Truth and Consequences of a U.S. Debt Default

We believe the risk of a technical default remains extremely low, but the consequences would be swift and painful, likely compelling elected officials to find common ground for a resolution.

Matt Toms, CFA
Global Chief Investment Officer

Here we are again. After 12 years of routine increases to the U.S. debt limit, the threat of a default is back in focus as we near the ominous yet unknown "X-date," when the Treasury will run out of options to pay America's bills.

Investors tracking the talks between Congress and the President may feel like Washington and Wall Street are living in parallel realities. Though the financial press is looking to poke the bear with soundbites from pundits debating whether or not the U.S. will default, the financial market reaction as of publication on May 19 has been fairly sanguine. Other than a dislocation in short-dated T-bills around a narrow window of maturities, prices for most financial assets continue to be swayed mostly by economic data and company earnings. (That could change in a hurry the longer this drags out.)

Which reality is closer to the truth? In this case, the truth is intertwined with the consequences.

The truth

1 This is about politics, not economics. The debate has nothing to do with the ability of the United States to meet its debt obligations. Rather, it is the political theater of a divided government that is throwing into question its willingness to service its debts.

2 A failure to reach an agreement in time would result in a technical default. There are concerns and risk that certain upcoming Treasury maturities may not be paid on time. But there is no real concern about the U.S. government's long-term ability to repay its debts.

3 Three of the five central players in the discussions right now were "in the room where it happened" back in 2011. President Joe Biden was vice president, Charles Schumer was the senior Senate Democrat, and Mitch McConnel was the senior Senate Republican. Presumably, they recall the chaos that ensued and the unpalatable environment it created.

The consequences

While we believe the two parties are likely to come to a resolution before a technical default occurs, the consequences of such a default would be substantial. The extent of the damage is difficult to predict given the scope and nuances involved. However, we see several likely outcomes:

1 A downgrade of U.S. government debt — and a potentially long road to recapturing its AAA rating — could have cascading impacts across capital markets, including higher funding costs for the U.S. (and, by extension, nearly everyone else) going forward.

2 U.S. money market funds could come under strain. Money market reforms have compelled these low-risk vehicles to focus their investment strategies on the U.S. Treasury market. What had been risk-free would become, at least in form if not substance, classified as risky.

3 Disruption in collateral management could have negative impacts on financial markets. Many investors put up collateral for various trading strategies. That collateral comes with a haircut on its value depending on the quality of the asset, with AAA rated paper subject to the lowest haircut. If the rating on U.S. Treasuries were to fall from AAA to AA, the haircut would increase and investors would need to post additional collateral, draining liquidity from the system, challenging these strategies and adding volatility to markets.

4 U.S. Treasuries and other fixed income investments could see forced liquidations. Some investors have guidelines stipulating that they must maintain a minimum allocation to AAA rated paper or a minimum weighted-average credit quality. As a result, some portfolio managers would have no choice but to liquidate their Treasury holdings in favor of other AAA issuers such as supranationals (i.e., the European Investment Bank or the World Bank).

I recall an astute commentary from *The Atlantic*'s Megan McArdle in 2011, "The Giant Disconnect Between Wall Street and Washington." She observed that few people on Wall Street understand Washington, D.C., and vice versa. It appears that assessment remains true today.

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