Analysis

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Watch out if the USA defaults – it won't be pretty

Key take-aways

- US Treasury bond yields act as the foundation or risk-free rate of the global economy, so it could cause global market chaos should the US Treasury be unable to meet their repayments on time.
- Although it's not likely that US debt would have to be rescheduled or that investors would actually lose money, a technical default or the inability of Congress to raise the debt ceiling could spark a downgrade of the US sovereign credit rating, as occurred in 2011.

The most powerful nation in the world, the USA, stands on the brink of a self-inflected debt default, an event that the US Treasury Secretary Janet Yellen says would cause recession and a stock market plunge, and which the credit rating agency Moody's says would cause Americans to "pay for this default for generations". We know how we got here – the polarisation of American politics and the toxicity the Trump years which has led to some 70% of Republicans not accepting Biden's Presidency as legitimate.

But this isn't entirely new, and President Obama faced a similar crisis in 2011 when the Republican Party also refused to increase the debt ceiling. The debt ceiling is a measure which was originally intended to prevent a President from increasing spending to fight foreign wars, but which today has become a political tool used to try to ruin Joe Biden's fiscal stimulus plans, make him look weak,

and pave the way for the GOP to regain control of Congress in next year's important mid-term elections, leaving Biden as a lame duck for the remainder of his term. Treasury Bills maturing around the time of the possible default (likely to be December this year if nothing else happens) have started to wobble, and US Credit Default Swaps (a measure of the cost of insuring Treasury bonds against default) have increased, albeit to still-low levels.

Looking back at the 2011 debt ceiling crisis, it did lead to the US government's sovereign credit rating being downgraded by S&P, from AAA to AA+, which was a huge deal at the time. S&P said that it expected the US's fiscal position to deteriorate over coming years, and it did, by more than they predicted. Net General Government Debt hit 80.7% of GDP in 2015, and 103% of GDP in 2021 (Covid spending of course was partly responsible for the most recent increase), all way above what was traditionally seen as "safe" for a AAA rated economy (around 60% or below). S&P also then worried greatly that the absence of bipartisan consensus on fiscal policy put America's credit rating on a weak footing – fears that must surely be higher now. Should we expect to see further US credit rating cuts?

> "Expect a missed coupon payment to cause chaos in global financial markets"

Well yes, and especially if the US does default on an interest payment, even if that default is more technical in nature rather than a formal debt restructuring resulting in losses for investors. US Treasury bonds are the foundation assets of the global

economy – all other sovereign bonds are compared to them. Their yields set the “risk free” rate for the global economy, and from that we value equities, real estate and everything else. So expect a missed coupon payment to cause chaos in global financial markets.

There is little likelihood that investors (including China and Japan, each with over $1 trillion of Treasuries) will take a haircut (or losses) on this debt. Why would a sovereign nation with the ability to print its own currency, ever need to restructure its debt? And that for me is a problem with the credit rating agencies – when looking at the US, the real risk for investors is normally around inflation. A government could inflate away its liabilities (10% inflation would halve the “real” debt burden over seven years), and yet because investors get their $100 back when the bond matures, the rating agencies are happy. The AA+ credit rating only tells you that S&P expects you’ll get $100 paid to you, not that you’ll be able to buy the same amount of goods with it as you used to. And this seems like a failing of the methodology. In the meantime, watch out below as the US’s reputation for fiscal and political competence takes a hit - global markets and economies won’t like that.

*This article was sourced from M&G Investments (UK). Read more here. □

Jim joined M&G Investments (UK) in 1997 and in 2020 was appointed as the Chief Investment Officer of M&G Public Fixed Income. He is responsible for managing and co-managing a range of fixed income funds domiciled in London and Luxembourg; and heads the team responsible for investing across investment-grade and high-yield credit, government debt and emerging markets debt. With nearly three decades of investment management experience, Jim started his career in the investment industry at the Bank of England in 1992 where he worked as a gilt market analyst and dealer. His qualifications include a B.A. (Econ) Economics from the University of Manchester and completion of the Executive Programme at Singularity University, Silicon Valley. He is also an Associate of the CFA Society (UK).