Default in Our Stars?

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is May 18th, 2023. Two weeks from now, it will be June 1st. Now that's the date circled on a lot of investors' calendars, especially here in the US. That's the date which US Treasury Secretary Janet Yellen has identified as the day on which the US will run out of money to pay its bills. That is, unless Congress raises the debt ceiling, that's the amount of money the country is permitted to borrow by law. To get a view into what some investors are thinking, what could happen if the US does indeed default and a little historical context for good measure, we sat down with MSCI's head of portfolio management research and, you know it, BFF of the pod, Andy Sparks. Andy, welcome back to the program. It's always great to speak with you.

Andy Sparks (01:13):

I'm delighted to be here, Adam.

Adam Bass (01:15):

As you know, we are here to talk about the US bumping up against what's known as the debt ceiling and what may happen within markets and the general economy. But before we look forward, let's take a look at where we are. What's been the actual impact on the market so far?

Andy Sparks (01:36):

In terms of the broader markets, including equities and bonds, it's probably a good assumption to say that the broader markets have not yet been materially affected, but definitely in certain corners of the market we have seen effects of potential for a US default. In the T-bill market, we've seen a noticeable increase in short-maturity T-bills whose payments could be affected by hitting the US debt ceiling, and credit default swap spreads on the US government have sharply spiked up since the start of the year. We find a very nice feature of looking at CDS spreads is that they can be used to derive a market implied probability of default. According to MSCI analysis, the CDS market implied probability of default over the next year is now approximately 4%, double the level of a couple of months ago, and up almost 10 times from the level at the beginning of the year.

Adam Bass (02:43):

Is the rise more important than the absolute level? 4% by itself doesn't seem all that high.

Andy Sparks (02:50):

It's the market's way of saying that this is still viewed as a tail event. It's not like it's 50%. I know, just from talking to friends and acquaintances, some think that a 4% market implied probability is way too low. Others think it's way too high. The CDS market does provide an objective measure, but I will definitely say that it is a thinly traded market. I don't want to say that is the estimate of default probability, but it does have the advantage that it is a traded market.

Adam Bass (03:28):

What is it about this area of the market and others where we have seen an impact as opposed to others? Why in these areas and not, say, the broader equity market, as you mentioned?

Andy Sparks (03:42):

Number one, just taking that 4% market implied default probability we just mentioned, it's not a large number. So in terms of assessing what could be the impact on the current markets, I think it's useful to think about what is the probability of default, and then if there were to be a default, how bad would it be? And so, like I said, it's very hard to detect any impact on the broader markets, and that may be partly attributed to a relatively low probability of default. But also, if there were a default, maybe it's just going to be a technical default where there's delay payments for several days, and then the government makes those payments and even pays some accrued interest for those bond holders who had delayed payments. So under one view of the market, the technical default really does not have a tremendous impact. That could help explain why there's been a relatively small impact to date on the broader market.

Adam Bass (04:59):

Sticking with that idea, just for one more moment, if somehow this question all went away tomorrow, does this tell us that the effect might continue along a muted path and perhaps even have a positive repercussion?

Andy Sparks (05:17):

To the extent that we don't think there's been a big impact on the broader market yet. If this problem just went away, there probably wouldn't be a large positive impact on the market, but volatility could be affected. It might go down. Some investors generally do not like uncertainty, and this has been hanging over the market, so the credit default swap market as well as the T-bill market, where we have seen a major move in very short T-bill yields, particularly those T-bills whose payments could be affected by the US city and the debt ceiling, then, in those corners of the market, there could be some significant reaction to a resolution in the short term.

Adam Bass (06:12):

What types of questions are clients asking? What's on their minds around this?

Andy Sparks (06:18):

I'd say there are broadly three different questions. The first is, A, what is the probability of default? B, if there is going to be a default, what are different possibilities for that type of default? And then, three, given default, what sectors could be most impacted? And this is definitely where scenario analysis comes into play. MSCI Research is currently working on modeling several different scenarios under the assumption of a US default. In all of the scenarios we're looking at, there are some negative economic effects, and the equity market does trade off, but the impact on treasuries may differ.

(07:12):

Two of our scenarios assume a technical default where Treasury payments are delayed by a few days but are ultimately paid. The third scenario is a much more dire one. It's where they're so protracted default, and the default may extend weeks and many, many Treasury holders are missing payments. In our modeling, this is truly a very bad scenario where both bonds and equities are hard hit. By the way, let me just underscore. Do not get me wrong, we are not saying that the US will default. We're just focusing on, if the US defaults, what could be potential impacts on different markets.

Adam Bass (08:00):

Thank you for that disclaimer, but let's get into a little bit more of the detail, perhaps starting with the technical default.

Andy Sparks (08:09):

We're looking at two different versions of a technical default, and both of them in terms of existing Treasury holders who are expecting payments. In both of our technical default scenarios, they are paid with the crude interest, they're made whole. But in one, we are saying that there will be a negative impact on GDP of minus 0.5% over the next year. We're modeling. Call it stigma effects. The idea is that for the broader Treasury market, they don't like the idea, even the possibility of missing a payment. Even though this time they were made whole, there's some concern that this could be a repeated game. At the margin that the treasury market reacts a bit negatively. You could say it leaves a bad taste in investors' mouth, and there's a general trade-off in treasury yields. In our other flavor of a technical default, we're assuming that the economic hit is larger.

(09:22):

We're assuming that GDP over the next year goes down 1%, it triggers a mild recession. So you still have this stigma effect. Investors don't like the fact that the government did default, albeit for a short period of time, but you also have this recession effect, taking pressure off of the Fed. The Fed does not need to be as aggressive at keeping rates high. A natural slowdown in the economy in our modeling actually leads to a small rally in treasuries. So under our two different technical default scenarios, each has a negative economic effect because the recession outweighs the stigma effect that affects the more mild technical default scenarios. Now, that third scenario is where it's really bad for investors in treasuries as well as equities, and so call it political gridlock, creates this protracted crisis and it has a very sharp negative impact on the equity market.

(10:45):

Rather than equity holders all rushing in US treasuries, treasury sell off too. For investors in multi-asset portfolios, including bonds and equities, it's truly a very bad situation. The diversifying role that a lot of investors have become accustomed to when there's a sharp selloff in equities is absent. The real difference is the recession. The Fed, of course, has raised rates very significantly over the past 14 months, and we've heard the Fed is thinking of pausing. That was apparent at the last FOMC meeting and the press conference that Chair Powell, held and a recession could help the Fed do its work. You could have inflation beginning to come down. It could take pressure off of the Fed, and effectively, it could help push rates down over the longer term, and the treasury market, anticipating that, could rally in response. It very much hinges on one's view about the depth of the economic decline and the idea that in a stronger economic decline, the Fed maybe needs to be less vigilant in combating inflation.

Adam Bass (12:14):

How much of a role does the Fed have to play here?

Andy Sparks (12:17):

The Fed, at their last meeting, this issue was discussed, and as you may recall, the Fed did raise the Fed funds rate 25 basis points, and Chair Powell did say that the debt ceiling was discussed, but it was not an important decision in raising rates. Going back to remarks he also made in March, he basically says that the Fed cannot protect the economy or preserve the US government's reputation if the government does not pay its bills. So understand, the Fed is supposed to be an independent agency, and the Fed tries very carefully to stay outside of political fights. The Fed's point is that they can't do anything about the deficit and the likelihood of fitting it. In Chair Powell's words, he says that he realizes that the consequences of default are hard to estimate but could be extraordinarily adverse and do long-lasting harm. They're paying close attention to this.

(13:40):

I should say that in previous time periods when we came close to hitting the debt ceiling, most recently in 2013, the Fed did have some special working groups looking at the potential of hitting the debt ceiling and what could happen to financial markets. Chair Powell was not chair then, but he was working at the Fed, and he was involved in some of those discussions. Chair Powell does have some personal experience when it comes to looking at the impact of the debt ceiling, but like I said before, I think they want to steer clear of policy debates with a, call it a 10-foot pole.

Adam Bass (14:27):

That's certainly consistent and reminds me of some conversations that you and I have had before in terms of the importance of investors and markets around the world, frankly, having faith in the Fed. It almost seems like part of what you're saying and part of maybe what Chair Powell is trying to do is by reasserting this independence but still talking about some potential downfalls if the government were to default, trying to make sure that they're letting markets know that they can have this faith, that we are sticking with our mission, so to speak. Is that a fair assessment?

Andy Sparks (15:09):

Yes, and take into account, the Fed has a huge research staff, so they have lots of well-trained economists who are looking at all sorts of different issues. Although I'm personally not privy to exactly what the internal research groups are focusing on in the information that they're feeding Chair Powell, I think it's safe to say that they are very attentive to this and also take into account that although the Fed's mandate is to maximize employment and to provide low and stable prices, they do have a financial stability role as well. We have seen them play that role at various times. Of course, going back to the global financial crisis in 2008, they were highly interventionist. They launched a huge wave of quantitative easing, and then during the early stage of the pandemic, they launched another huge round of quantitative easing, and they set up other emergency vehicles to help stabilize the economy at that time.

(16:25):

Even more recently, in March, when we had the first signs of problems in regional banks and several significant regional banks failing, the Fed did introduce some emergency programs to calm market. In the case of a really bad situation involving a US default, particularly if US financial institutions, if there's some risk. At some point, the Fed could play the financial stability card and say we need to intervene to try to stabilize markets, but it may require a really, really bad crisis before they would play that card because, again, this is inherently a partisan debate.

Adam Bass (17:14):

A lot of what we're looking at is helping investors manage risk, but is there anything in any of the scenarios that present potential opportunities for investors even in the case of default?

Andy Sparks (17:29):

I've worked around investors many years, and some investors love volatility. It creates trading opportunities. Where there is major movement in markets, oftentimes dislocation creates mispricing. Some investors, they try to keep some powder dry precisely to seize on the potential for market dislocation. Even though, for the average investor, a general selloff in volatility in the market is bad, there will certainly be some investors who can actually seize the opportunity and take advantage of it. Let's call them the more nimble investors who are willing to live through the early stages of a crisis and it can intervene and buy where others are selling. They're able to buy at potentially distressed prices. Also, let me just say, the CBO just came out with a report a few days ago looking at projected deficits going forward, and their numbers show deficits as a percent of GDP as growing.

(18:44):

There are some out there who say that the current level of debt is unsustainable over the longer term. So some investors might say, "We have a long-term problem with debt. It's maybe better to take some short-term pain and go through this situation now." That's one view. Another view is that the current level of debt is not that big of a deal, and under that view of the world, it's maybe better to avoid short-term pain. There are plenty of buyers of US treasuries, even though rates have risen over the past year and a half by historical standards, they're still relatively low. Even rising deficits are not necessarily that bad as long as you have lots of buyers of US treasuries, and depending on what camp you're from, you could say that the current situation is necessary or is something that we really need to avoid at all costs.

Adam Bass (19:51):

What about outside the US? What are investors, markets, and even policymakers thinking as they watch this unfold?

Andy Sparks (20:00):

As we look at the scenarios that I mentioned earlier, we were having the dollar weaken. So the idea is that this crisis is homegrown. It's emanating from the US. Under that view of the world, markets outside of the US, although they could be negatively affected, they may be less negatively affected than in the US.

Adam Bass (20:29):

What's different today, say, compared with 2011, in terms of the state of the economy? The state of the markets, obviously, inflation, a lot higher, but what's the impact of these conditions?

Andy Sparks (20:43):

2011 was, in modern US financial history, it was probably the situation where we came closest to a default. I mentioned earlier that MSCI analysis, the current CDS market implied probability of default is about 4%. We also did a similar analysis of 2011 and the debt crisis that we experienced then, and our estimate of default when CDS spreads were at their widest in 2011 is that probability of default was actually higher than that, it was actually 7%. That was the market's way of saying that it was a real serious issue, just as it is now, but there was a very strong market reaction to not just to the possibility of default, but several days after a compromise was reached and the debt ceiling standoff was addressed in Congress, the S&P did downgrade the US credit rating, and that appeared to have set in motion a very strong reaction in financial markets.

(22:07):

There was a strong selloff in the equity market, but somewhat it was very ironic, but there is a strong rally in US treasuries. So even though seemingly US treasuries were the cause of a lot of the problem, it actually seemed to benefit from the downgrade, and at least for several months it benefited. A natural question in the current situation is, if there was that strong positive bind of US treasuries back then, might that occur this time around? It is a possibility, but I think it's also important to look at differences. In 2011, the Fed was still very much involved in quantitative easing. They were adding to their balance sheet. They were buying US treasuries. In the current markets, we have a Fed that is engaged in quantitative tightening. They're letting their balance sheet run off. So that Fed backstop is absent.

(23:12):

Now, number two, 2011, we had in Europe, we had the Greek government bond crisis, which was dominating a lot of the news and casting a shadow over the entire Eurozone sovereign bond market, and you don't have that cloud now. I think those are a couple of important differences that could lead to a very different reaction in the treasury market, and also take into account that the US did not default and that rally occurred after the political compromise. But this time around, we don't yet have a political compromise, and it's not clear what form or when it may occur. We're getting back to the scenarios we've modeled. In our bad scenario, there's an actual outright default, and in our modeling, it does lead to a sharp selloff in strong contrast to what happened in 2011.

Adam Bass (24:22):

Now that's a good point. Even given all the political turmoil, et cetera, in 2011, as you mentioned, there was no default there, that we did pull back from the brink. Could that be another driver into why treasuries remained this destination for folks who are, quote, unquote, "fleeing into quality"?

Andy Sparks (24:49):

Absolutely. Ultimately, that 2011 default was averted, and it may have restored some investors' confidence in the willingness of the US government to pay bondholders what they are due.

Adam Bass (25:07):

The other example you mentioned was a couple of years later, 2013. What did we see there?

Andy Sparks (25:16):

Again, it's interesting. As I mentioned, 2011 was really the first time in quite a while that we came close to hitting that debt ceiling. Two years later, we came close to hitting the debt ceiling again, and it was within a few days of hitting it. But what's interesting then is that we did not see this sharp selloff in equities. We did not see a sharp rally in treasuries. There definitely were some effects, but they were considerably more muted than what we observed in 2011. One view of that is that, inside of those two years, the market had become, let's say, a little accustomed to this happening, and a little bit of an issue of the same thing is going on now.

(26:14):

In the past 12 years, we've seen twice this happening before, and now we're entering into a third time period and we are able to look at what happened in the past. I think many investors feel that even in case of default, it will be a technical default, and the consequences of having this protracted default are so consequential and so negative that the likelihood of it occurring is very small. Maybe the current market is partly looking back to 2013 and is saying, "It wasn't that bad then." But again, we did not technically default then. And the real question, I think, facing investors now is that, "What if it is a default?" And even if it is a technical default, how bad might it be?

Adam Bass (27:12):

We've talked about a lot of different things here over the course of the conversation, but when you're speaking with clients or just to our audience here, what can you offer them in terms of particular data points to continue to watch for as they try and figure out how to best manage these risks in their portfolios?

Andy Sparks (27:35):

First of all, these market-based measures of default and trying to observe the current impacts on markets, those are very important. Like I said, so far it's mainly been in corners of the market like the CDS market and the T-bills market. We haven't really seen this broader impact, but it's something to be very attentive to. It's also being attentive to, let's call it, sealing into uncharted waters. Certain statements, I think, the market will be very attentive to is that, if it is going to be a default, what guidance could policymakers and political figures be saying in advance of that? If we do enter into default, if there's political consensus and if there's actually acts of Congress saying, "We have to solve this issue within a week." That's going to be the type of comfort investors would like to hear.

(28:39):

I'm dealing in conjecture here. We're dealing in hypotheticals, but even into a technical default, the investors are going to be looking very carefully at what form of a technical default might happen and particularly whether it's going to be bounded. What investors do not want is an open-ended default. That could be this more protracted situation I mentioned to you, to the extent that congressional leaders can assure investors, if there's a default, we're really going to make sure that it's extremely short-term, and this time you can believe us. That assurances would be very comforting but also potentially not necessarily easy to deliver. We'll have to wait and see.

Adam Bass (29:33):

Andy, thank you so much, as always, for joining us and providing your insights on a continually fluid situation, unfortunately, but we will continue to watch as it unfolds. Thank you so much.

Andy Sparks (29:44):

Thank you very much, Adam. Bye.

Adam Bass (29:47):

That's all for this week. A big thank you from Joe and me to Andy, and to all of you for listening. You can find Andy and Team's latest research on the debt ceiling debate, as well as other insights, at msci.com. Next up on the program, we dive headfirst into the sea of climate-related regulation that investors are facing in the European Union. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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