TD Wealth

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Let's talk about the debt ceiling.

First of all, what is it? According to the U.S. Department of the Treasury, the "debt limit" is the total amount of money that the United States government is authorized to borrow to meet its existing legal obligations. Simply put, like you and I, the U.S. government has bills with due dates and a credit limit, and it's set to max out its credit at the beginning of June. Treasury folks call this the "X-date."

The fact that we are here is not really a surprise. The U.S. Treasury Department initiated "extraordinary measures" to pay the federal government's operating expenses back on January 19, 2023, after the government hit its statutory debt ceiling of US$31.381 trillion. There is a degree of uncertainty around the X-date, particularly in the month of June, given that a surge of cash in the form of quarterly tax receipts is expected to come in on June 15th.

The U.S. Congress has always acted when called upon to raise the debt limit. It has done so 78 times since 1960. It's like a blockbuster summer horror movie with too many sequels that gets worse with each passing summer. The reason it is so contentious this time, bottom line, is that the United States is a deeply divided nation. The parties seem entrenched at polar opposites, and yet, if they do have one thing in common, it seems to be their limited understanding of the tremendous benefits accrued by the United States due to its status as the global safe haven for capital.

Imagine the costs of living in a world where the security of the greenback is questioned. As a nation, the United States is truly in an enviable position — and the generational damage that both political parties could potentially inflict on this incredibly beneficial status is unthinkable. Its impact could be felt for generations.

While negotiating, each side should pull out a $10 bill and look at the portrait of Alexander Hamilton and recall his arguments on the imperative of honouring all of the states' debts in the aftermath of the Revolutionary War. Now that's courage and leadership during a time of deep division. Winston Churchill once famously observed that Americans will always do the right thing, but only after they have tried everything else. We are of the view that, for a 79th time, this will once again be true, but this time it's likely to be down to the wire.

Before considering the potential impact and best practices for structuring portfolios during this time of uncertainty, let's consider the scenario analysis that was provided to us by the very capable mind of James Orlando, CFA, Director and Senior Economist at TD Economics.

Highlights

- Time is running out for Congress to raise the debt ceiling and prevent the U.S. government from defaulting on its obligations.
- The impact of a prolonged debt ceiling standoff could be greater today than in the past, especially considering the economy is operating in the later stages of the cycle, where financial vulnerabilities are far higher.
- Our baseline is that a deal will get done, but the longer the stalemate persists, the greater the odds that financial markets and the economy get burned.

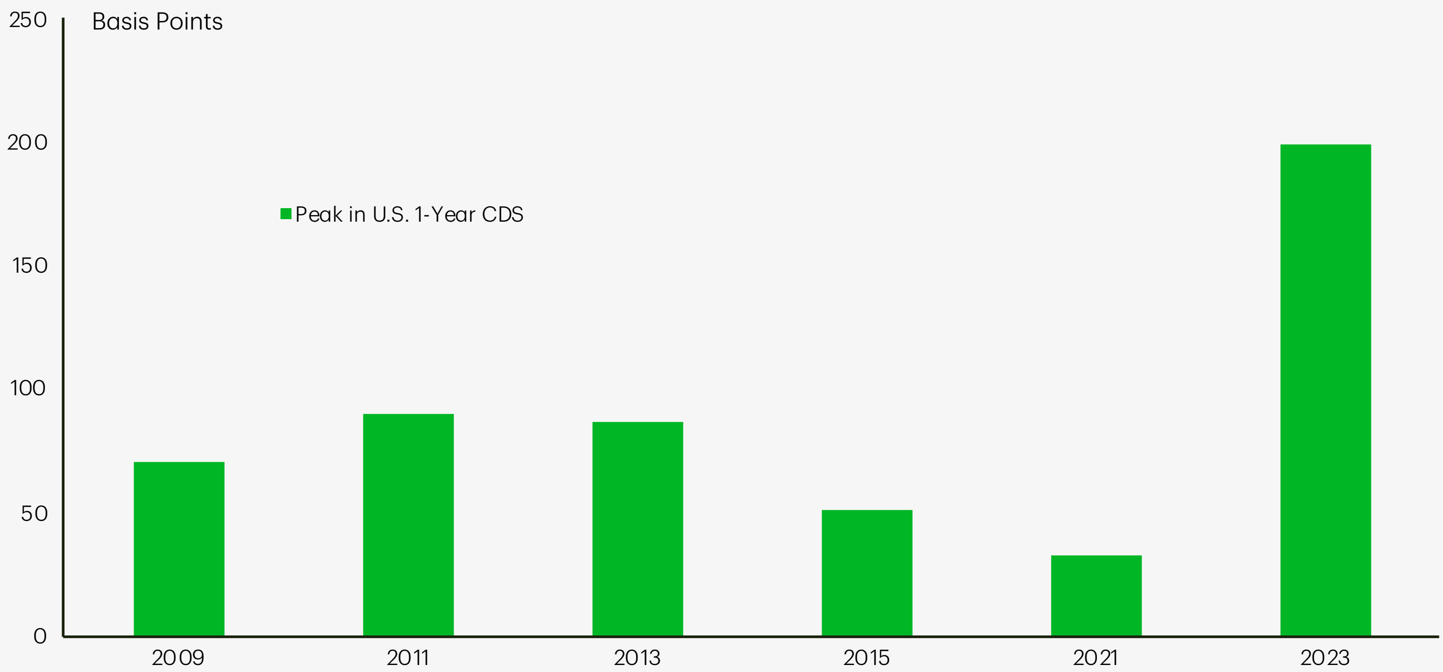
Congress is running out of time to raise the debt ceiling. Treasury Secretary Janet Yellen has stated that the government is estimated to be unable to pay its bills by early June, and potentially as early as June 1st (the X-date). More recently, the Congressional Budget Office backed up Yellen's warning with similar guidance. While it seems inconceivable that the government would voluntarily allow that to happen, investors are hedging against this risk. Insurance against government default has soared to its highest level on record, more than doubling that witnessed during the infamous 2011 U.S. debt downgrade (Figure 1). Given risks already present within the economy, we believe that the current debt standoff is a much larger threat. Although this has yet to bleed into broader financial markets — with equity, credit and currency markets hoping for resolution — politicians are playing with fire. The longer the standoff persists, the greater the risk that markets and the economy get burned.

Can't we all just get along?

The political divide in Washington has grown over the years. The Pew Research Center estimates that Democrats and Republicans have shifted farther apart in terms of ideology than at any time in the past 50 years. Researchers note that not only have Democrats moved farther to the left and Republicans to the right, but recent elections have removed many centrist members of Congress who could help a deal get struck.

Republicans passed the "Limit, Save, Grow Act" last month, which would have allowed the debt ceiling to be raised, but included deep spending cuts, work requirements to qualify for social-safety-net programs and other demands. Democrats had stated that they were uninterested in accepting a debt-ceiling deal with strings attached. However, as formal talks have heated up in recent days, both sides appear to have eased their hard lines and have conveyed optimism that a middle ground can be reached. Still, time is of the essence, with little wiggle room in the event that talks fall apart or other roadblocks be hit.

Figure 1: Insurance against U.S. government default elevated



Source: Bloomberg Finance L.P., TD Economics

The many roads to reaching a deal

There are several ways this debt ceiling showdown could go (Figure 2). Let's start with the best and most likely scenario. That is the one where a longer-term deal gets reached in a timely and orderly fashion. It would include the $1.5-trillion (or more) debt-ceiling increase the Republicans have already proposed, but the size of the spending cuts would be smaller than the nearly $5 trillion in the initial bill. In terms of market reaction, the cloud of uncertainty would be lifted, causing equities to rise. Bond markets would see yields increase as investors refocus on the Fed and the increased probability that rates would remain higher for longer. This would be favourable for the USD, which has also been closely aligned with the path of the Fed.

In terms of economic impact, this scenario would remove a key tail risk, thus increasing odds of a softish landing in the U.S. economy. Real GDP growth would average 1.2% for 2023, before decelerating to 0.8% next year under the weight of already high interest rates. The unemployment rate would follow suit, rising from an annual average of 3.6% this year to 4.4% next.

The next most optimal deal would be a short-term agreement — again, negotiated in timely fashion — that allows the Treasury to keep borrowing through this summer. Although there would be a new (though delayed) X-date, lawmakers would be given more time to bridge differences. By kicking the can down the road, the time pressure would be alleviated, bringing hope that a longer-term deal could eventually be struck. Equities, bond yields and the USD could all rise under this scenario, but the reaction would be muted. This scenario would be mildly negative for the U.S. economic outlook as it still leaves a cloud of uncertainty.

Figure 2: Likelihood of various scenarios

	Likelihood Rank	Equity		Treasuries		U.S. Dollar	
		Near-Term	Long-Term	Near-Term	Long-Term	Near-Term	Long-Term
Long-Term Deal Reached (Orderly)	1	▲	▲▲	▲▲	▲	▲▲	▲
Short-Term Deal Reached (Orderly)	2	◀▶	▲	▲	◀▶	▲	◀▶
Messy Deal Reached	3	▼	▼	◀▶	▼	◀▶	▼
Short Default	4	▼▼	▼▼	▼	▼▼	▲	▼▼
Long Default	5	▼▼▼	▼▼▼	▼▼	▼▼▼	▲▲	▼▼▼

Source: TD Economics

This is where things get messy

This brings us to another relatively high-probability scenario, whereby a deal is reached, but lawmakers leave it to the 11th hour. Recall that the 2011 episode that is often referenced was one where a deal got reached, but the extent of brinksmanship reduced confidence in the U.S. government. The rating agency S&P responded by downgrading U.S. government debt to AA+ from AAA. Although another downgrade on brinksmanship alone seems less likely, with all agencies currently maintaining a "stable" rating for U.S. debt, a messy deal could cause investors to get panicky. Indeed, it is easily argued that the timing of the shock would be far worse today than in 2011, given that it would be hitting late in the cycle, when financial vulnerabilities are far higher.

As such, we would expect equities to drop sharply, with a flood into safe-haven assets. The U.S. would still maintain its safe-haven status in this scenario, causing flight into U.S. dollars and preference to long-duration Treasuries. If any resulting risk-off move is pronounced enough — even if only temporary — it could tip the U.S. economy into a technical recession and pull forward increases in the U.S. unemployment rate.

Given that a recession could occur even with a messy deal, scenarios that breach the X-date would act to increase the severity. That said, the duration matters. While only time would tell, we believe that a short-lived default would likely lead to financial and economic impacts not far off the brinksmanship scenario just discussed. In that case, the government would fail to pay all of its bills for a short time, but a likely dramatic sell-off in equities and likely rating-agency downgrades would motivate lawmakers to swiftly get a deal done. Short-term Treasury yields would rise on the threat of a missed payment, but long-term yields would fall. The USD would rise as the threat of financial market stress would cause investors to sell more risky currencies abroad.

If the X-date is reached and lawmakers fail to reach an agreement for a more protracted period (say, beyond one to two months), then we would clearly be getting into unchartered waters. Not only would financial-market impacts be more dramatic and sustained, but the inability of the government to spend money on counter-cyclical supports for consumers and businesses would act as a fiscal cliff. Economic impacts would thus be non-linear and akin to a severe downside stress. For example, the U.S. Council of Economic Advisers estimates that the unemployment rate would rise to a level similar to what happened in the Global Financial Crisis, with real GDP contracting by as much as 6.1 percentage points. The Council also projects a drop in equity values by 45%, with investors exiting any kind of risk, including soon-to-mature Treasuries. Given the U.S. Treasury's market size, there may be few options for investors seeking safety. They would instinctively buy longer-dated Treasuries and U.S. dollars with no other alternatives. But the long-term impact of lost confidence would embed permanently higher yields in U.S. Treasuries and a lower resting point for the USD as investors look for alternative safe assets.

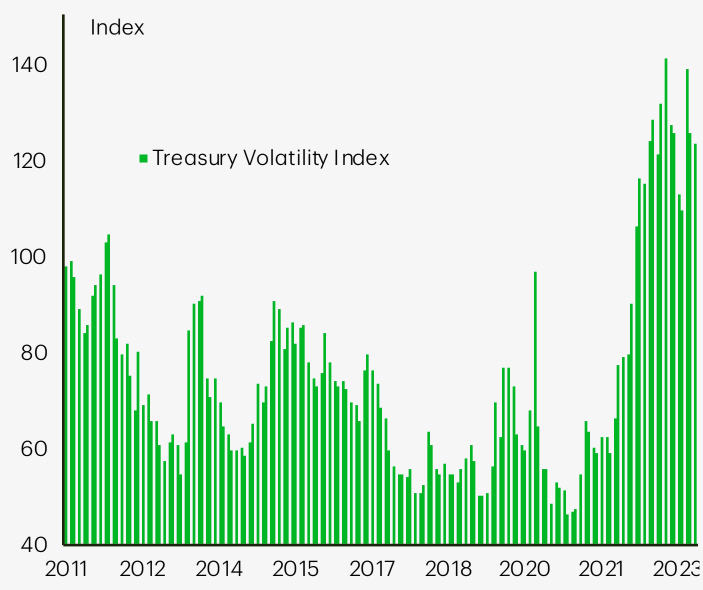
Bottom Line: Starting points matter

It is clear that a deal needs to get done. And the earlier, the better. While some commentators have proposed backdoor solutions like minting a trillion-dollar platinum coin, using the legal angle in the 14th Amendment, or prioritizing payments, an actual agreement is the only real solution. And for other commentators that seem relaxed about pushing to the 11th hour or even allowing a default, our analysis above points to an economy that has little room to absorb this shock.

Our economic forecast already has U.S. GDP growth hovering around zero growth for the rest of this year. The lagged impact of the Federal Reserve's historic interest-rate hiking cycle is starting to take hold, while the U.S. regional banking sector is acting as a significant headwind. Financial markets are more vulnerable now than in the past. In 2011, the Fed's policy rate was at 0.25%, with quantitative easing ongoing. Now, after 500 basis points in rate hikes, the bond market is under stress, with the Treasury volatility index at its highest level since 2008 (Figure 3).

The vulnerability of markets has bond yield risk skewed to the upside. Equities too are at risk. As we saw during 2022, rapidly rising yields can be bad news for stock prices. And while the USD rose 13% over the past two years, it has room to drop should investors sour on the U.S. This increase in market sensitivity means that, if politicians aren't careful, what would have been a short-term flare-up in markets in the past could turn into a financial-market blaze.

Figure 3: Treasury volatility elevated



Source: BofA Securities, TD Economics

Investment Portfolios

Scenario Analysis

As part of our investment-strategy process, we consider various scenarios and potential outcomes to ensure we are prepared, well-positioned and well-protected.

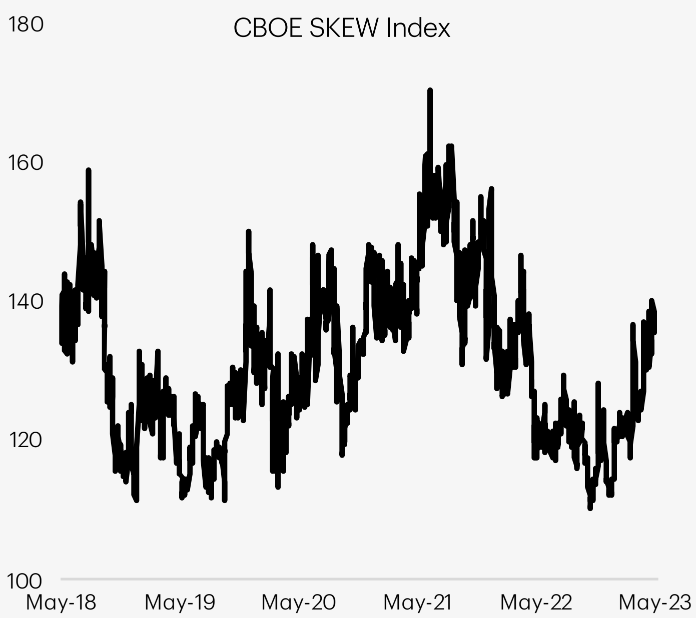
Worst-case Scenario: No resolution results in U.S. default

Under the short or protracted default scenarios, the debt-ceiling impasse will undermine stock fundamentals, with negative implications to economic growth and employment levels. Both of these are low-probability but high-severity scenarios that will reprice equities. If an agreement can be reached within a reasonable timeframe under the milder brinkmanship scenario, the market may only experience a short period of heightened volatility leading up to the resolution, and the market could immediately move on after. Short-term damage could come from a temporary liquidity crunch, if the Fed or other government agencies fail to intervene, but the impact on the real economy is more palatable. For example, according to the White House, the job loss is estimated to be 200,000, which is close to one week's worth of jobless claims in the U.S.

Although it is hard to gauge directly how much risk equity investors have priced in as a result of the X-date showdown, we can get a sense of market sentiment by looking at hedging activities and the pricing in the derivatives markets. As of May 19, equity investors did become more cautious in terms of positioning, but they were not in panic mode. The June S&P 500 contract's open interest is near YTD highs. However, that's well within the range seen in 2022, when hedging demand was higher.

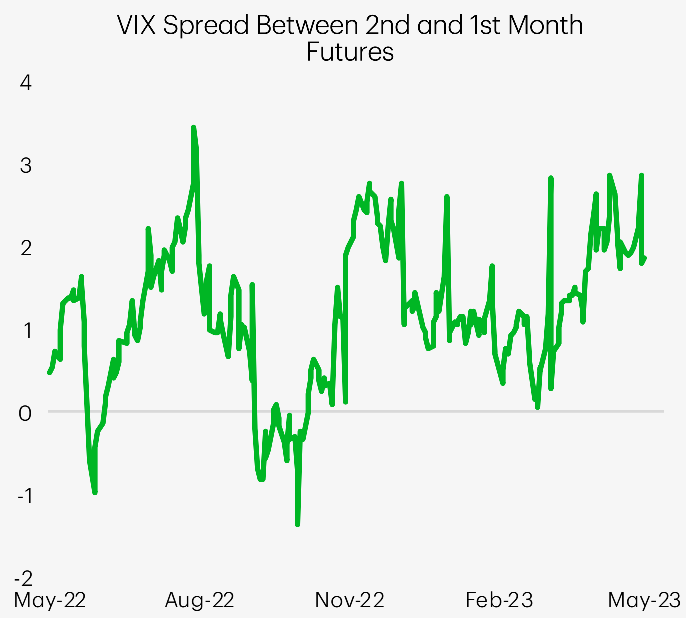
In the options market, things look more bearish. The Chicago Board Options Exchange's Skew Index, which measures the slope of implied volatility curve of S&P 500 options, has increased to a one-year high (Figure 4). The reading indicates growing demand for downside protection from put options buying. The spread, meanwhile, between May and June VIX futures, which reflects investor expectations of the fear gauge before and after the X-date, is wider than the average over the past year, but it is still much lower than the high seen last summer (Figure 5).

Figure 4: Growing demand for protection



Source: FactSet as of May 19, 2023

Figure 5: Markets expect a deal



Source: FactSet as of May 19, 2023

The impact on the dollar will also depend on which scenario plays out. A protracted default is akin to economic self-destruction by way of a permanent and unreconcilable political divide. If this remote-probability scenario ever plays out, the dollar would likely suffer, along with many other financial assets.

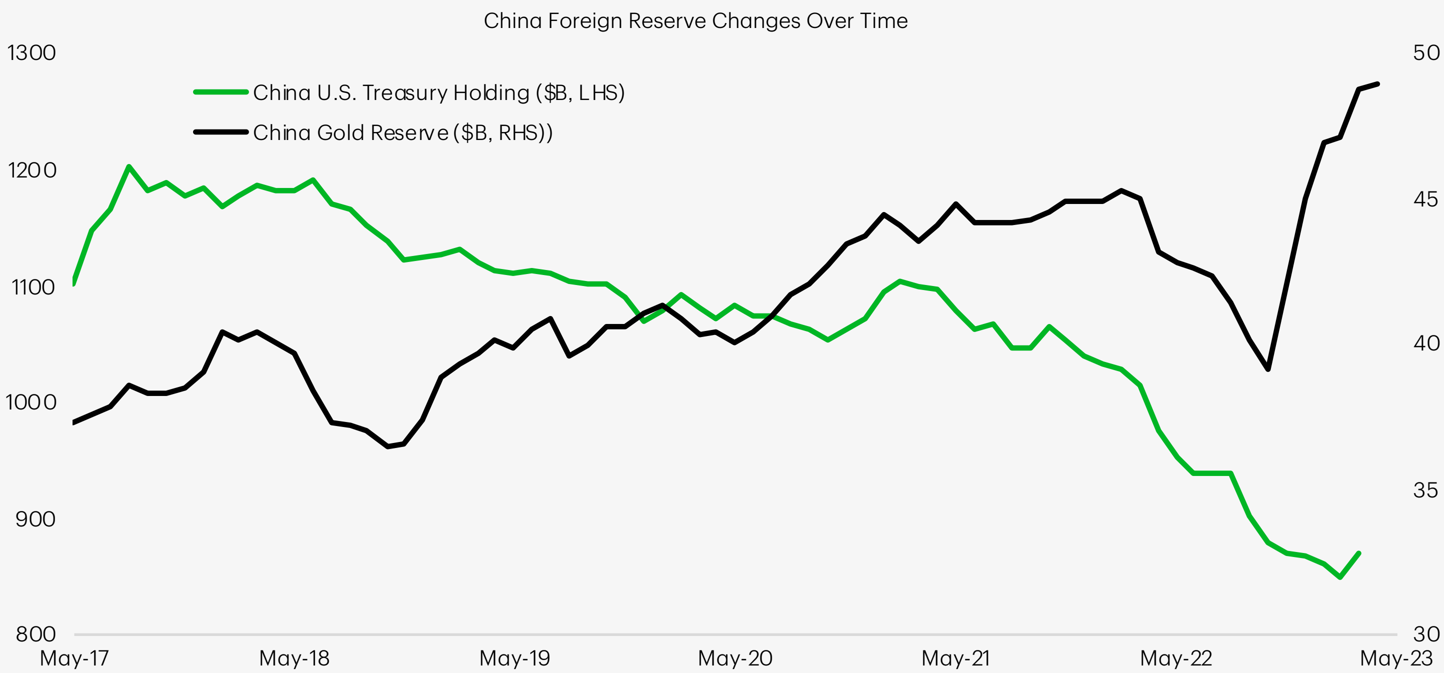
Base-case Scenario: Deal is finalized before the X-date

Under the other milder but much more likely scenarios, if the U.S. government and the Federal Reserve mobilize their policy tools to ensure the integrity of the financial system and investor confidence, the dollar will continue to be a safe-haven asset. However, after the episode, global investors may question the reliability of a global reserve currency under frequent disruption from the debt ceiling. De-dollarization is a trend that emerged after the financial crisis, but it has really picked up in speed after the U.S. dollar was weaponized in sanctions against Russia (Figure 6). A U.S. debt-ceiling impasse will further speed up the transition.

Speaking of a dollar alternative, gold might be one of the few beneficiaries of debt-ceiling-induced market volatility. For most low-probability, high-severity tail risks, gold is the ultimate safe haven, especially when the U.S. dollar and U.S. Treasuries are no longer risk-free. In term of positioning, we do see increased flow into the yellow metal, but it is still far below extremes. The weekly inflow into the SPDR Gold Share is currently elevated, at the 85th percentile over the past two years, while the COMEX non-commercial gold futures position stands at the 65th percentile.

Due to the binary nature of the debt-ceiling risk, we believe it is prudent not to position our client portfolios based on a tail-risk scenario. Our multi-asset solutions have been positioned to weather market volatility and debt-ceiling-induced market volatility is no different. We continue to believe that — under the highly probable "brinkmanship" and "short-but-controlled" default scenarios — our current overweight positioning in Canadian bonds, dividends and low-volatility stocks, as well as our allocations in infrastructure and long/short equity strategies, will provide stability to client portfolios.

Figure 6: China Foreign Reserve Changes Over Time



Source: FactSet as of May 19, 2023

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