US debt ceiling game of chicken and default risk

A US default likely won't happen. But it still could. Any imminent default would be on one of the four bills that mature between 1 to 13 June. Even if we get close to a default, rating downgrades are probable. An actual default, and it's a multi-notch downgrade. Damage to the US Treasury product as collateral is big; it could be huge. Hence the risk to the system

Looking for a prospectus for US Treasuries? Good luck, as it does not exist!

Treasuries are simply backed by the good faith of the US government. So there are no cross default provisions, meaning that if one bond is defaulted on it does not (necessarily) place the entire market into a state of default, where all bond holders would demand a simultaneous resolution. There is also no 30-day grace period, as is often typical in bond documentation. Basically, here, there is no “documentation”. So what would happen?

If there is one missed payment on a bill or bond, that bond or bill would move into a state of default

Fitch, having just moved the US to negative watch, have noted that it would move the security on which a payment has been missed from AAA to D (default), so a stand-alone default in that security. But Fitch also note it would severely downgrade all securities on which there is a payment due in the subsequent 30 days, the logic being they’d be up next for default. Bonds would move to CCC and bills would move to C.

A default on one security is a very low probability possibility (albeit not low enough for comfort). But a state of default that extended for 30 days is extraordinarily difficult, as over those 30 days the entire system is at risk of going down, and there would be a high probability attached to that. That said, to continue the analysis, likely there would be a rolling 30-day domino downgrade of securities into the C to CCC buckets as the state of default persisted.

Again, that would be the least of our concerns, as we would not have a system to talk about.

For now Bills are at risk of default. Treasuries are not, but will be at risk should we move past 15 June without a deal

So the question now is which securities are at immediate risk of default? And how big is the problem? The bipartisan policy center has revised the elevated “X-date risk range” to the period between 2 June to 13 June. There are some lumpy payments to be made through 1/2 June which could push us over the edge. And if we get beyond that, there is gauntlet to be run between then and the 15 June tax receipts deadline. If we get to 15 June without a hiccup, then the tax receipts push the X date well into the mid-to-late summer.

So, the period of immediate concern is from after 1 June to just before 15 June. The good news is no Treasuries are due either coupon or redemption payments through these dates, as payments on Treasuries are made either on a 15th of the month or on the last day of the month. So, for example, there are redemption and coupon payments due on Treasuries on 31 May. This also eats into cash, but the recent refunding also helps cover it.

The default focus therefore is on bills that redeem between 1 June and 13 June

The default focus therfore is on bills that redeem between 1 June and 13 June. There are four of them, due on the 1st, the 6th, the 8th and the 13th. The total amount due here is US$489bn. The

US Treasury currently has some US$76bn in cash at the Fed, so you can see the problem here. The difference overstates the issue as the Treasury can still issue as part of its extraordinary measures. But still, to get through that period will require quite some jiggery pokery.

If there were a missed bills payment, the only way to right this would be for Congress to act quickly to suspend the debt ceiling. Recently, Kevin McCarthy, the Speaker of the House, said this could be done within 72 hours. If there was a default on 6 June, that could be too tight to make good on the 8 June payment. But a default on 1 June or 8 June would allow enough time to get a suitable bill passed, and presumably there would be some fast-tracking employed to boot.

Expect downgrades as we enter the early part of June without a deal. That's okay. A default would not be

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There is a danger that even in the case of a default on one bond that the game of chicken continues. Maybe because the Fed acts quickly to take the defaulted bond out of circulation through an emergency bond buying measure, to protect the system. But this would be extremely dangerous, and could quickly unravel to undermine the dollar and the system. In all probability, a collapse in the Dow Jones would be enough for Capitol Hill to come to its senses and pass something to make this all go away.

But then what? S&P downgraded the US in 2011 to AA+, and it has been there since. Moody's and Fitch have the US at AAA. Fitch have now moved to negative watch. One or more of them could downgrade the US even if there is no actual default. Uncontrolled spending and elevated deficits could be enough. But the elevation of a risk for a missed payment is the most obvious front-and-centre rationale.

A downgrade or two and no default would not be structurally problematic. It would be bad, but we'd move on. However, an actual missed payment on a security would leave a more lasting legacy.

First, a technical default would have happened. Fitch, for example, would attach an immediate 2-notch downgrade to this event alone. Second, most likely, there would be a downgrade in anticipation of default. So a 3-notch downgrade is probable should there be a default on one just one security, whether a bill or a bond. And importantly, this assumes defaulted upon holders are subsequently made whole.

That would move the US to low AA (as Fitch have intimated). It could be worse should there be remnants that point to more of this cropping up again in the near future. In either case, clearing houses and other counterparties that accept US Treasuries as collateral can act to reduce their implied value. That would be a really bad front-and-centre outcome (and potentially a legacy one). The sooner this ends in a good way the better.

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