Opinion **Unhedged**

The debt ceiling is scarier this time

Markets are more complacent and Congress more reckless

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Robert Armstrong & Ethan Wu 7 HOURS AGO

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Good morning. The disturbing insurrection in Brazil, for all its parallels to the US Capitol riot, has one striking difference. It took Brazil's police just hours to detain or arrest more than a thousand coup-mongers, while most of the American rioters walked free for weeks or months. Is it too far to call that hopeful?

In other news, Ethan is just back from a vacation in the Bahamas, where, sadly, he was unable to visit the old FTX HQ. Lots of tropical fish, though. Email us: robert.armstrong@ft.com and ethan.wu@ft.com.

The debt ceiling

Last week's tragicomic House Speaker election has caused a lot of anxious ink to be spilled about the debt ceiling. Here's the FT, for example:

> But the historic gridlock over who to select as Speaker has raised fresh concerns on both sides of the aisle that a small group of rebels stands to block big pieces of "must pass" legislation later this year.
>
> Top of mind is the debt ceiling, the limit on how much the US government can borrow. Economists have warned that if lawmakers do not vote to raise the limit in the coming months, the US government risks defaulting on its debts for the first time in American history.

The US places statutory limits on its total debt that must be raised by a simple majority vote in both houses of Congress. Absent such a vote, the Treasury cannot pay the government's bills after its bank account at the Fed runs dry. The limit is set at $31.348tn, a threshold the government is expected to hit — depending on spending and tax receipts — sometime early in the autumn.

For investors, there are three levels of worry here.

The lowest level of worry is that the political posturing, threat-making and general tomfoolery around the ceiling will be particularly bad this year, causing volatility in both the Treasury and equity markets. "I think the kabuki theatre is going to be particularly annoying and ugly this time . . . it will force the market to pay attention," says Isaac Boltansky, policy analyst at BTIG.

It will be uglier this time not just because the same Republican rebels who held up Kevin McCarthy's speakership are, or enjoy posturing at being, fiscal conservatives. It will also be uglier because the last few times we've played this game (2013, 2018, 2021) things turned out mostly fine (unlike in 2011, when US debt was downgraded by S&P, the market volatility was awful and everyone got a real scare). Mark Zandi, chief economist at Moody's Analytics, puts it like this:

> Markets are inured to this whole process. We've seen this movie before, and markets think they know the ending. At the eleventh hour legislators get their act together. But this is scary. Lawmakers will look to the market for guidance, and markets will look to lawmakers. They are looking to each other for cues, and taking the wrong ones.

"Legislators will land this plane, but the pilot will have the seatbelt sign lit up the whole time," Boltansky says.

The second level of worry is more serious, but only for investors in certain sectors. Fiscal hawks will try to use the debt ceiling as leverage to force though temporary or permanent spending cuts. Companies whose revenues come largely from the federal government could come under pressure. Daniel Clifton of Strategas wrote the following in a note to clients yesterday:

> [Kevin] McCarthy agreed to allow three House Freedom Caucus members to sit on the Rules Committee and these members are likely going to demand spending cuts, which do not have the support of a majority of House Republicans, let alone Democrats, as a condition of raising the debt ceiling. The importance of this cannot be overstated. Legislation has to go through the Rules Committee to be placed on the floor under regular order in the House. Conservatives have weakened the Speaker and have leverage.

Clifton notes that defence stocks — which have performed well lately — are vulnerable:

> While cutting defence spending will be difficult in this environment, we would not be surprised if some caution builds in the stocks. It is unlikely we pass new spending for the next 18 months and there will be constant fighting over the money that just passed. We also believe conservatives are calling up progressives to see if they can join together to cut defence

It is worth noting, however, that much of the budget-cutting measures that were enacted to get the debt ceiling raised in 2011 (the Budget Control Act) were promptly reversed.

The third and highest level of worry is that there is some sort of political accident, and the US actually misses an interest payment, falling into technical default. The chances of this are universally agreed to be low, but they are higher now than they were, both because of the self-reinforcing complacency among legislators and the market described above, and because of the procedural concessions wrung out of Republican leadership by the rightwing rebels.

Even if a default is brief, the ensuing financial damage would be severe. Zandi notes the example of what happened 40 years ago, when a missed payment was caused by a computer glitch. He writes:

> Just how costly [technical default] can be is evident in a 1979 episode when Treasury inadvertently missed payments on Treasury bills maturing that spring. The mishap was caused in part by fallout from a delay in raising the debt limit, but also by problems with word processing equipment the Treasury used at the time to pay investors. Even though investors received their payments with only a small delay, T-bill yields initially jumped by 60 basis points and remained elevated for several months thereafter. The cost to taxpayers was ultimately in the tens of billions of dollars.

The impact and risk of contagion to other markets would be much, much greater if the missed payment was caused by human stupidity rather than computer error.

There are members of Congress who might be prepared to risk it, says Ed Mills, policy analyst at Raymond James: "We have disrupted so many norms over the last couple of years that there are some on the Hill . . . who are kind of interested in seeing what actually happens" after a default. Says Zandi: "You have senators and congresspeople openly contemplating a breach [of the debt ceiling], saying 'we can prioritise spending, we can manage though it' . . . there are more people thinking this is no big deal."

But were a default to happen, it could be a real nightmare. "The confidence in the full faith and credit of the US government is the foundation of all other financial markets in the world," says Mills.

There are two proposed solutions to allow the government to avoid default even if an agreement on the debt ceiling cannot be reached, both of which are rolled out every time the ceiling approaches. One is the president invoking his 14th Amendment authority to pay the government's bills; the other is the minting of a trillion-dollar coin to refill the government general account. The problem with both is that they are legally shaky and reek of desperation and could scare markets almost as much as a default.

Markets just have to hope that Congress can do its job.

One good read

Has Citadel overtaken Bridgewater as the best-performing hedge fund ever?