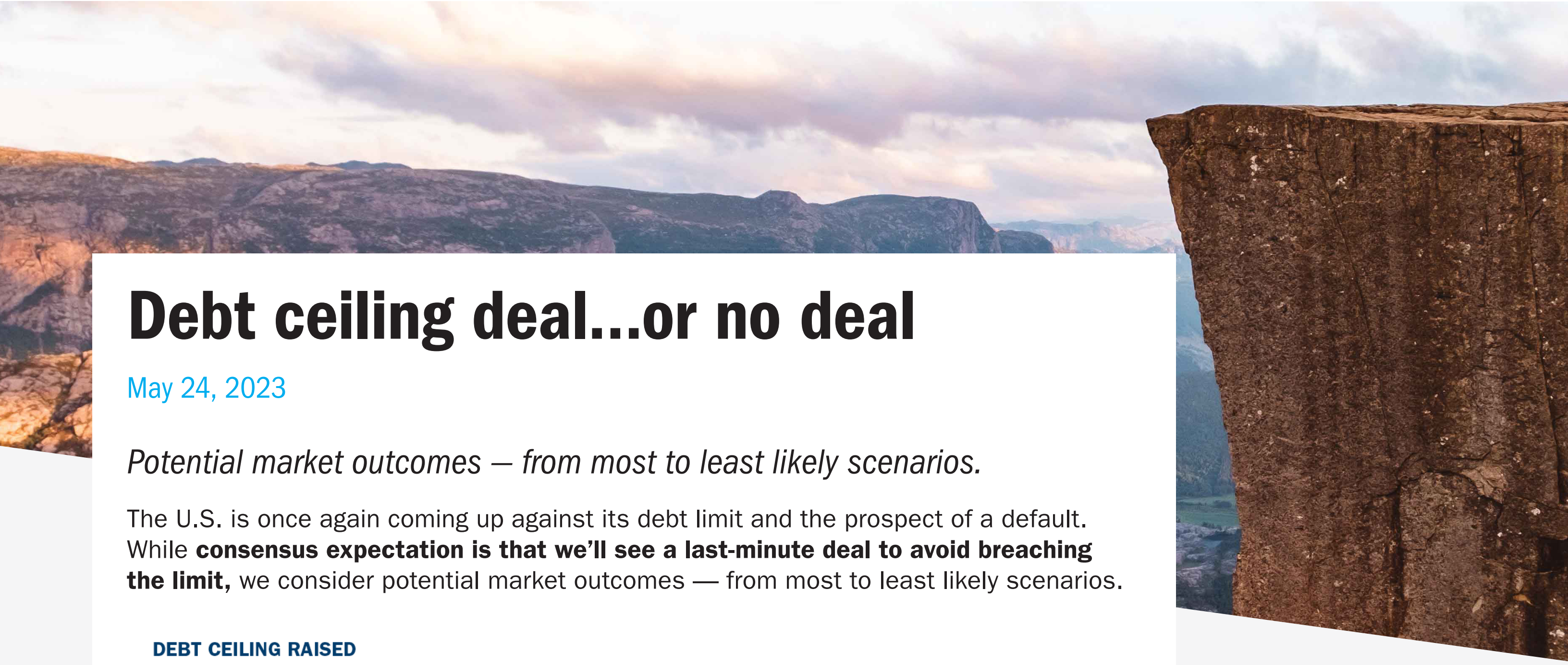

Debt ceiling deal...or no deal

May 24, 2023

Potential market outcomes — from most to least likely scenarios.

The U.S. is once again coming up against its debt limit and the prospect of a default. While **consensus expectation is that we'll see a last-minute deal to avoid breaching the limit,** we consider potential market outcomes — from most to least likely scenarios.

DEBT CEILING RAISED

Last-minute deal

Congress and the White House agree to raise the debt ceiling at the very last minute.

Market impact

We'd expect higher volatility and wider credit spreads as we approach default, and then a market rebound once a deal is struck.

Kick the can down the road

Congress agrees to raise the debt limit by a small amount, buying more time.

Market impact

Higher and more extended volatility as negotiations drag on.

DEBT CEILING BREACHED

Technical default

Because the U.S. Treasury will not have enough cash on hand to meet all obligations on time and in full, it will have to prioritize payments and potentially delay payout of principal/debt service. This is not the same as a wholesale debt restructuring.

Executive Branch action

The president could invoke the 14th Amendment, on the theory that a default is not permitted by the Constitution. This approach is constitutionally questionable and would likely be challenged and adjudicated before the Supreme Court.

Market impact

A risk-off environment, in which we could see:

- Equity volatility spike as the U.S. enters uncharted economic waters.
- The U.S. dollar weaken v. other reserve currencies.
- Gold and other flight-to-quality assets outperform.
- Wider credit spreads within fixed income.

Long-term Treasuries would usually rally in a risk-off event like this, but because Treasuries are at the center of the default story, we could see them sell off.

- If they do sell off, the banking system could come under further pressure, because its primary source of collateral is U.S. Treasuries.

A protracted period of debate or default could begin to damage the standing of the U.S. in global markets, impacting the standing of the U.S. dollar as a reserve currency and the relative appeal of the U.S. versus international equity markets.

There's also impact for the real economy. In a protracted technical default, the government will need to balance the budget, leading to a cut in spending equal to the size of the deficit (currently 5.3% of GDP*). This would result in a deep recession.

Other creative solutions have been floated, including minting a $1 trillion coin to be deposited at the Fed and then using the proceeds for payments, liquidating non-marketable securities from government pensions, and issuing premium bonds. We believe these are unlikely.

Joshua Kutin
Head of Asset Allocation, North America

Edward Al-Hussainy
Senior Currency and Rates Analyst, Head of Emerging Market Fixed Income Research

The bottom line

The base case scenario is that an agreement is reached — likely at the last minute — and we still expect higher volatility as rhetoric heats up. In 2011, the rating of U.S. debt was downgraded due to debt ceiling brinkmanship. There could be longer term implications once again, especially if the rest of the world grows tired of our repeated debt ceiling crises.

*Congressional Budget Office

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