

Three make-or-break crises impacting the US

There is a thread running between the three crises being felt in the US right now. The inflation crisis was borne from the pandemic, a politically toxic one. The looming debt ceiling crisis stems from politicking that is more aggravated than ever. And the third crisis is a banking one, in part brought on by a Fed reacting to the inflation crisis. Where now?



Three Billboards Outside Ebbing, Missouri

We have big issues in play. They have evolved slowly but surely. The coming months will prove to be a make or break period.

- As the baton of power was handed over from Trump to Biden during the pandemic years we had the seeds of inflation sown as an induced boom met with a lack of ability to get hands on stuff. The inflation crisis was borne.
- The pandemic itself did little to calm the extreme heat that had built in politics pre and post Trump; in fact it has only become more intense since. Hence the looming debt ceiling crisis.
- And then, shifting gears from zero rates to 5% ones and from massive liquidity injections to

taking them away always risked a reaction somewhere. The crisis in banking is not all down to this, but it's also clearly not unrelated. The inflation crisis brought this on.

And looking forward, the last thing we really need now is a material threat to the system coming from politics and debt ceiling stubbornness. So what is the market discount as we look forward? Mixed – we assess.

Banking crisis development as measured by the Regional Bank Index and FRA / OIS – risky but tolerable

There are a number of indicators that we can track to help assess where we are and where we are likely to get to. Let's start with the banking story, and the small and regional bank stress on deposits in particular. Here the US Regional Bank Index tracks sentiment. It was at 120 a couple of months back. It's now at 80. In the rear view mirror the pandemic took it down to 60. Before that, the Great Financial Crisis saw it dip to 40. That's the potential doom leap, from 80 to 40 ahead. The question is, will it?

Bank discount is troubling, but not discounting collapse of the system or anything like that

So far the answer is probably not. We look here at the 3mth FRA / OIS spread for guidance. It essentially measures the premium that banks impliedly need to pay over risk free rates in forward space. Currently the 3mth FRA / OIS spread is at about 40bp. It spiked to 60bp when Silicon Valley Bank went down. Having journeyed back down to the low 20's bp, the crescendo in the First Republic story saw it re-edge higher. As the Great Financial Crisis broke some 15 year ago the FRA/OIS spread quickly got up to 70bp, and then gapped to over 150bp.

We're nowhere near that. The simple reference of neutrality would be the 20's bp. We are practically double this right now. Troubling, but not discounting a collapse of the system or anything like that.

Inflation crisis resolution as measure by market breakeven inflation rates – reasonably optimistic

The genesis of bank stresses in part reflects the switch in the stance of Fed policy to tightening on mounting inflation concern. Such concern has eased but has not gone away – latest core PCE readings still identify the US as a “5% inflation” economy. But there is some good news coming from market inflation break-evens, as derived from the difference between conventional Treasury yields and real yields on inflation protected securities. These inflation break-evens not only have 2% handles right along the curve, but moreover are far closer to a big figure 2% than 3%.

Inflation breakevens have a low 2% handle – that calms things if delivered

In fact, the 2yr breakeven has just this week dipped below 2%. If that's what gets delivered, the Fed's hiking job is done and dusted, and indeed the ground is laid to rationalise future cuts. While interest rate cuts likely coincide with higher consumer delinquencies and corporate defaults, and there is a feedback loop to the stresses in the banking system, where pressure in the commercial real estate sector remains under immediate scrutiny. This would become further acute should these inflation expectations not be realised, making it more difficult for the Fed to execute those cushioning cuts.

Debt ceiling crisis as measure by US sovereign Credit Default Swaps – Concerning but fixable

And as we navigate this course, we face into a debt ceiling dilemma laced with political menace that is so intense as to risk a default. Just one missed interest rate payment would imply a default. Market concern on this front is quite elevated, with 5yr Credit Default Swaps now in the 75bp area. This is the highest since the Great Financial Crisis, and is at the widest spread over core eurozone, ever. While there is no cross default in Treasuries, where one defaulted bond pulls the rest into a defaulted state, there would still be a material tarnishing of the Treasury product even if just one interest payment were missed.

One default on one bond does not have to be catastrophic – but it could be

Many players would not want to take on the risk of having a defaulted bond on their books, and the collateral value of Treasuries would come under scrutiny. One default should not take down the system if holders are immediately made whole through a swift resolution of the debt ceiling. But at this same time things could unravel quite quickly and uncontrollably. In essence the entire global financial system is at threat. Note though that while US CDS is indeed elevated, it's also far from discounting an actual default, it's just playing the (mild) probability of default.

There is sequence here that is untenable – Inflation remains high, Banking stresses intensify and US Default risks becomes real. That combination, especially the latter two, cannot be allowed to happen. If they do, forget the inflation concern, the Fed has no choice but to attempt a system rescue.

The sequence that's more likely is the one that is broadly discounted in the market – Inflation gets back toward 2%, Banking stresses ease (apart from maybe one or two further causalities), and the US does not default. This combination still brings US rates (right along the curve) down to 3%, or briefly through. But it does not cause rates to go through a GFC-type collapse.

In the end though, should any one of these three go wrong, there is a path to a far more painful outcome. That painful outcome could take rates crashing below 3%. In the extreme they go back to zero. We don't think that happens. Nor does the market discount. But the uncontrollables make the path ahead a difficult one.

There is also a route here to materially higher market rates, and that would be through a default on debt. As unlikely as that is, if it did happen it would likely be followed by a subsequent crash lower in market rates as system stresses dominate in the aftermath of a debt resolution.

None of these extremes are expected to happen. But they do make for a potentially troubling cocktail ahead. Net net they add downward pressure to market rates.

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