HOW THE US DEBT CEILING AFFECTS CANADIANS

May 2023

Michael Sager, Ph.D. – Executive Director, Multi-Asset & Currency, CIBC Asset Management

The debt ceiling is a limit set by the US Congress on the amount of permitted borrowing the US Department of the Treasury (Treasury) is approved to use to fund the gap between its tax receipts and spending. This limit—currently set at $31.4 trillion—was reached on January 19, 2023. Since then, the Treasury has been undertaking what it calls "extraordinary measures" to prioritize government debt payments, as well as military and social security payments, by deferring payments in other areas of government.

How long these extraordinary measures can sustain the Treasury depends upon the strength of tax receipts. At the beginning of this month, Treasury Secretary Janet Yellen and the Congressional Budget Office (CBO) both concluded that the Treasury could run out of funds by early next month (termed the "X-date"). Without some form of debt ceiling agreement by that time, a partial shutdown of the federal government will likely occur. In the worst-case outcome, this could be followed by a debt default.

Looking past the political brinkmanship that is likely ahead, the probability of a US debt default remains low. However, we remain alert to this risk and are closely monitoring events.

The implications of a default would likely be severe, from both an economic and political perspective. This means a compromise agreement will likely be reached, even if it takes until the eleventh hour. The Republican majority in the House of Representatives recently passed a bill to raise the debt ceiling. This bill will not be approved by either the Senate or the White House, given the extent and nature of spending cuts it also requires. Serious negotiations between Republicans and Democrats have yet to begin. Market participants are understandably concerned.

How does the debt ceiling impact markets?

The market impact of debt ceiling concerns is intertwined with ongoing US banking system stress, as well as general recession fears. This makes it difficult to disentangle and isolate the precise impact on markets of the debt ceiling. But we can identify the broad themes we expect to see. According to the White House, "History is clear that even getting close to a breach of the US debt ceiling could cause significant disruptions to financial markets that would damage the economic conditions faced by households and businesses."

Markets do not like uncertainty, particularly when it surrounds the safest financial asset in the world: US Treasuries. Since the beginning of May 2023, volatility in both equity and fixed income markets has moved higher. The level of equity volatility is still relatively low and could rise further depending on events. Based on historical precedent, higher volatility could be accompanied by a decline in equity markets. Equity prices have weakened in the past couple of weeks, at least partly due to debt ceiling concerns. Together with our downbeat assessment of the economic outlook and elevated equity valuations, these concerns are likely to push equity markets lower in the near term.

The negative impact on equity markets and economic growth of debt ceiling uncertainty could be sustained even beyond the resolution of this issue because the Treasury will need to replenish its reserves of cash. Drawing liquidity from the private sector means there will be less available cash to invest in financial markets or to spend in the real economy.

Somewhat counterintuitively, the yield of US Treasury bonds (the debt instruments potentially subject to default) has declined in the past when the various branches of government have wrangled over the debt ceiling. We expect the same to occur again this time because of the low probability investors generally attach to a default scenario and the tendency to shift capital towards a perceived safe asset in periods of uncertainty. Stronger Treasury prices and lower yields, also indicate investors consider uncertainty bad for economic confidence and growth. We agree. Weaker growth is likely one of the more persistent implications of heightened market uncertainty expected in the next several weeks, whether or not the debt ceiling is ultimately resolved in a constructive manner.

Debt ceiling uncertainty is causing distortions at the short end of the Treasury yield curve, with the interest rate on bills maturing just after the projected X-date moving sharply higher than the rate on bills maturing immediately prior to this date.

Other measures of financial market stress, including corporate credit spreads, have remained relatively well-behaved. As we get closer to the X-date, we will likely see broader evidence of uncertainty and stress, at least temporarily.

Will the Canadian dollar's value against the US dollar be impacted?

Similar to US Treasuries, the US dollar (USD) is considered a safe-haven asset. It often outperforms during periods of heightened market volatility. Periods of debt ceiling uncertainty, however, are an exception to this general rule. During these times, and unlike US Treasuries, the USD typically weakens substantially before regaining at least some lost ground once an agreement has been reached.

We doubt the Canadian dollar (CAD) will benefit from USD weakness ahead of a debt ceiling agreement. The Canadian economy is highly reliant on the US economy. This puts the CAD at a disadvantage relative to its global peers like the Japanese Yen or the Euro. In addition, higher volatility and uncertainty are likely to adversely impact the outlook for global economic growth. The CAD is a pro-cycle currency. This means it performs relatively well in periods of strong growth, and less well in periods of economic slowdowns or recessions. Longer-term, we're more positive in our outlook on the CAD as a result of an expected trend- weakening in the USD, unrelated to current debt ceiling issues.

Will the debt ceiling influence the Bank of Canada's interest rate policy?

If resolved without a US debt default (our strong base case), current concerns over the debt ceiling will not change the trajectory of demand and supply fundamentals, which determine the behaviour of inflation. This is the Bank of Canada's (BoC) primary focus. In this case, there will likely be no substantive change in policy stance or thinking. The BoC is currently in 'wait-and-see' mode.

In the case of a technical default—which we don't expect—market volatility and risk aversion would rise significantly, and corporate and consumer confidence would likely deteriorate substantially. The risk of a deep and protracted economic recession would rise, including in Canada. If this happens, the BoC and the US Federal Reserve, along with other leading central banks, would likely respond by aggressively reducing policy interest rates and providing ample liquidity to the financial system.

Geopolitical considerations when Canada's biggest trading partner keeps playing with fire

For many decades, the USD has been the world's reserve currency. This status comes with benefits, including the ability to access capital at interest rates lower than other borrowers. In the past few years, the dominance of the USD's status has begun to erode a little. It would be undermined further by a failure of the US government to pay its debts.

Several countries, most obviously China, are seeking ways to diversify economic, technological, and financial relationships in order to minimize dependence upon the US economy, Treasuries, and the USD. At the margin, episodic uncertainty over the US government's willingness and ability to service its debt can only encourage this trend.

What are the potential impacts on investors and portfolio diversification?

Well-constructed portfolios built for long-term investors focus on long-term expected returns. Investors are well advised to look past short-term volatility and focus on the long-term fundamental drivers of portfolio performance. These include the outlook for growth and inflation, corporate profits, demographics, and productivity.

In this context, and in the absence of a US debt default, which we consider a low-probability event, the political drama surrounding debt ceiling posturing and resolution will likely prove to be only a temporary sideshow.

About the author

Michael Sager, Ph.D.
Executive Director,
Multi-Asset & Currency,
CIBC Asset Management

About CIBC Asset Management

At CIBC Asset Management, we believe that every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation, and responsible investments.

Across a spectrum of investment solutions, we commit to best-in-class research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

Contact us any time

To learn more about CIBC Asset Management and our investment solutions, please contact your advisor. For more insights, connect with us on LinkedIn and Twitter.

The views expressed in this document are the views of CIBC Asset Management Inc. and are subject to change at any time. CIBC Asset Management Inc. does not undertake any obligation or responsibility to update such opinions. This document is provided for general informational purposes only and does not constitute financial, investment, tax, legal or accounting advice nor does it constitute an offer or solicitation to buy or sell any securities referred to. Individual circumstances and current events are critical to sound investment planning; anyone wishing to act on this document should consult with their advisor. All opinions and estimates expressed in this document are as of the date of publication unless otherwise indicated, and are subject to change. Certain information that we have provided to you may constitute "forward-looking" statements. These statements involve known and unknown risks, uncertainties and other factors that may cause the actual results or achievements to be materially different than the results, performance or achievements expressed or implied in the forward-looking statements.

CIBC Asset Management and the CIBC logo are trademarks of Canadian Imperial Bank of Commerce (CIBC), used under license. The material and/or its contents may not be reproduced without the express written consent of CIBC Asset Management Inc.

592 | 05/2023