Mizuho Flash: US Debt Ceiling

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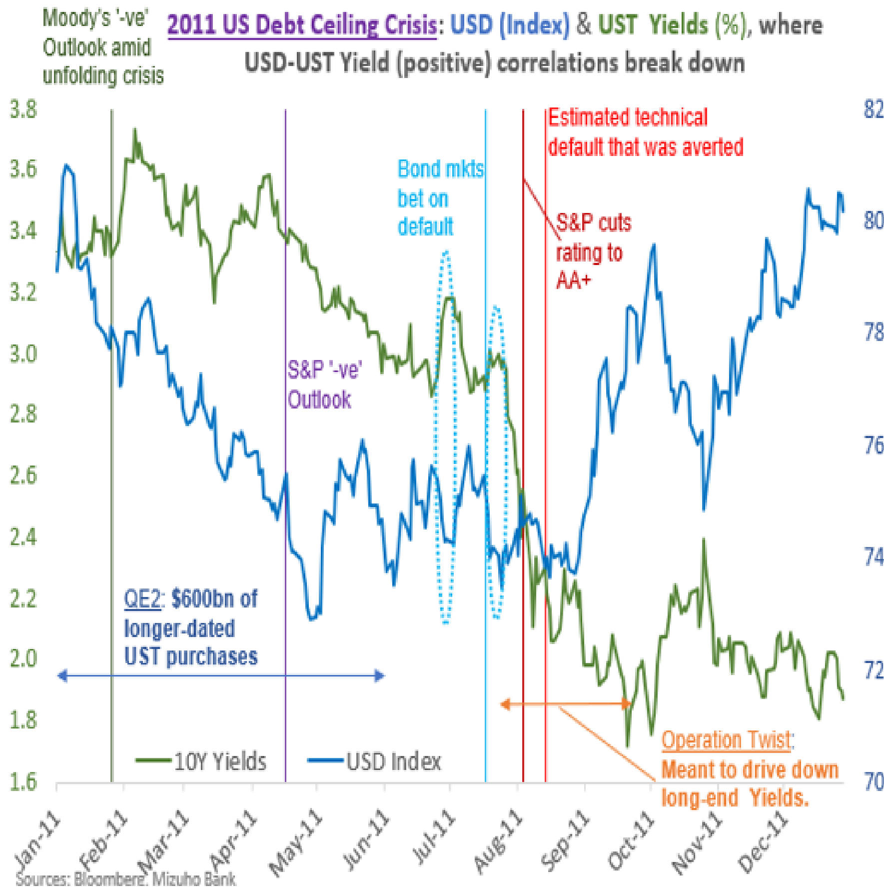
A Thought Experiment on US Debt Default



Debt Ceiling Risks

1) **Acute Yield Volatility**: Biased Higher *in contrast to 2011*
   - Sharply higher on brinksmanship & abrupt pullback on resolution.
   - 2011 yield slide fuelled by QE and "Twist"
   - In contrast, QT now may accentuate yield upside from debt ceiling woes.

2) USD-UST Correlation Compromised
   - Brinksmanship: **UST Yields up** and USD down. (*paradoxically "risk on" move*)
   - Resolution: UST Yields Down & USD up. (*oddly a haven reflex*)
   - US Debt ceiling: **Imposes Negative USD-UST Yield Correlation**; **flipping positive correlation from Fed dynamics**.

US Sovereign Credit Ratings

	Ratings	Outlook**	Watch*
S&P	**AA+**	**Stable**	N.A.
Moody's	**Aaa**	**Stable**	N.A.
Fitch	**AAA**	**Stable**	Negative

*Only invoked by impactful headlines (potential for positive or negative shocks impacting ratings).
At which point it overrides existing 'Outlook', with a 3-month window for potential ratings action.
** Typically refers to a 12-18month view of IG (investment grade) credit ratings.

"Named must be your fear, before banish it you can" – **Master Yoda**

In a Nutshell: Ratings agency **Fitch placing US sovereign ratings on 'Negative Watch'**, *flagging a serious downgrade risk within 3 months* (and supplanting the 'Stable' outlook), merely **resonates market concerns of political miscalculation that trips the debt default wire**. To be sure, this is not an unfamiliar scene, **invoking memories of the S&P's one-notch cut to US credit ratings back in May 2011** (which had been preceded by a Outlook downgrade to 'Negative' in April 2011.

Familiarity however does not mean that markets will be unfazed. What's more, **neither the high likelihood of narrowly averting a default** *nor* the **eventual relief that negative ratings action are unlikely to**

effectively compromise the credit standing of the US (upon resolution) are consolation enough for to dismiss the **potential for market upheavals on the rocky road** (*littered with brinksmanship and blame-shifting*) **to resolving the debt ceiling crisis in Washington**.

A **thought experiment about the ripples from a US debt default** (at least acute risks related to) reveals *a sharp retrenchment of US assets and accompanying tumble in USD* (as in 2011). But unlike in 2011, *UST yields/rates may surge* across the curve this time (imaginably most pronounced at the very short-end). **Diametrically opposed Fed policy** of 2011 QE ($600bn unleashed during the debt crisis) in contrast to ($95bn/mth) QT by a hawkish, Fed now **account for the difference**. In addition, and similar to back in 2011, and *equities/risk assets are also expected to swoon and slide.*

Uneven reversal of "debt ceiling brace" is likely on resolution; led by *USD rebound*, with *yield pullback checked by a hawkish Fed.* And *equities/risk assets though could struggle to fully recoup losses and/or re-establish bullish momentum* amid pre-existing geo-economic/policy risks and lingering liquidity constraints. All said, **debt ceiling risk convulsions ought to pass**; *but unevenly segue to pre-existing risks.*

Baseline Debt Ceiling Expectations

- To be sure, the **baseline is that the US cannot afford to, and hence, will not go into a default**.
- So, we **necessarily expect convulsions to be temporary***, although reversal of US debt ceiling risk positions may not be complete across all risk asset classes; given the backdrop of pre-existing risks.*

Ratings Inconvenience

- But **an extremely high likelihood of an eventual resolution** is inadequate and hollow relief for ratings agencies that by definition cannot wait for a default before reacting.
- And to be sure, **Fitch is merely tweaking S&P's playbook from 2011 in opting for a 'Negative Watch'**, *signalling more imminent downgrade risk* within 3 months.
- *Without being dismissive,* it may be worth noting that any follow-up **negative ratings action** by Fitch (or Moody's playing catch-down) **merely curate rather than create fresh US debt ceiling risks**.
- That's to say **negative ratings triggers accentuating and/or hasting markets sell-off**, but **not durably and significantly amplifying fallout** from US downgrade.
- This is **notably due to the US' "exorbitant privilege"** *of being the reserve currency*. As a result of which, markets are **likely to restore UST yields as the coveted benchmark of "risk-free rates"** for global credit/bond markets to price off; so long as the debt ceiling stand-off is resolved.
- The **irony of the risk-free rate benchmark possibly being rated below AAA by a majority major ratings agencies**, is **admittedly rich**. But *upon the debt ceiling crisis resolution*, this would be *a ratings inconvenience than an imminent catastrophe for the effective credit standing of the US*.

Technical Default/Acute Default Fear

- Not having the luxury to look past the current debt ceiling saga to a very likely eventual resolution is not just for ratings agencies, but for markets too.
- Fact is, the **odds of a technical default or acute fears of a default on a series of political miscalculations are not outlandish probabilities markets may dismiss**.
- Consequently, **possibly violent market reactions to debt ceiling headlines** are **par for the course**.

- And a **thought experiment about an outright US default** is helpful in identifying likely market instincts and any consequent fallout that will inevitably follow. To which end, de-composing outcomes to immediate "knee-jerk", subsequent calibrations and resolution helps with clarity.

Default Knee-jerk

- The **first instinct** of a US default would be a **frenzied retrenchment of US assets**.
- The consequent "risk off" is likely to trigger a **breakdown of the positive correlation between USD and UST yields**, in fact **flipping to negative correlation**. Moreover following:
  - i) Surging UST yields as US Treasuries are sold off aggressively
  - ii) USD plunge with a corresponding sell-off in USD with speculative positions piling in
    - a. *CHF, JPY and EUR might be the biggest gainers;*
    - b. *with the former two (CHF and JPY) being haven demand and;*
    - c. *the latter (EUR) the biggest counter-weight.*
    - d. *Regional haven such as SGD may benefit too.*
    - e. *Gold could have some allure here amid flight to safety, but the conflict between elevated real yields and sustained Gold rallies warns of post-resolution payback for Gold (as was the case back in 2011)*
  - iii) Sharp pullback in equities/risk assets amid generalized risks aversion rubbing off globally.

Considered Curve Nuances

- As with all things, and *true to Orwellian wisdom, some risks "are more equal" than others.*
- **Bills**: We expect the **short-term bills to bear the brunt of the blow-out** as default will imminently jeopardize liquidity from adverse money-market shocks, accentuated by USD hoarding.
- **2Y UST**: While **2Y yields may spike up sharply initially**, (overly hopeful) bets on **massive Fed easing to alleviate the fall-out**. In turn, this may leave 2Y spiralling lower with respect to bills.
- **10Y UST**: The sheer liquidity of the 10Y yields may send yields sharply higher. But with similar dynamics and recessionary fears setting in 10Y yields could also partially soften subsequently. This may be possibly less pronounced than in the 2Y if Fed cut expectations exceed 10Y liquidity effects.
- **Curve Inversion**: Consequently, this **may accelerate the reversal of current inverted yields**.

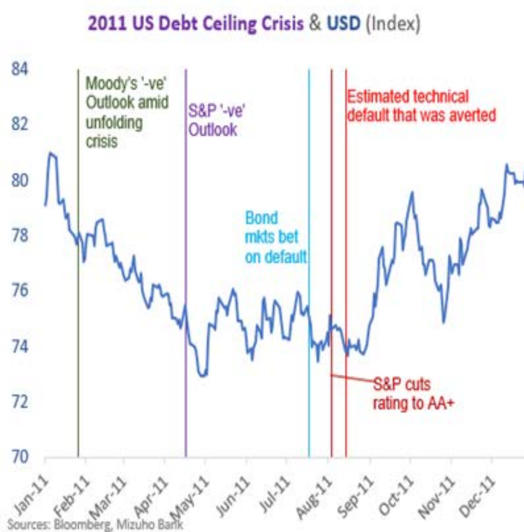
Resolution

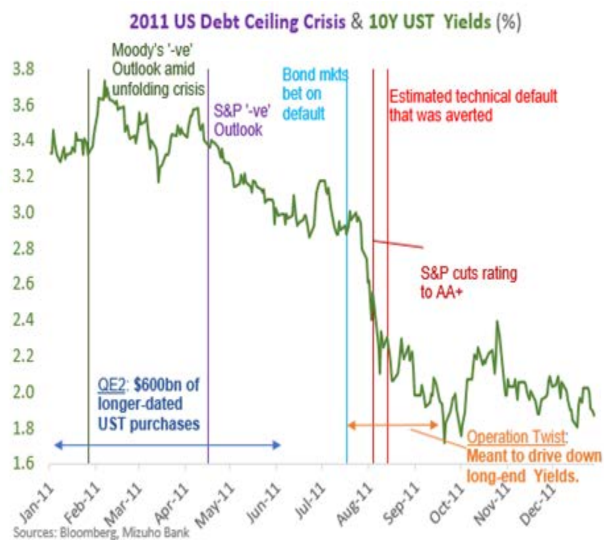
- A subsequent resolution of the debt crisis is a fair cause for abrupt reversal of the "default dumping".
- USD Snapback: This necessarily means *pronounced USD rebound* on debt default relief, *accentuated by speculative shorts squeezed* and (dovish/crisis) monetary policy bets being reversed out.
- UST Yield Ease, Not Collapse: For yields, outcomes may be more nuanced due to tensions with Fed and calibrations across the curve/liquidity. On one hand, the **exaggerated surge in UST yields** (on the initial UST sell-off) **will reverse**. But on the other, a **"higher for longer" Fed** (*especially as earlier, and likely overdone, bets on sharp Fed cuts are reversed*) **will check the depth of downside in UST yields** as will dynamic pricing of inflation-recession risk tensions.

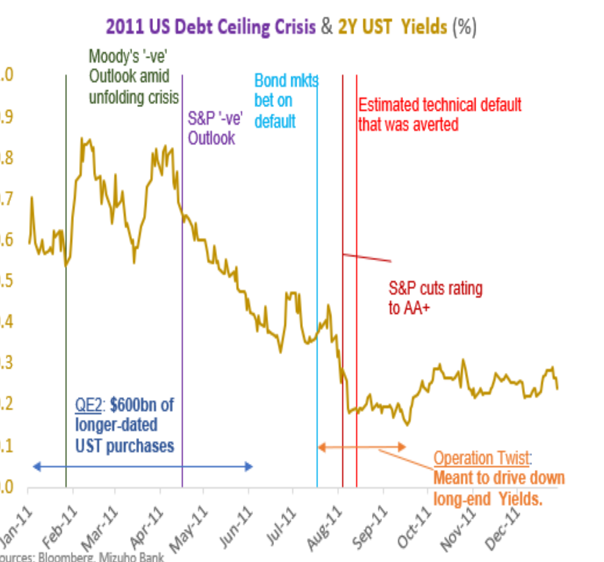
- Equities: We expect **relief rallies in equities**. But **perhaps only partially**; as full restoration and follow-through bullish momentum may be hampered by *global economic risks* and *QT constriction* alongside *credit tightening*. Moreover, *catch-up UST issuances may compete for liquidity.*

How it Differs from 2011

- One **key difference from 2011** is that **10Y UST yields were on a downward trend through the 2011 episode** (looking past fleeting bouts of bumps along the way triggered by bond market fears or ratings knee-jerk triggers) **in sharp contrast to our view of upside risks to yields now**.
- *But this was because of the overwhelming monetary policy impact of $600bn QE* then; which was *followed by 'Operation Twist'* that was means to more enduringly suppress long-end yields.
- *Whereas monetary policy is diametrically opposed this time around* with a *distinctly hawkish* slant helmed by *a "higher for longer" Fed that is concurrently engaged in $95bn/mth QT*.
- Hence the **2011 experience is insightful, but arguably irrelevant**. Fact is, this time in contrast, **upside risks to yields are likely to dominate**; hence ought not to be discounted on account of 2011.
- **USD decline into the debt crisis was more pronounced back in 2011** (again due to QE). But that merely calibrate depth, not validity, of USD rebound following a resolution.







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