higher unemployment rate. Treasury prioritises payments to UST holders to try and limit the financial market fallout.
Debt ceiling crisis	Congress fails to reach an agreement. The political standoff continues despite serious economic and market consequences, leading to several months of formal default.	1%	<ul style="list-style-type: none"> Significant gaps on policy between both parties continue. Congress cannot pass a suspension of the ceiling to avoid breaching the x-date. Market stress fails to incentivise agreement as both sides double down and blame the other party. 	<ul style="list-style-type: none"> Equities would decline around 30%. Credit spreads would increase around 550bps for HY high yield and 200bps for IG. The dollar could sink by 10% in trade weighted terms. The Treasury delivers very large cuts across its domestic spending programs, is unable to offset the very deep recession unfolding through fiscal support and misses payments to bond holders.

Source: abrdn, May 2023

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