Opinion **US Treasury bonds**

Investors are waking up to America's debt dysfunction

Market movements suggest concerns about the state of the fiscal debate on Capitol Hill are growing

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This month, global investors face a peculiar paradox. A mantra of modern finance is that Treasuries are "risk-free" assets, implying that it is inconceivable that the US government might default.

But in January, the Treasury breached the $31.4tn debt limit, capping bond issuance, and warned of a crisis unless Congress raises this — something Republicans refuse to do without massive spending cuts. And this week, Janet Yellen, US Treasury secretary, warned that funds could be exhausted on June 1.

So credit default swap prices have now jumped above 165 basis points, suggesting investors fear a small, but rising, chance of default. And while the CDS market is thinly traded, other indicators are also flashing red.

The spread between one- and three-month Treasury bills, say, has exceeded 180bp, a record high. And Alan Schwartz, chair of Guggenheim Partners, told the Milken conference this week that "short-term Treasuries yields are higher than corporate [bonds]." This implies that America's C-suite is now considered safer than Uncle Sam. So much for that "risk-free" tag.

So what should befuddled observers conclude? There is good and bad news. To start with the first: the chance of a near-term Treasury default, as classically defined, is still

very low — notwithstanding the movement in CDS prices.

That is partly because American politicians have a longstanding (and shameful) habit of repeatedly flirting with disaster before cutting a last-minute deal. And even if this does not reoccur now, the Treasury has three options to avoid a technical default if its funds really do expire on June 1.

One is to prioritise interest payments, while slashing other budget expenditure. Another is to ignore the legal cap and keep issuing bonds. A third is a gimmick like selling a trillion-dollar coin to the Federal Reserve, to boost revenues.

However, the bad news is that none of those tactics are simple to organise — or likely to calm investors. If Yellen ignores the Congressional debt limit, say, there will be legal challenges. And even if "prioritisation [for interest payments] averted an immediate default, the damage [to confidence] would be vast," notes Bill Dudley, former New York Fed President. "Stocks and bond prices would decline violently."

That would probably also spark credit rating downgrades. One agency, Standard & Poor's, has already removed America's top-notch rating. However, this has had limited impact because Moody's and Fitch still retain the AAA grade.

But, if a second downgrade now occurs, finance industry protocols will force most asset managers to take Treasuries out of the all-important AAA bucket. This could create unpredictable chain reactions.

So can this be avoided? Perhaps. Next week, Joe Biden will meet Congressional leaders, and they might try to cut a deal to keep the Treasury functioning for six months. If so, the next debt ceiling negotiations will occur amid Congressional discussions around the 2024 fiscal budget, potentially creating more bargaining chips. "The right thing to do is a short-term [ceiling] increase," Maya MacGuineas, president of the Committee for a Responsible Federal Budget, told Milken.

However, Biden says in public that he will fight any effort to link these two discussions — not least because House Republicans say they will only raise the ceiling if Democrats' favourite spending programmes are slashed. And Mick Mulvaney, former budget director in Donald Trump's White House, fears that far-right Republicans will oust their speaker, Kevin McCarthy, if any deal happens without such cuts.

"I am not worried about this ceiling — I think they are going to pass something," Mulvaney observes. "But I am worried about the next one [since] the question is: can

McCarthy survive?"

Anyway, what is desperately needed now is not just a short-term ceiling fix, but a long-term fiscal plan to tackle America's spiralling national debt. However, this will almost certainly require significant reforms (that is, cuts) to social security and Medicare — an idea that both Biden and Trump have ruled out.

Indeed, there is such political polarisation that it is unlikely the two sides could even create a joint fiscal reform commission now; or not unless forced to do this to quell a market panic. Which is not what bond holders (nor Yellen) want to see.

Maybe that crisis will now occur. And perhaps it will even spark enough humility, or terror, in Congress to start fiscal talks. After all, as Schwartz notes, the key reason the US government has been able to ignore the growing debt burden in the past decade is that ultra-low rates meant that "we were able to have flat interest rate expense for 17 years while we tripled our deficit. This is now over."

But the rub is that if market panic does erupt it will not be easy to contain and could create "economic catastrophe," as the White House notes. And "no matter how these [negotiations] play out, we have already demonstrated to the world that we are dangerously broken," as MacGuineas laments.

Or to put it another way, the real surprise of 2023 is not that the "risk free" mantra around Treasuries is cracking — but that it has remained in place for so long, given America's political dysfunction. Investors should worry.

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