

Market Commentary

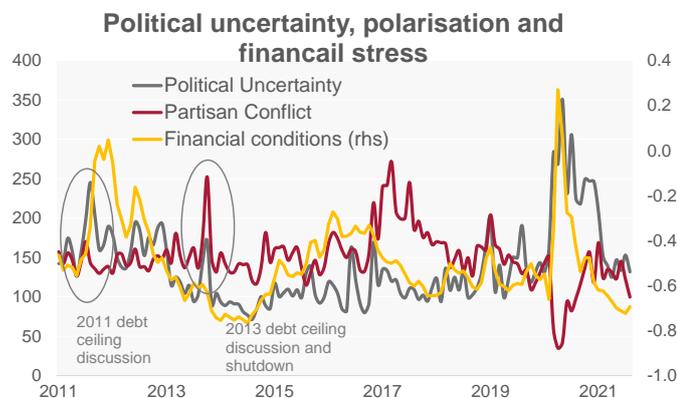
Fiscal squabbles may trigger short-term volatility in US yields

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- Two important deadlines loom for fiscal policy in the US: on September 30, the fiscal year ends and Democrats and Republicans must find an agreement to extend the funding of federal activity and avoid a shutdown. Sometime in the first half of October, if the debt ceiling is not adjusted or suspended, the Treasury will run out of cash.
- A temporary, and overall painless for the economy, shutdown is possible. A default on debt as the ceiling is not lifted appears extremely unlikely, but the Democratic majority will have to find a compromise, either within its representatives or with the Republicans.
- Either way this is likely to entail a sizeable watering down of the ambitious US\$ 3.5bn package aimed at overhauling the welfare system and speed up the green transition of the economy. The US\$ 1.2tn bipartisan deal on infrastructure may at worst be delayed.
- Even without a catastrophic ending, past experience shows that market volatility increases in the runup to the fiscal deadlines, especially for Treasuries and T-bills. This may be happen by the first half of October.

Over the next weeks, the outlook for the US fiscal policy will come again to the fore. The discussion over the size and shape of the ambitious fiscal plan aimed at reforming in-depth the welfare system and accelerate the green transition will overlap with the more prosaic need to tackle the problem of the federal debt ceiling. This is a recurring problem as the legislation sets a hard threshold that periodically the Congress suspend, normally with a bipartisan vote. Over the last year, increasing political polarisation has turned a routine decision into an opportunity for infighting. On top of it, the funding for the fiscal year 2022, will have to be decided by the end of September. In the past, failure to comply with this deadline has led to a partial shutdown of nonessential federal activities. This happened in 2013 under the Obama presidency, for reasons directly related to the budget and twice (2017 and 2018) under President Trump, mostly because of immigration and national security.



Source: Refinitiv, Federal Reserve of Atlanta

To set the stage it is useful to start from a timeline of the most important events:

- On Sept. 27 the final vote on the US\$ 1.2tn bipartisan deal on infrastructures is expected. There is a wide agreement on the measures, but the dispute could lead to a delay.
- On Sept. 30 the Fiscal year ends. By then the Congress must have passed a bill to fund governments activity. Otherwise, federal activity shuts down.
- According to Treasury secretary Yellen, the cash available to fund government activity without raising or suspending the debt ceiling ends sometime in early October. Another estimate by the Congressional Budget Office, made in July, put that date at the beginning of November.

The funding for the following fiscal and the raising of the ceiling both need a qualified majority, under the standard procedure. To attain their goals, and given the tiny majority they enjoy in both the House and Senate the Democrats have two options:

- Seek a bipartisan deal with the Republicans to settle both the funding for FY 2022 and raise the debt ceiling. The current strategy put forward by the Democratic leadership is to attach the debt ceiling suspension to the FY 2021 bill, which includes extra money to aid communities hit by natural disasters during the summer. Republicans are opposed to it, but their representatives of states hit by natural events may find it hard to vote against it.
- Lump the raising of the debt ceiling with the US\$ 3.5bn plan and pass it with just Dem votes, using the resolution (a special procedure used to pass bills with a simple majority, that normally is used only once per fiscal year). This option has quite a few drawbacks. Politically, the Democrats will take in full the responsibility for increasing the debt, while at the same time expanding welfare expenditure. This may also not go well with a couple of centrist senators; whose vote is essential and have already voiced concerns about the size of the bill. Procedurally, the enabling legislation already approved to vote the welfare bill would need to be passed again. Moreover, the House Committees have already started working on the details of the package and would have to restart from (almost) scratch. This would require some time. Moreover, the reconciliation does not allow for a suspension of the debt ceiling, but just for an increase by a hard amount of dollars. This would create further tension as the debt dynamics is highly uncertain.

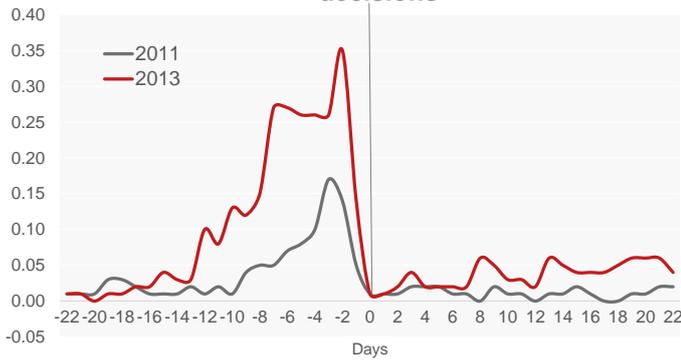
In principle, without a rise or suspension of the debt ceiling, the US could default on its debt; so, the stakes are too high to contemplate the possibility of not finding a solution. Moreover, given the slump in President Biden's popularity and the very thin and risky majority they have in both houses, the Democrats need to do something concrete ahead of the 2022 mid-term election on top of a solution to the debt ceiling issue. The fact that the two Democratic senators who are most opposed to a large spending bill are not up for re-election next year toughens the discussion within the party.

There are two possible ways out. Democrats may eventually turn to reconciliation but will have to scale down the size of the welfare bill to somewhere between US\$ 2.5 and 3tn to make sure that the whole party is on board. An alternative would be to trim the size of the bill in exchange for the Republicans' agreement to add a temporary suspension of the debt ceiling in the bill funding FY 2022. A key factor pushing for a deal is the ending of the extremely popular Child Tax benefit (early January 2022); extending them would pave the way to other measures.

Either way, the ambitious welfare reform advertised by the Biden administration would be significantly watered down. The short term economic and political fallout can be minimised by reducing the duration of the expenditure plans. So the impact on 2022 GDP would be small. On the political side, unlike other instances (like 2011 or 2013), this time the stalemate occurs when a party controls the White House and the whole congress. A compromise would be then damaging for the Democrats and the President standing, already battered by the hasty withdrawal from Afghanistan.

The risks are mostly in the short term and stem from the fact that given the level of polarisation leaders would probably need pressure (from markets, voters and business) to finalise a deal. A temporary shutdown, if the budget for FY 2020 is not voted by September 30, may shave GDP by 0.1-0.2% per week, which will be recovered afterwards when spending resumes. As the debt ceiling deadline approaches and the debate proves inconclusive tensions may emerge, especially for T-Bills. A temporary miss of the deadline would prevent the government from raising money and this like to affect mostly short-dated papers, like that T-bills as they mature every week, sometimes several times a week. Looking at the 2011 and 2013 episodes this is indeed the case, but longer maturity debt was also affected, especially in 2011 when the debt ceiling debate coincided with a rating downgrade by S&P.

One month T-bill yield around debt ceiling decisions



Source: Datastream

10-year Treasury yield around debt ceiling decisions



Source: Refinitiv

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