Capital Markets Strategy
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Getting Comfortable with Discomfort

10 Quick Thoughts on the US Debt Ceiling

MAY 2023

"Power is not an institution, and not a structure; neither is it a certain strength we are endowed with; it is the name that one attributes to a complex strategical situation in a particular society."

Michel Foucault, influential French philosopher
and political theorist (1926-1984)

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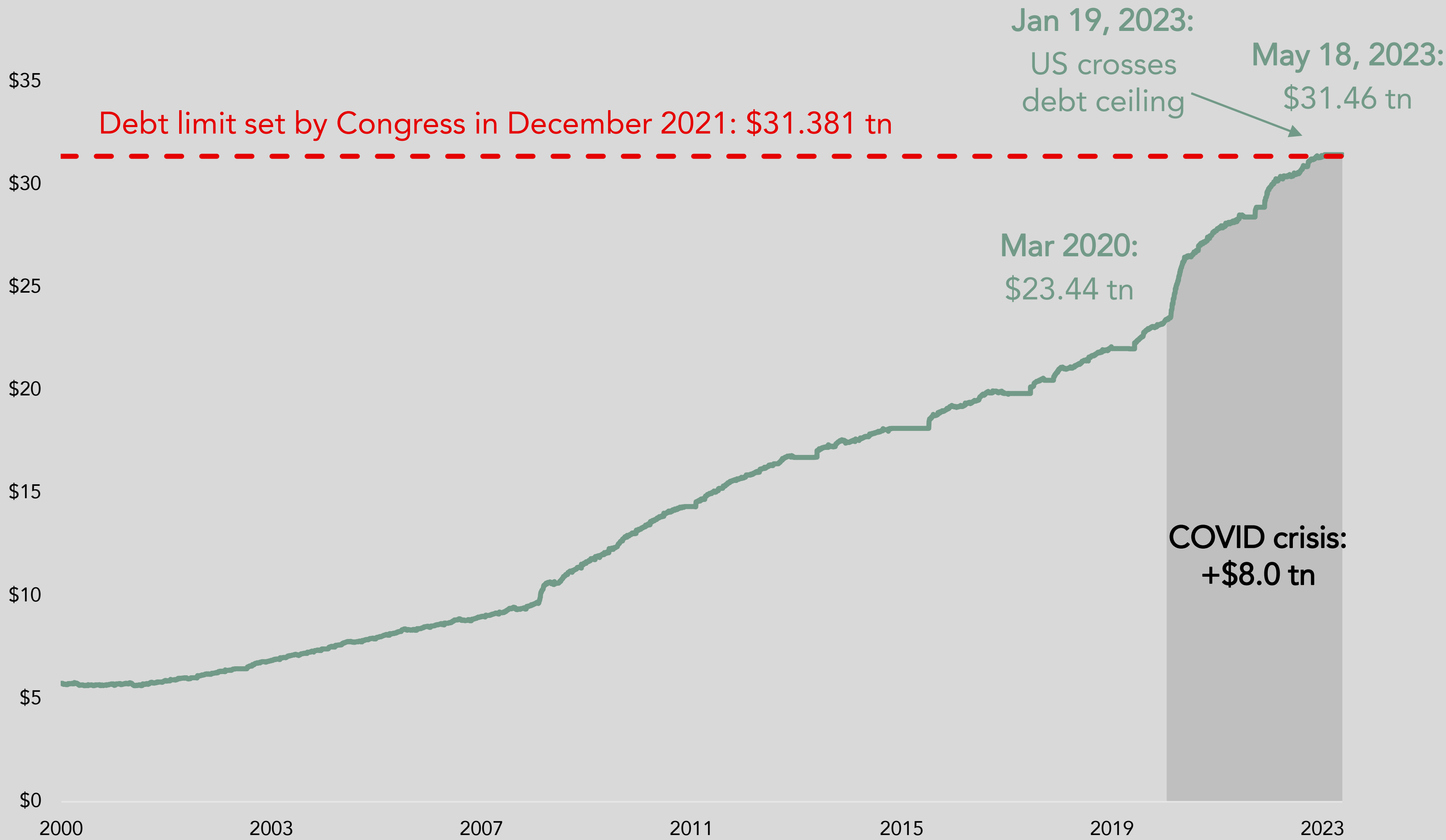
1. **We remain optimistic despite elevated risk and uncertainty.** Political risk is inherently difficult to forecast. Washington is more polarized than ever. Tail risk remains high. The motivations of individual politicians on both sides of the aisle may not align well with resolution. Nonetheless, we believe Republicans and Democrats are closer to a compromise framework than may appear to be the case. **We remain optimistic that a modest deficit reduction "deal" by June 1, that pushes the debt ceiling out to Q1 2025, is "more likely" than a short term "kick-the-can" extension by weeks or months.**

2. **The calendar is dictating the process, while timing of the Memorial Day holiday has made it more complicated.** The US Memorial Day holiday is on Monday, May 29, 72 hours before the Thursday, June 1 "x-date." The US Senate left for recess last week and does not return to Washington until Tuesday, May 30 (unless called back sooner, which could happen if needed). The House of Representatives is scheduled to leave for their recess this Thursday, May 25th (a date likely to be pushed back to this weekend).

The Debt Ceiling Was Actually Crossed in January

US daily total public debt outstanding, USD tn



Source: (1) Bloomberg. Data as of May 22, 2023. US Treasury.

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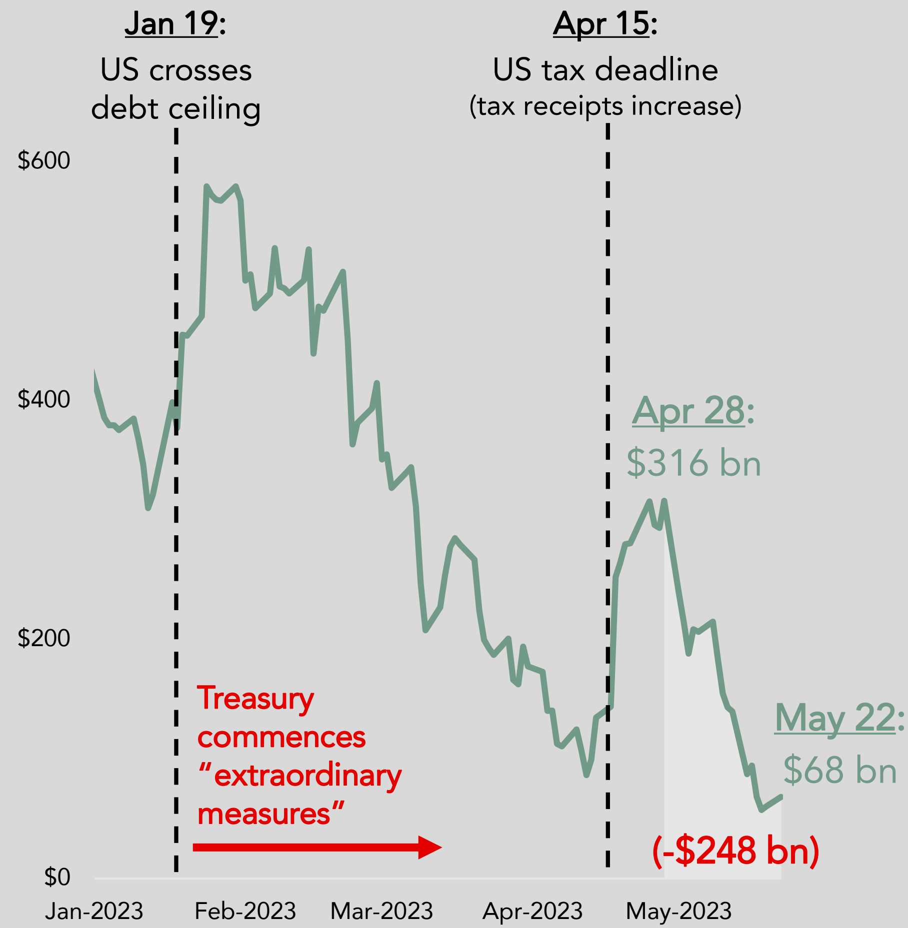
3. **The "heavy lifting" was always going to happen in the last two weeks.** 10 days is a long time in Washington with markets likely to become more "uncomfortable" than political leadership as June 1 approaches. **Whether the "x-date" was set at June 1, Sept 1 or Dec 1, the work by Congress was always going to happen in the last two weeks, with final resolution most likely in the final week.** During the debt ceiling escalation in 2011 and 2013, Congress did not reach a deal to raise the debt ceiling until the day immediately before the "x-date." If the White House and Speaker Kevin McCarthy fail to reach agreement this week, we are likely to go right up to the June 1 deadline with a wider range of potential scenarios on the scope and timing of a deal.

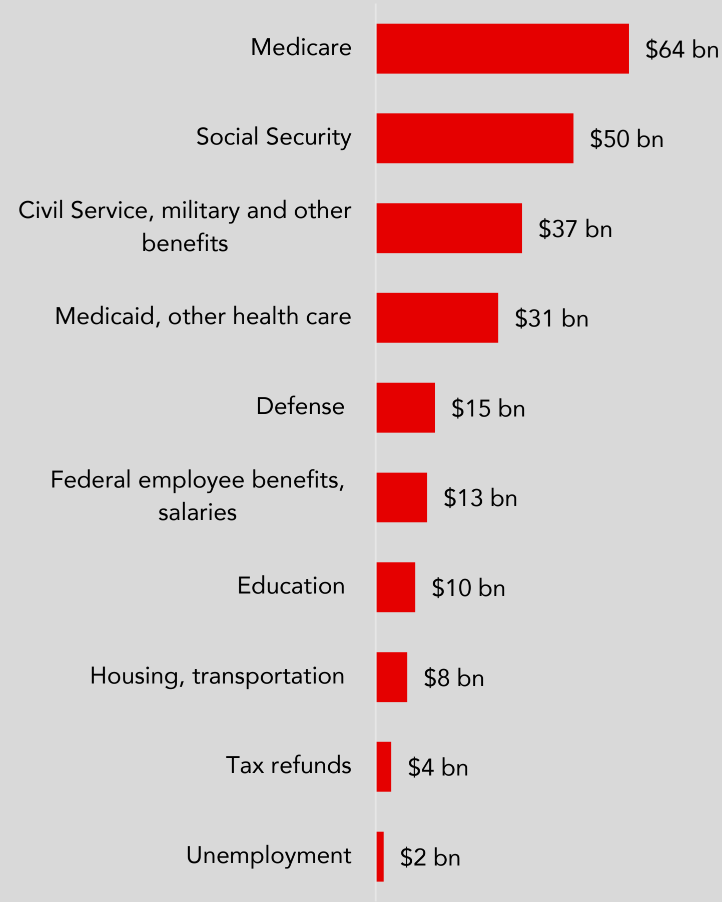
4. **President Biden and House Speaker McCarthy have made considerable progress in recent days. If an agreement between the White House and House Republicans can be reached, expect the House/Speaker Kevin McCarthy (R-CA) to "move first" to pass legislation as early as this week.** Under this optimistic scenario, and as Speaker McCarthy has committed to a 72-hour period for Members of the House to review any legislation before a floor vote, **the House could hold a vote as early as this Friday, May 26** (just ahead of Memorial Day weekend). Senate leadership – Majority Leader Chuck Schumer (D-NY) and Minority Leader Mitch McConnell (R-KY) – will be closely monitoring any post-agreement House action to assess whether to call the Senate back early from recess to vote on a measure over the Memorial Day weekend (as early as Saturday, May 27), or wait until the Senate is scheduled to return on Tuesday, May 30. **Should any potential House effort stall, expect the US Senate to assume the lead in driving towards a resolution – with a potential Senate vote some time Memorial Day weekend – a higher risk path which introduces a more complex and variable set of outcomes that pushes right up against the June 1 deadline.**

Treasury Cash Balances Depleting Rapidly

Treasury cash balances depleting from over $300 bn to below $70 bn in May



Over $200 bn in non-debt related payments due June 1-14



Source: (1) Bloomberg. Data as of May 23, 2023. (2) Oxford Economics, "A default on debt isn't the key risk in early June" (Nancy Vanden Houten).

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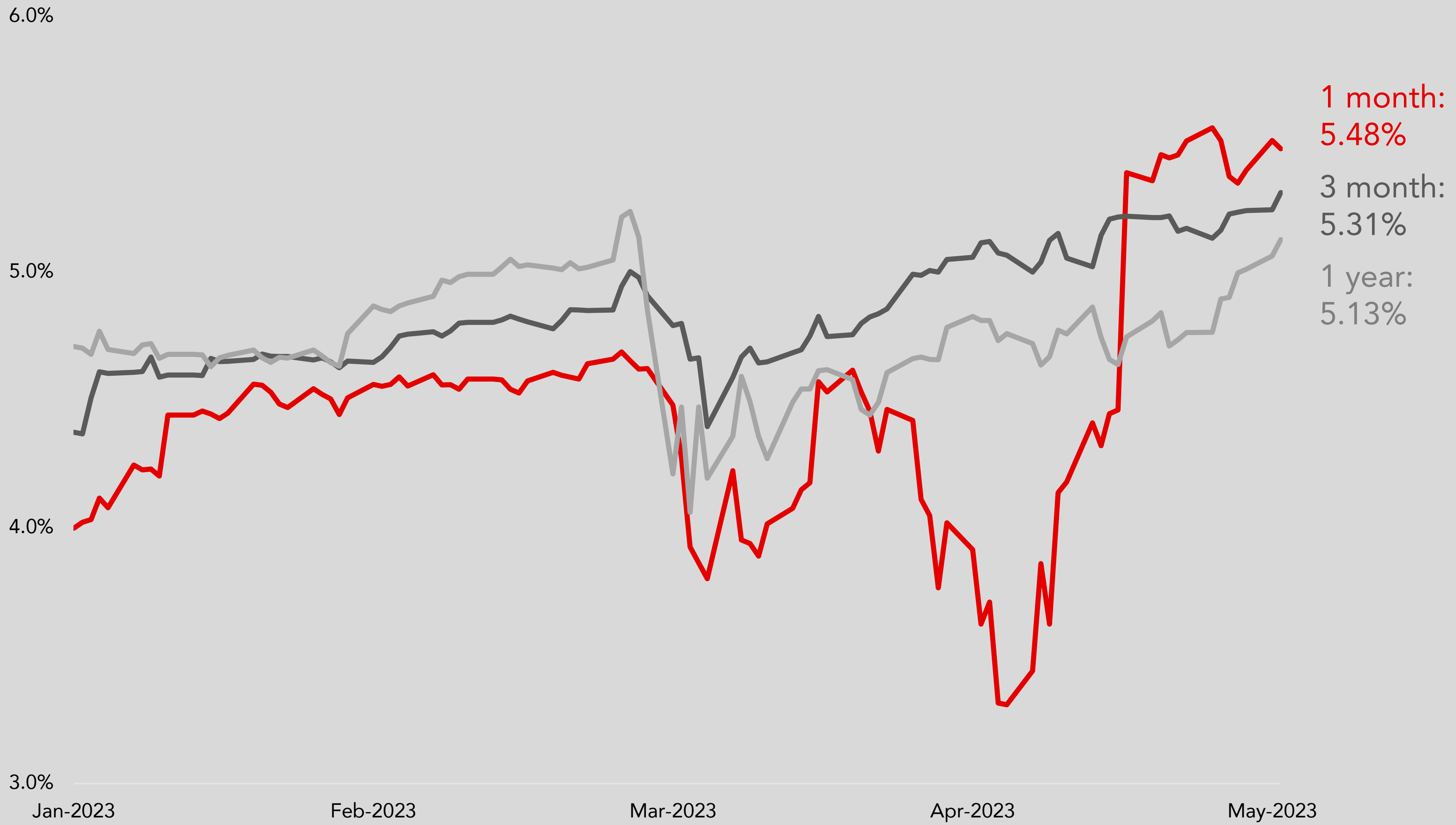
5. **The framework of a "deal" is becoming more clear, but the devil is in the details.** Spending reductions of **$200-400 bn via caps** to slow spending growth, with differences on length (2 years vs. 6 years, **with compromise around 3-4 years**) and rate (based on FY 2022 or FY 2023, **with an "adjusted" or "modified" FY 2022 more likely**). Returning ~$50 bn of unspent COVID money. $100 bn decline in debt service costs from reduced spending. Expedited energy sector permitting likely, but not a given (different priorities across electric transmission, clean-energy, fossil fuel projects). Enhanced workforce requirements (scoring impact unclear). In addition, the CBO could score "anticipated savings" of $1.5 trillion over 10 years based on a short term 2-3 year spending reduction agreement, thereby facilitating a political "win" for both sides. **The challenge, of course, is in the details.**

6. **"Default" is not an imminent risk.** Default is a third rail that Congress and Treasury will not touch. **Further, significant new tax receipts will arrive June 15. Secretary Yellen can issue new debt to roll maturities until then. The next significant coupon interest payment ($2 bn) is not due until June 15.** Further, Secretary Yellen can extend the Debt Issuance Suspension Period (DISP) when it expires on June 5, thereby giving Treasury about $10 bn in additional cash. By contrast, payments due on over $200 bn of entitlement programs in early June pose a greater challenge.

T-Bills Repricing for Elevated June Risk

US Treasury yields



Source: (1) Bloomberg. Data as of May 23, 2023.

Higher "Negative Watch" Risk After June 1

Recent commentary from rating agencies

S&P Global Market Intelligence

"The fraught negotiations in 2011 moved S&P Global Ratings to downgrade the U.S. government credit rating from AAA to AA+. In the current fight, ***Ratings expects a "protracted debate" before a resolution is found."***

"With US default date looming, divided Congress risks repeat of market shocks", March 9, 2023

Moody's

"We ***expect Congress to pass a series of small extensions that push the X-date back until the end of the fiscal year (30 September)*** to align it with the annual budgetary appropriations negotiations. The convergence of two separate but intertwined issues could seriously complicate both negotiations and ***sets the stage for a dangerous fiscal cliff reminiscent of the brinkmanship in 2011*** that ultimately resulted in forced spending cuts. Should that recur, reductions in non-defense discretionary government spending and entitlement program reforms will likely have ***negative credit effects on public finance debt issuers***."

Moody's Credit Outlook, May 8, 2023

FitchRatings

"As we have previously stated, ***we believe the debt limit will be raised or suspended to avoid a default***. If, ahead of the X-date, we were to assess the risk of a default as having become more material, ***the US's rating would likely be placed on Rating Watch Negative and further rating action could be considered***."

"Short-Term US Debt Limit Increase Would Not Prevent Future Standoffs", April 25, 2023

Source: (1) S&P. Moody's. Fitch.

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7. **Thursday, June 1 should be treated as a "real" deadline.** While default on debt may not be an imminent risk, Secretary Yellen will have to make over $200 bn of payments on Social Security, Medicare and other programs in the first two weeks of June. Using cash balances, incoming receipts and extraordinary measures, we have seen varying estimates of when the US Treasury "actually" runs out of money to make program payments at somewhere between June 7 - 14. Secretary Yellen suggests earlier. **While Treasury may "in theory" be able to move beyond June 1 by prioritizing payments, the market and rating agency implications of doing so may be prohibitive.**

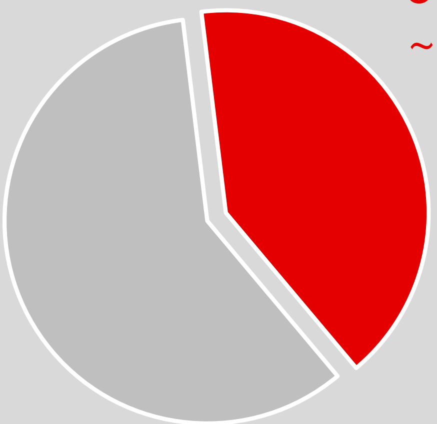
8. **Rating Agency "Negative Watch" and "downgrade" risk.** The credit rating agencies have signaled the **possibility of a "Negative Watch" designation on the US sovereign credit rating in the event of breaching the June 1 target date.** An actual "downgrade" in the US rating would likely follow a missed payment event on Government programs (i.e., Social Security, Medicare), and would not necessarily require a missed payment on Government debt.

The Stakes are Higher This Time

Size of US Treasury market

2011

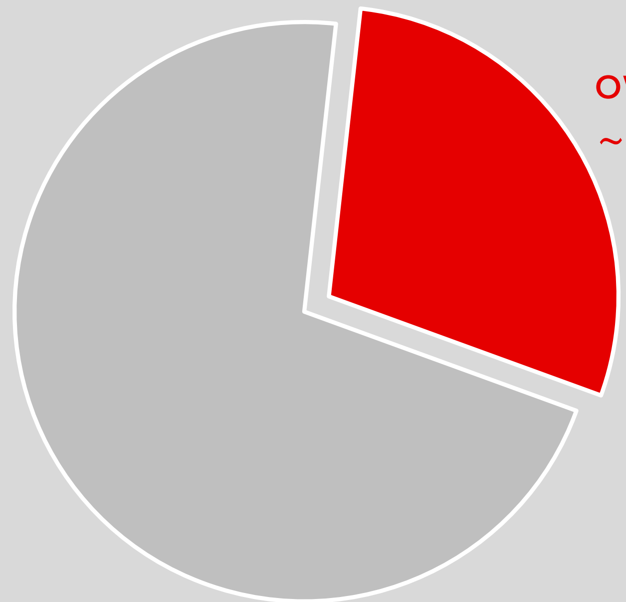
Foreign ownership: ~$4 trillion



Total UST market: **$9.8 trillion**

2023

Foreign ownership: ~$7 trillion



Total UST market: **$24.3 trillion**

$ Trillions of global contracts linked to Treasuries

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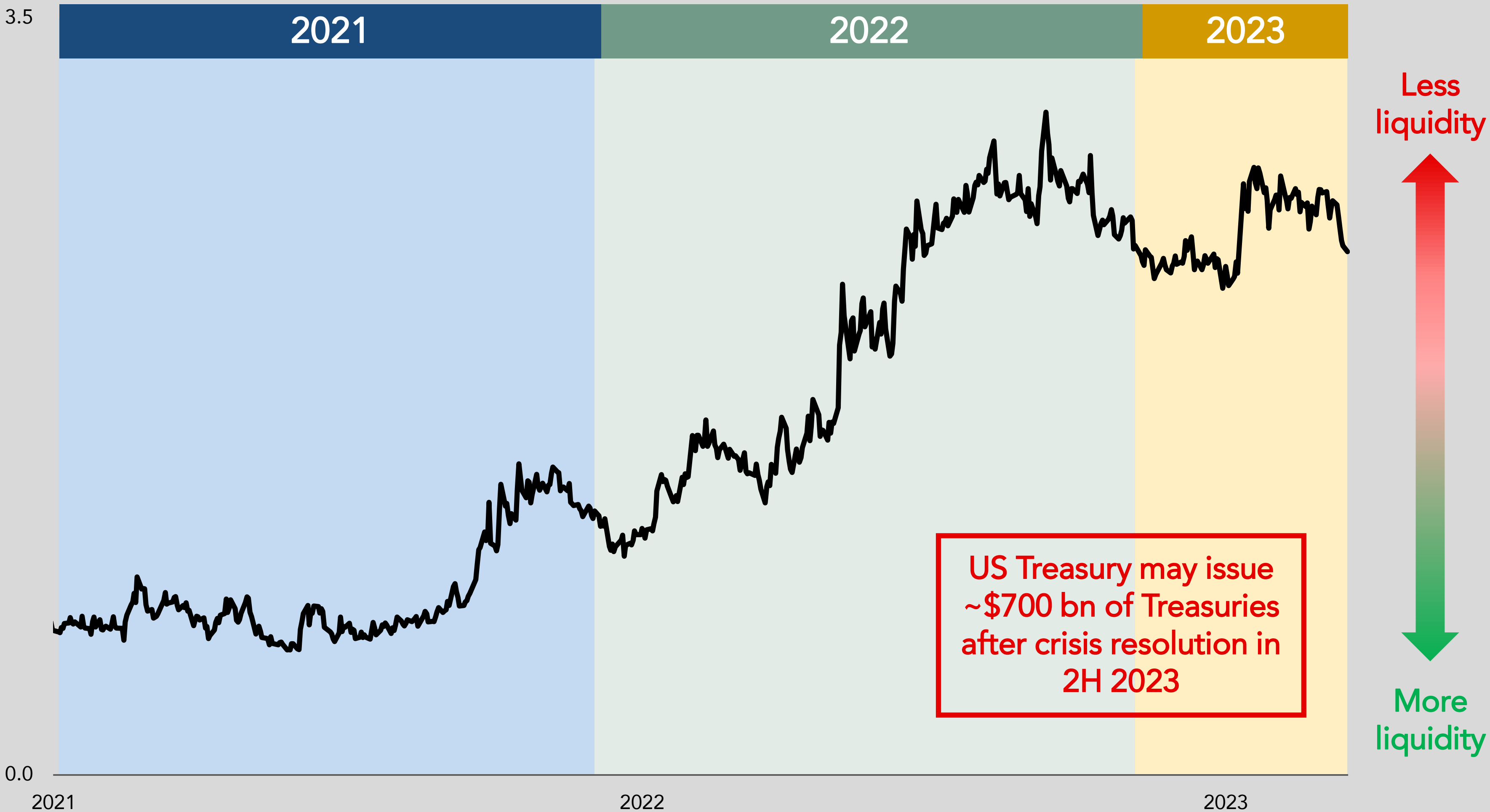
9. **2023 is not 2011.** The stakes this time are arguably higher, the risk lower. The shadow of 2011 mistakes looms large. **The UST market is nearly $25 trillion in size today (vs $9 trillion in 2011).** Trillions of global contracts are linked to Treasuries. GOP performance in the 2022 Midterms was not nearly as strong (4 person House majority) as in 2010 (24 person House majority). **The need to reduce spending today is greater, but the political mandate to do so may not be as strong.** Support among an aging US population for Social Security and Medicare is much stronger today than a decade ago, and has therefore been "taken off the table" by both sides of the aisle. Regional bank sector stress, US recession risk and a more complicated geopolitical backdrop this time.

10. **Longer Term Damage to US Funding Costs:** With nearly $25 trillion of USTs outstanding, and nearly $3 trillion of annual issuance, even a few bps of longer term impact on US funding costs would be material. In 2012, with a much smaller debt stock than today, the US GAO estimated that the 2011 US downgrade crisis cost the US Government $1.3 bn in higher borrowing costs in that year alone. **In less than 10 years, net interest expense on USTs will surpass defense spending and individual US entitlement programs (i.e., Social Security, Medicare) to become the #1 annual US Government spending outlay.**

Less Treasury Liquidity Anticipated After Ceiling Raised

US government securities liquidity index



Source: (1) Bloomberg. Data as of May 22, 2023.

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Role

Tom Joyce is a Managing Director and Capital Markets Strategist within MUFG's global capital markets and investment banking business. Based in New York, Tom heads a team that creates customized analytical content for multi-national S&P 500 companies. His team provides in depth analysis on the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

Experience

Tom has over 25 years of Investment Banking experience in New York, London, Hong Kong, and San Francisco. Over the last 15 years, Tom created and built the Capital Markets Strategy role, advising corporate C-Suite executives (Boards, CEOs, CFOs, and Treasurers) on the pervasive macro forces driving markets. Tom also presents at dozens of corporate events each year including Board meetings, CEO ExCo sessions, CFO and Treasury off-sites, corporate leadership events and conferences.

Education

Tom's educational background includes a year of study at Oxford University from 1991 - 1992, a Bachelor of Arts in Political Science from Holy Cross College in 1993, and a MBA from Kellogg Business School, Northwestern University in 2000.

Personal

Tom resides in New Canaan, CT with his wife and four sons, where he serves on the Board of Trustees of the New Canaan Library as well as the Holy Cross College President's Council.

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Role

Hailey Orr is a Director in MUFG's Capital Markets Strategy group within the global capital markets and investment banking business. The team provides market based content for corporate clients to assist in strategic decision making. Focus areas include the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

Experience

Hailey has over a decade of Wall Street experience, including three years as a Consumer Sector Specialist in Equity Sales and nine years as a Capital Markets Strategist. Hailey is also a member of MUFG's Inclusion & Diversity Council and has devoted years to participating in and developing Wall Street recruiting programs.

Education

Hailey graduated with honors from the University of Michigan's Ross School of Business with a BBA and a minor in International Studies.

Personal

In March 2020, Crain's New York Business Magazine named Hailey one of the "Rising Stars in Banking and Finance".

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Stephanie has spent over five years as a Capital Markets Strategist. She is an active member of the University of Michigan recruiting team and is focused on the diversity recruiting effort at MUFG. Stephanie is also a part of MUFG's DEI, Culture & Philanthropy (DCP) Council.

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Stephanie graduated with honors from the University of Michigan's Ross School of Business with a BBA .

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Stephanie is actively involved in NYC's iMentor program, mentoring high school students with their journey to college graduation.

MUFG's Capital Markets Strategy Team

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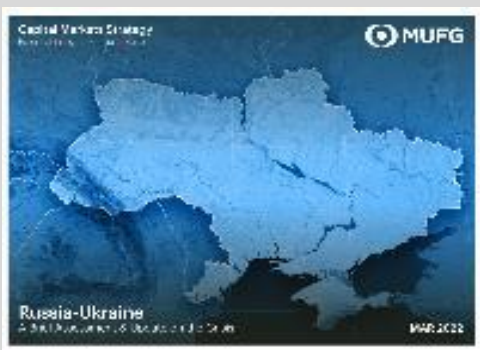

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