Policy Note

The Stakes are Higher This Time

With 3 of the 4 largest US bank failures of the last 20 years having occurred in the last two months, and a US Treasury market that is more than double the size of 2011, we believe the stakes of a US debt ceiling crisis and default are much higher today.

Size of UST Market: Today's $24 trillion UST market is 2.5x larger than 2011, and the anchor to trillions of contracts in the global financial system

Less US Hegemony: China is a more formidable economic and global power than in 2011, offering a more predictable and competitive alternative to Washington

China & EM Reserves Past Peak: China's FX reserves, and the need to cycle into US Treasuries, peaked in 2014. Since then, global central banks have purchased more gold than US Treasuries.

Russia-Ukraine: Unlike 2011, the US is driving the largest G20 economic and financial sanctions campaign in history. Weaponizing US dollar dominance has increased incentives for alternatives.

Dollar Dominance: Multi-currency settlement has increased post Russia-Ukraine, and could proliferate further if confidence is damaged

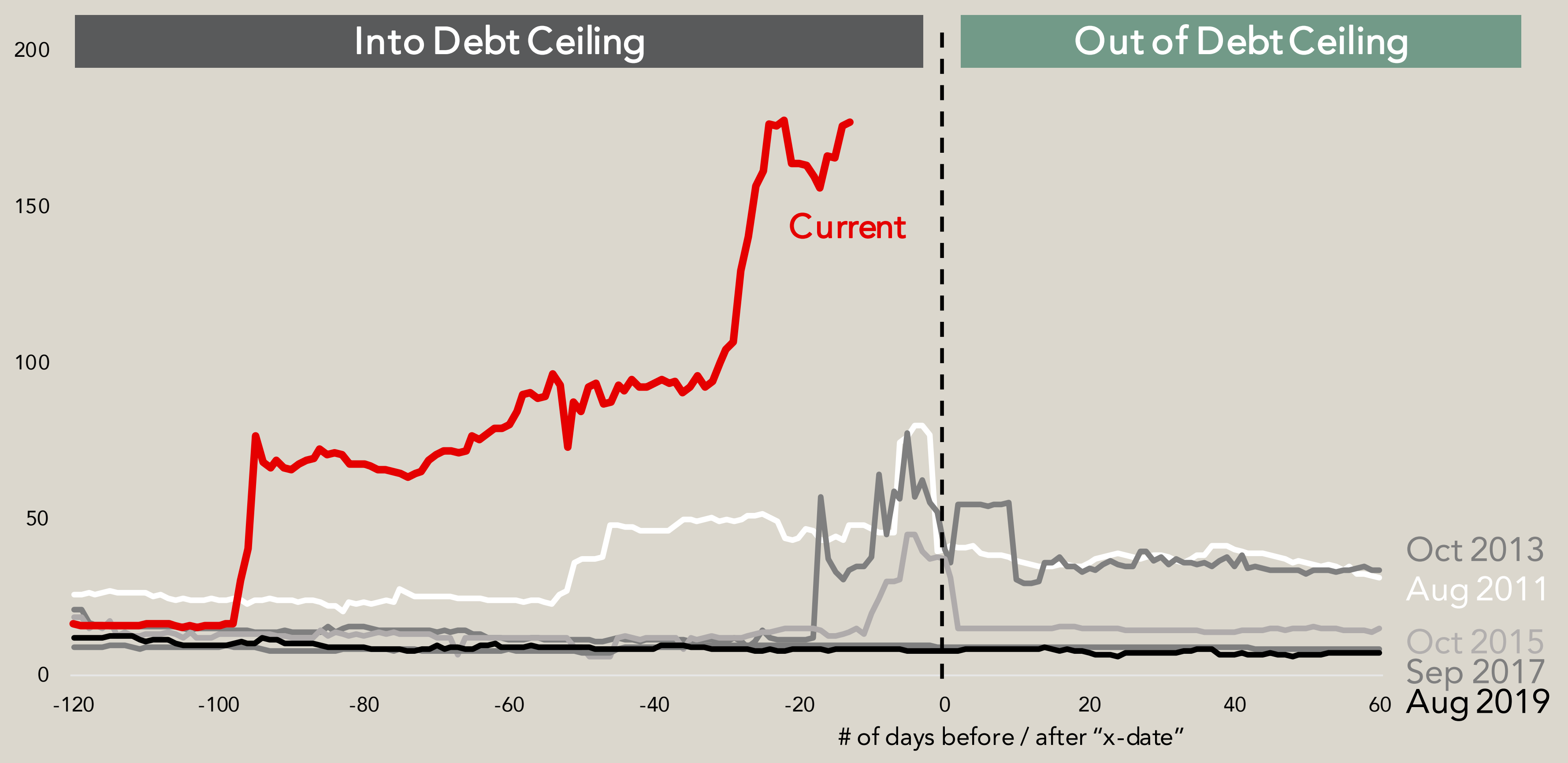
Market Sensitivity: Given the long shadow of the 2011 AAA downgrade, markets today are more sensitive to US debt ceiling and default risk, as evidenced by CDS today vs 2011

Digitized Financial Markets: The speed and magnitude of risk-off deposit and capital outflows are measurably higher today than in 2011. Structural volatility is significantly higher.

Markets More Sensitive This Time

With the long shadow of the 2011 AAA downgrade and other debt ceiling stand-offs looming large, and with the "stakes" much higher this time (larger UST market, bank stress, geopolitical backdrop), we believe that markets are more sensitive during the current debt ceiling crisis – a development we expect to accelerate as we get closer to June 1.

US 1 year CDS level around debt ceiling, bps



The Risk is Lower This Time

While the risk of US default and protracted brinkmanship should be taken VERY seriously, we believe that the risk of US default is arguably lower today than during the debt ceiling crisis and US AAA downgrade of 2011. We recognize that House Speaker Kevin McCarthy's precarious hold on his Speakership does introduce more risk and complexity to this conclusion.

Less GOP Leverage: GOP coming off massive House gains in 2010 midterms. GOP under-performed expectations in 2022 midterms just 7 months ago.

Narrow GOP Majority: 24 person GOP House majority in 2011. Only 4 person House GOP majority today.

Politics of Austerity: While debt reduction is critically important today, the "politics of austerity" were arguably stronger in 2011, with 63 Tea Party Republicans driving a debt reduction mandate.

2024 Presidential Election: With less leverage than 2011, narrower majorities, and 2022 Midterm underperformance, moderate GOP members may be more focused on projecting "governance" going into the 2024 election season.

Entitlement Spending: Represents > 60% of US spending today. With a rapidly aging population, support for Social Security and Medicare, the two largest US Gov't outlays, is much stronger than a decade ago. McCarthy has taken cuts to both "off the table."

Defense Spending: With a more complicated multi-polar geopolitical climate than 2011, strong bipartisan support in 2023 for increased defense spending.

Debt Ceiling Polling: Surveys suggest more Americans today support an increase in the debt ceiling than a decade ago. Polling signals strong bipartisan support for avoiding default.

The Long Shadow of 2011: Although 2/3 of House lawmakers were not here in 2011 and 2013, the shadow of S&P's AAA downgrade in 2011 still looms large. Markets today are also more sensitive to debt ceiling risk than 2011.

Source: Henrietta Treyz (Veda Partners). Libby Cantrill (PIMCO). Roger Hollingsworth (MUFG). Washington research and media. Bloomberg. Data as of May 12, 2023. FRED. MUFG Rates Strategy (George Goncalves).

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