

All the Credit® Episode 39

Transcript

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Female Voice: You're listening to *All the Credit*, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager. And now your host Senior Portfolio Manager, Mike Collins.

Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: Hello, welcome to Episode 39 of All the Credit, PGIM Fixed Income's monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income and your host of *All the Credit*. I'll be joined by another co-host in this episode, my longtime colleague, Alyssa Davis. Alyssa is a Portfolio Manager on PGIM Fixed Income's Investment Grade Corporate Bond team. Alyssa's been with the firm for over 25 years now. And I actually have to take some credit for bringing this talent into our fixed-income team decades ago when I was on our strategy team working beside Robert Tipp. Alyssa was one of our great hires to PGIM Fixed Income. So, thank you, Alyssa, for all these years, and welcome to *All the Credit* and your inaugural hosting role. I'm really excited to have you join us today.

Alyssa Davis, U.S. Investment Grade Corporate Bond Portfolio Manager: Thanks, Mike. I'm thrilled by the opportunity to join you today. As you mentioned, you and I have worked together many times during our tenure at PGIM Fixed Income, so it's exciting to collaborate with you on *All the Credit*.

Mike: One of the goals of this podcast is to provide our listeners with thoughtful research and our views on really timely, important topics that are impacting financial markets and investors right now. And certainly, the U.S. debt ceiling is right on our doorsteps with the U.S. Treasury Secretary, Janet Yellen, just recently indicating that this X-date, which is the date that effectively the U.S. Treasury runs out of money, may be as early as this June. So, time is running out for the U.S. Administration and Congress to negotiate a deal that will prevent a potentially catastrophic U.S. government debt default. In fact, U.S. Treasury bills that mature around the time of a potential missed payment have seen their yields spike, and even credit default swaps, which is the cost of insuring against a debt default on U.S. Treasury government debt, believe it or not, have really soared recently.

Alyssa: Indeed, Mike. So, in today's podcast, we'll take a deep dive into the U.S. debt ceiling. First, we'll take a look at the brief history of the debt ceiling before moving into some of the more recent impasses which may provide insight applicable to the brewing crisis we're facing today. For most of the discussion, we'll focus on the current situation, including how we got to this point and our current status. We'll weigh the potential outcomes in an attempt to assign some probabilities to the possible solutions focusing on the most likely path ahead. To wrap things up, we'll evaluate the economic market and investment impacts we could experience ahead.

Mike: So, we have a really full episode today, and here to help us decipher all things debt ceiling is PGIM Fixed Income's very own Chief Global Economist, Daleep Singh. Prior to joining us last year, Mr. Singh served as a Deputy National Security Advisor for International Economics and Deputy Director of the National Economic Council for the Biden Administration where he coordinated the administration's policies at the intersection of economic policy and national security. He also acted as the President's representative at major international forums. Previously, Mr. Singh was an executive vice president and head of the markets group at the New York Federal Reserve where he led the implementation for most of the Fed's emergency facilities launched during the COVID pandemic. Mr. Singh earned a BA from Duke University and graduate degrees from MIT and Harvard University with a focus on international economics. Daleep was recently named one of the 2022 Bloomberg 50, an annual list of innovators, entrepreneurs, and leaders who have changed the global business landscape. Daleep, Alyssa, and I are here to give you all the credit. Welcome back to *All the Credit*, Daleep. You were featured in an episode last fall in which you and Greg Peters discussed the different macroeconomic scenarios we were contemplating at the time, and of course, we're still debating between this hard and soft landing. But of course, now we're on to the next looming crisis. So why don't you start by giving our listeners the background? It's a fascinating history, of the debt ceiling, how it came about. I bet a lot of listeners don't realize that the debt ceiling was really originally created to make it easier for Congress to spend money. But right now, of course, it's anything but.

Daleep Singh, Chief Global Economist and Head of Macroeconomic Research: Well, great to be with you both. And you're right, Mike. It's not the best dinner party conversation starter, but the history of the debt ceiling is actually pretty fascinating. It was created in the middle of World War I. And yes, the original purpose was to make it easier, not harder for Treasury to issue debt during a fragile geopolitical moment. Previous to 1917 when the debt level was created, Congress had to approve each instance when the Treasury issued debt, because, according to the Constitution, only Congress has the authority to tax, spend, or borrow. But with the debt ceiling, Treasury could borrow as much as it wanted so long as total debt stock remained under the limit set by Congress. Now leaving aside how unusual that arrangement was, no other developed country has a debt limit except for Denmark. The creation of the debt limit is generally seen by historians as a patriotic concession by Congress to share its fiscal authority with the executive branch in service of a shared purpose. And as a direct dividend of sharing this power, Treasury ramped up its issuance of war bonds. America mobilized its industrial base and helped turn the tide in favor of the Allies. And in the aftermath of World War I, the dollar overtook the British pound as the world's dominant currency. More than a century later, sadly, the debt limit is now the ultimate symbol of our political polarization and dysfunction.

Alyssa: Thank you for that historical perspective, Daleep. Let's shift now to some of the recent impasses which could provide some insight into how this current situation may be resolved. So, if we think back to 2011, the resolution really went down to the wire and the impact on the markets was pretty ugly. The S&P 500 was actually down 16.5% in less than a month's time. In your opinion, can the situation today play out in a similar way or potentially even worse?

Daleep: So, you're right. We've raised the debt limit 78 times since 1960: 49 times under a Republican president, 29 times under a Democrat, and mostly without drama. But you're right, 2011 stands out as an example of when there was quite a bit of drama and disorder. So that year, if we rewind, the X-date in 2011 was estimated to hit on August 2. Compromise on the debt ceiling was not reached until two days prior to that X-date. But then S&P downgraded the U.S. by a notch to AA+ about a week after the X-date. And the rationale they gave was pretty unconventional but prescient in retrospect. They said there's a weakening in the effectiveness, stability, and predictability of American policymaking and political institutions. And so, in the run-up to that downgrade and the aftermath, there was a sizable market impact. As you said, the S&P 500

dropped over 15% from its July peak. T-bills that were set to mature just before the X-date built a yield premium of 15 to 20 bps. General collateral (GC) repo rates rose by about 20 basis points. Commercial paper issuers had to shorten maturities because liquidity was being hoarded. But the good news is before long, most of this dislocation were traced. But reaching a compromise required deep spending cuts that set the stage for a decade of fiscal austerity, low growth, below-target inflation, and a really slow recovery in the labor market when the U.S. economy was just getting back on its feet after the Global Financial Crisis (GFC). And it really was China at that point that put a floor under global growth with what at the time was one of the largest fiscal expansions in economic history. So that's 2011. If we fast forward to today, yes, my view is the context is even more difficult and the stakes are even higher. Congress is as polarized now as it's ever been. The national debt stock is more than twice as large as it was in 2011. Foreign holders of treasuries, those holdings are up two and a half trillion since 2011. More than half of that number is held by non-G7 countries that are no longer aligned with the U.S. The Fed is now in the middle of quantitative tightening (QT), not quantitative easing (QE), as it was in 2011. And lastly, the dollar really had no competition from other currencies at that point. Europe was in an existential debt crisis. China had yet to make a serious push to lure forward inflows. Digital assets had yet to go mainstream. So, all of that, all those circumstances in 2011, they have changed. And in fact, the dollar is now the tip of the spear in the most severe sanctions campaign in economic history, not to mention the fact that we've just had our fourth emergency intervention this century to save the economy from the financial sector. So, in my view, the debt ceiling drama this year just adds needless impetus for countries across the world that are thinking about whether to hedge their exposure to the dollar-based financial system.

Mike: Yeah, that history is really amazing. People think it's a really polarized, a kind of partisan debate right now. But just looking back, doing some research, we found out that under the Reagan administration, the debt ceiling was raised 18 times, right? So historically, like you said, it's not one party or the other that's driving it. But certainly today, it's a lot of finger-pointing. So how did we get to this situation today? Where do we stand exactly? A lot of debate about what that X-date is. What are some of the tricks Treasury has up its sleeve? Obviously, they've already kind of hit the debt ceiling, right? So, we're using some extraordinary measures already. Where do we stand and what's the near-term trigger points?

Daleep: Yeah, you have it right, Mike. The debt ceiling is set by statute. Only Congress can raise or suspend it. The most recent increase to the debt limit was made in December 2021 to its current limit, which is \$31.4 trillion. That limit was reached in mid-January of this year. And so, once the debt limit is reached, Treasury has three options. One is to pay its bills out of its cash balance. The second is to deploy extraordinary measures, which are really accounting gimmicks. They just reduce the stock of debt that's subject to the limit and allow for new debt issuance. For example, retirement funds for government employees are typically invested in special Treasury securities that count towards the debt limit. The extraordinary measure is to suspend the issuance of those securities and replace them with IOUs that don't count towards the debt limit. And that creates headroom for the Treasury to issue more debt. So, Treasury has been exercising options one and two that I just described. The third option is to reduce net spending, which Treasury has not done. In terms of the X-date, it's projected to hit sometime between early June and late July. And expectations are bimodal. Why? Well, it's important to step back and understand that tax revenues really are the most important variable for estimating the X-date. They fluctuate much more than spending in any given month. April was, of course, a huge month for tax receipts. They came in somewhat below expectations. And that makes it a very close call as to whether Treasury will have enough cash to pay its bills through mid-June. If Treasury can find enough coins in the cushion to get to mid-June, there's another scheduled influx of corporate tax receipts on June 15. And then another slug of extraordinary measures that become available at

the end of June that could probably give Treasury enough cash to make it to late July. So that's why the forecasts are bimodal. Treasury is taking the conservative approach, rightly so in my opinion, and they're saying the X-date could hit as early as June 1. That's what's triggered more attention in the markets. Now, Mike, you asked, "Is there a magic bag of tricks for Treasury to deploy if Congress fails to act before the X-date?" And I don't think there really is any credible unilateral option because if you look at the menu, they're either legally dubious, unworkable, or just deeply damaging to the economy. I'll just mention a couple. One idea that's in the news is for President Biden to invoke the Public Debt Clause of the 14th Amendment. That clause says the validity of the public debt shall not be questioned. And if he invokes that clause, he could claim that the debt limit itself is illegitimate and he could direct the Treasury to keep borrowing beyond the limit. Of course, if the president makes this declaration, the decision would almost certainly get challenged in the courts. It would almost certainly crescendo into a constitutional crisis because many would argue the president's decision is subverting the singular authority of Congress to tax and spend. Then there's the gem of an idea to issue a trillion-dollar platinum coin. Just by a quirk of the law, the face value of platinum coins minted by the Treasury is unlimited. So, Treasury mints a trillion-dollar platinum coin. In theory, it could deposit that coin in its account at the Fed and withdraw a corresponding amount of cash to pay its bills. But that's the textbook definition of conflating monetary and fiscal policy. And it sets a terrible precedent whenever political authorities want to bypass Congress to spend money. That's why Secretary Yellen has already rejected this option. The last option is prioritization. In other words, prioritize payments on interest in principle ahead of other spending obligations. But here I think this idea suffers from four drawbacks. One is the operational complexity. Treasury makes 80 million payments a month and figuring out which payments to make and which ones not to make would probably overwhelm the capacity of the existing team. Second, it requires judgments made by those with no democratic legitimacy to determine who gets paid and when. Third, it's very likely that in this circumstance, we'll have questions raised about whether all investors are willing to roll over their maturing debt in full, which is not guaranteed in a full-blown debt ceiling crisis. And lastly, in terms of the economics, prioritization requires spending to equal revenues. And with a deficit baseline that's above \$200 billion per month, if you zero that out, the hit to liquidity-constrained households and businesses could be quite meaningful, to say nothing of the amplifiers through sentiment and financial markets. All of that could amount to a quarterly hit to GDP growth in multiple percentage points, not annualized.

Alyssa: So, Daleep, can you share with us how you're thinking about the various probable or potential outcomes? And please, walk us through your probabilities that you would assign to each of these.

Daleep: Sure, Alyssa. So, in thinking about scenarios and probabilities, I think there are four main ones to think about. Number one, the most benign scenario, which is an orderly resolution of this debt ceiling drama well before the X-date, I think there's only a 5% chance of that happening for the reasons I've discussed about the polarization of this moment. The second scenario is that we have a nail-biter in which we go right to the end, just like in 2011, before getting a compromise before the X-date hits. And I'll remind you, that caused a lot of market pain. It caused a rating downgrade from S&P. I'd put a 40% chance of that happening. The most probable outcome, my modal scenario of 50%, is that we go through a period of prioritization that allows us to stay current on our debt obligations but involves us failing to meet our other spending commitments. And that just leaves a small but significant negative tail risk. This is the most severe scenario in which we have an outright default, including on our debt obligations, at least for a period of time. Just to complicate things a little bit more, we are getting whispers in the press that we might get a punt on all of this until the end of September, which is when the fiscal year concludes. Why? Well, we just have an extremely short legislative runway between now and the possible June 1 X-date. Now, if we get a punt on the debt

ceiling deadline until the end of September, I would leave the probabilities I just laid out very much the same, because time is not the binding constraint. This is about political will. And deadlines are a necessary forcing function. They crystallize the mind. So, whether the deadline is in June or at the end of September, that's second order.

Mike: Yeah, politicians are really good at kicking the can down the road, right? Leaving the hard decisions for somebody else to make or just putting them off. So, it certainly feels like that's a very plausible scenario. I mean, the prioritization, which is your modal case, 50% probability sounds pretty brutal, right? As you said, people won't get paid. Either Social Security checks won't get cut or other payments won't be made. And wow, the pain associated with that, never mind the political implications of that are just profound. So, if you were sitting in Washington and at the negotiating table right now, what do you think could really happen? Obviously, you have that prioritization, but it seems like when the pain is enough, that compromise normally occurs. So how would you really expect this to play out?

Daleep: Yeah, Mike, I think you just nailed it. Things have to get worse before they can get better. It's going to be, I think, a similar sequence this time as we saw in 2011. But I think the context is more difficult. So, whether the X-date is in June or late July or gets punted to September, I think we're going to see market stress intensify in concentric circles. We've already seen it start to happen in sovereign CDS which you mentioned at the top. We're seeing it in T-bills that mature just after the assumed X-date. I think that stress will broaden as we get closer to the X-date to credit markets, equity, and currency, just as we approach the deadline. And counterintuitively, Mike, market pain is going to be the strongest signal that we're getting closer to a deal. Because let's remember, this is a manufactured drama, and market participants, wittingly or otherwise, they have a lead role to play as the victim. Their role is to express pain in the run-up to the X-date because the market's pain is what politicians need to give them cover for a face-saving compromise to raise the debt ceiling. In other words, they have to be able to say, look, we have too much debt. We have to figure out a way to reduce spending. But right now, we have no choice but to raise the debt limit to save the 401(k)s of hardworking Americans all across the country. So, I think that's the sequence that will hold. And I think the most likely outcome ultimately is we get a few days of prioritization to get both sides to blink. And that'll have a direct cost because you have to run a balanced budget immediately under prioritization. Just to give you some numbers, if prioritization goes on for a week, that's worth about \$50 billion in government spending that doesn't get made. So, \$200 billion annualized, we're close to 0.8% of GDP, times the spending multiplier. And then you've got to consider the drag from whatever compromise ultimately ends prioritization. And I think that's going to involve more spending cuts. Republicans want to cut discretionary spending relative to the baseline by about 1% of GDP for the next 10 years. Let's just say compromise splits the difference, so that's half a percent of GDP, again, times the fiscal multiplier. If you add up the direct cost of prioritization plus the cost of a deal, you're easily getting a fiscal hit that's well above 1% of GDP. And it can easily tip us into contraction when you think about the amplifiers through financial markets and sentiment.

Alyssa: As active investors, we're continually evaluating the macroeconomic and market implications of the various potential outcomes. In fact, there's actually potential for us to position the portfolios to benefit from any market dislocations. So, in the event we experience even a temporary debt default, what impacts could we see in the markets?

Daleep: We're really venturing into unknowable territory, in my view. Nobody can make confident predictions about what happens when the issuer of the world's dominant reserve currency and only risk-free asset chooses to default for the first time in its history. It's all deeply speculative, but I think in the short term,

we can be sure there would be rating downgrades. Treasury-only money funds could see outflows on the scale that we saw in 2011 and 2013, which was somewhere around 5 to 10%. Although you can make an argument that the Fed's reverse repo facility now gives the money fund complex a safer place to park their assets. Investors in the repo market and T-bills, they might, again, seek to avoid any securities that are implicated by passing the X-date. And it may be that just like in 2011, the dollar strengthens and longer-term treasury yields fall, but I'd be less confident about making that assumption now for the reasons that we discussed earlier. Some say the Fed can come to the rescue, that it can be the white knight. And my response is, yes, the Fed has options, but none of them are costless. The Fed could treat defaulted obligations the same way that they treat non-defaulted obligations in their liquidity facilities. It could say as a supervisor of banks that defaulted securities shouldn't be risk-weighted any differently than non-defaulted securities. And in the most extreme version, the Fed could buy the defaulted securities and basically quarantine them from the secondary market. But exercising any of those options could be seen as the Fed subverting the will of Congress, which is its creator and potentially its destroyer, at least in the way that we know it. The Fed would instantly become a lead player in the most bitter political battle of our time. It's the very last place the Fed wants to be as an institution that considers its independence to be sacrosanct and from which it derives its credibility. So, I think pushing the Fed into this drama would do lasting and irreparable harm to what I think is the greatest economic institution in the world.

Mike: To Alyssa's point, obviously we are trying to position our clients' portfolios to not get hurt by whatever plays out, but also maybe to be able to potentially benefit. One of the themes we have in our shop that you've been a driver of is this debt ceiling to some extent is a symptom of the polarization in Washington and the pushback on more fiscal spending, right? The big deficits we incurred during COVID, there's been a lot of pushback against that and thinking that that's what caused some of the inflation problems we're seeing now. So, if anything, if you do, notwithstanding the debt ceiling, go into a worse economic slowdown than is our base case, I mean, the typical fiscal response may not be there, right? So that's something that we think about. We're certainly positioning our portfolios to be pretty defensive right now to reduce the cyclicity in case you have that kind of fat hard-landing scenario play out. You may not have the fiscal response, and who knows if you still have sticky inflation in the threes, fours, or fives. Maybe the Fed isn't able to come to the rescue either, right? So certainly, positioning for that is something we've been doing for more than a year now.

Daleep: I think that's right. We would have a negative fiscal impulse alongside restrictive monetary policy and tremendous uncertainty domestically and also geopolitically at a moment when many are already thinking that the underlying growth rate of the economy is slowed to something well below trend.

Mike: Yeah. So, Daleep, as we wrap up, any final thoughts you'd like to leave our listeners with, many of whom are our good loyal clients?

Daleep: Well, you know, everybody loves analogies, right, Mike? So let me just offer one as a parting shot. So let's say that our country is a family run by two parents, and it's the wealthiest, most trusted, most powerful family the neighborhood has ever seen, and it's been so for several generations. But the family has been borrowing and spending beyond its means, sometimes for stuff that it doesn't need, and it's often borrowed from up-and-coming neighbors that envy our house at the top of the hill. And meanwhile, the marriage is rocky, okay, arguably more than it's ever been. And the arguments between the parents are loud. They're visible. Everybody in the neighborhood thinks the parents hate each other. And now one parent is saying he'd rather burn down the house than pay back our neighbors. Now, again, our neighbors can see and hear us. They're wondering whether they can still trust us. And this drama is the best gift we could possibly give our

geopolitical rivals. And meanwhile, the kids and the entire neighborhood are being held hostage because we can't act like a family. We've just got to do better than this.

Mike: Wow, that's a very sobering analogy, so thank you for all the great, succinct thought leadership, really great thoughts. And thank you, Alyssa, for joining, and thank you as always, Daleep. And for all the listeners, you can see all of our thought leadership, our weekly views from the desk on pgimfixedincome.com. You can see a lot of great and a hard-hitting quick reads on our bond blog. It's also accessible on our website. In fact, Daleep recently co-wrote an op-ed in *Foreign Affairs* entitled "Great Powers Don't Default: The Dangers of Debt Ceiling Brinkmanship," which was obviously really timely. So, we've been focused on this topic, and hopefully, we don't get one of those brutal outcomes. But thank you all for listening. Until next time.

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