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U.S. debt dispute deferred

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Moritz Kraemer -- Chief Economist

LBBWResearch@LBBW.de

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Disaster is avoided, but further tensions are highly likely

After some acrimonious wrangling, Republicans and Democrats were able to agree on a compromise. Moderates on both sides pushed legislation through the Congress to suspend the debt ceiling until early 2025. So: All's well that ends well? Not so fast ...!

Postponed, not canceled

Disaster averted in the short term

It is to be welcomed without ifs and buts that a default by the U.S., by far the largest debtor on the planet, has been averted. A calamity for the world economy was thus avoided. For now. It would be a mistake to view the debt dispute as a black-or-white affair. Considerable risks remain despite the current fix.

First and foremost, the compromise is short-term in nature. The debt ceiling has been suspended until Jan. 1, 2025. The unseemly political spectacle will, then, repeat itself.

The Debt Ceiling Show will return to a theater near you in early 2025

The problem is that the negotiations will then take place in what is likely to be an even more riotous political environment. After all, November 2024 is not only when a presidential election will happen, but also a congressional one. When the debt ceiling comes back into effect, neither the newly elected Congress nor the new (or old?) president will be in office. In a long and bitter election campaign, maybe amidst claims of stolen elections, the ability to compromise could take a further bruising.

Brace yourselves, therefore, for an even more rancorous negotiating process than the one seen in recent weeks. The risk of an accident increases accordingly. All the more so as candidate Trump, in his inimitable cluelessness about such matters, has recently openly advocated default. No taboo seems too enormous.

Ambivalent consequences for the financial markets

In recent weeks I was often asked, whether we should expect a relief rally after the resolution of the debt dispute. I am not convinced. It is possible that this rally will be aborted, according to the ancient market wisdom of "buy the rumor, sell the fact".

Anyway, not all that glitters on the surface is gold: The compromise includes a noticeable reduction in government spending. This will increase the likelihood of a recession.

Hopes for relief rally may be disappointed

In addition: Unlike in the summer of 2011, the last near default experience, the Fed will now not be able to hold out the prospect of interest rate cuts. Inflation is currently still far too high. On the contrary, averting the default, and all the financial stability risks that would have come with it, has probably increased the probability that the Fed will tighten even more than the markets (and we) currently expect.

Please, remember: In 2011, equities on both sides of the Atlantic fell by over 15%. Risk spreads widened by about 2%. All that happened after the compromise had been signed into law.

Beware of the Treasury tsunami!

Since January, the U.S. government has not been allowed to take out any new loans because the debt ceiling had been reached. Instead, cash reserves have been drained down all the way to the coffee cash register to keep things running.

With the debt limit suspended, the government will now be issuing new debt in a big way. Not only to keep the current loss-making operation running, but also to rebuild its own reserves.

As much as $700 billion in new issuance is likely to come our way in the second half of the year. This will reduce liquidity in the market and weigh on valuations of equities as well as bonds.