NEWPERSPECTIVES

Commentary from New Century Advisors – May, 2023

Debt Ceiling Scenarios

Please find below our view of various debt ceiling scenarios and what the consequences might be if an agreement isn't met. We also wanted to discuss any changes we've made to the portfolios we manage in light of the situation.

Overview:

We see the risks to the negotiations skewed toward a relatively benign outcome, but believe that the upside/downside to risk/markets is skewed negatively.

1. Markets near their highs already, pricing in little risk of default and ignoring continued stress in banking sectors and general weakness of global economic data
2. Markets not yet focused on the anticipated issuance wave to follow resolution of the debt ceiling
3. Any risk on rally post-resolution expected to be minimal/short lived

Scenarios:

1. Base Case: 11th hour deal struck (70%)
    1. Short-term extension may be required to iron out the details of a deal, write the legislation, allow time for the CBO to opine, etc, prior to bringing to a vote, but only if a deal is "done"; 3 month "can-kicking" unlikely
    2. Brief 'risk on' (higher equities, rates, commodities), but risk rally short-lived as mostly already priced in already
    3. Markets then quickly shift focus to anticipated T-bill issuance wave (upwards of $1T of additional issuance through the end of Q3)
        1. Rising TGA (Treasury General Account; expected to rise from ~100bn to ~$600bn) mostly offset by falling RRP (reverse repo) balances and bank reserves (think QT) at the Fed
        2. Slightly higher front end yields
        3. More downward pressure on bank deposits (and credit creation in turn)
2. Partial Government Shutdown (25%)
    1. Debt principal and interest payments prioritized, avoiding a technical default
    2. Other payments delayed, including federal and military salaries and contractors; social security prioritized ahead of salaries and contracts, but after debt payments
        1. Increased uncertainty, temporarily reduced consumer spending
    3. 'Risk off' (lower equities, rates, commodities); weaker USD
    4. Possible U.S. debt downgrade which would further the bid for Treasuries (lowers investors' average quality, driving a bid to higher quality bonds which would still include Treasuries)
    5. Increased political pressure leads to a deal before a technical default occurs
3. Default (5%)
    1. Missed payments on Treasury interest and principal

2. Treasury would need to extend the maturity date of maturing issues in order to maintain their Fed-wire eligibility
3. Ex-maturity bonds would trade at a discount to par driven by market pricing of the timing of eventual resolution
4. Sharp 'risk off' (lower equities, rates, commodities); weaker USD
5. U.S. debt gets downgraded, driving a sharper rate rally

NCA Positioning:

We have positioned portfolios more defensively. We have added duration with reduced exposure to risk assets due to what we perceive as skewed risks around the negotiations, the longer-term impact of an eventual deal (particularly regarding issuance and liquidity), ongoing stress in banking and broader risks related to an economic slowdown.

For more information on any of the data, trends, or strategies in this piece, or to discuss how New Century Advisors might help your fixed income allocation, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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