THE BEAR TRAPS REPORT
Investment Research Publication

11/22/2022

Debt Ceiling Drama 2.0

Taking Back the House, Fighting the Ceiling

The midterms are over, Republicans have taken back the House and we expect an epic fight over the debt ceiling. The high drama may start far earlier than many expect. After taking back the House in the November 2010 midterm elections, hysteria started by the summer of 2011. The "Tea Party" Republicans - in control of the purse strings - pushed the U.S. to the brink of a technical default.

Memories -- the Summer of 2011

US loses AAA credit rating after S&P downgrade

6 August 2011 · Comments

News of the downgrade ended a tumultuous week for US finances

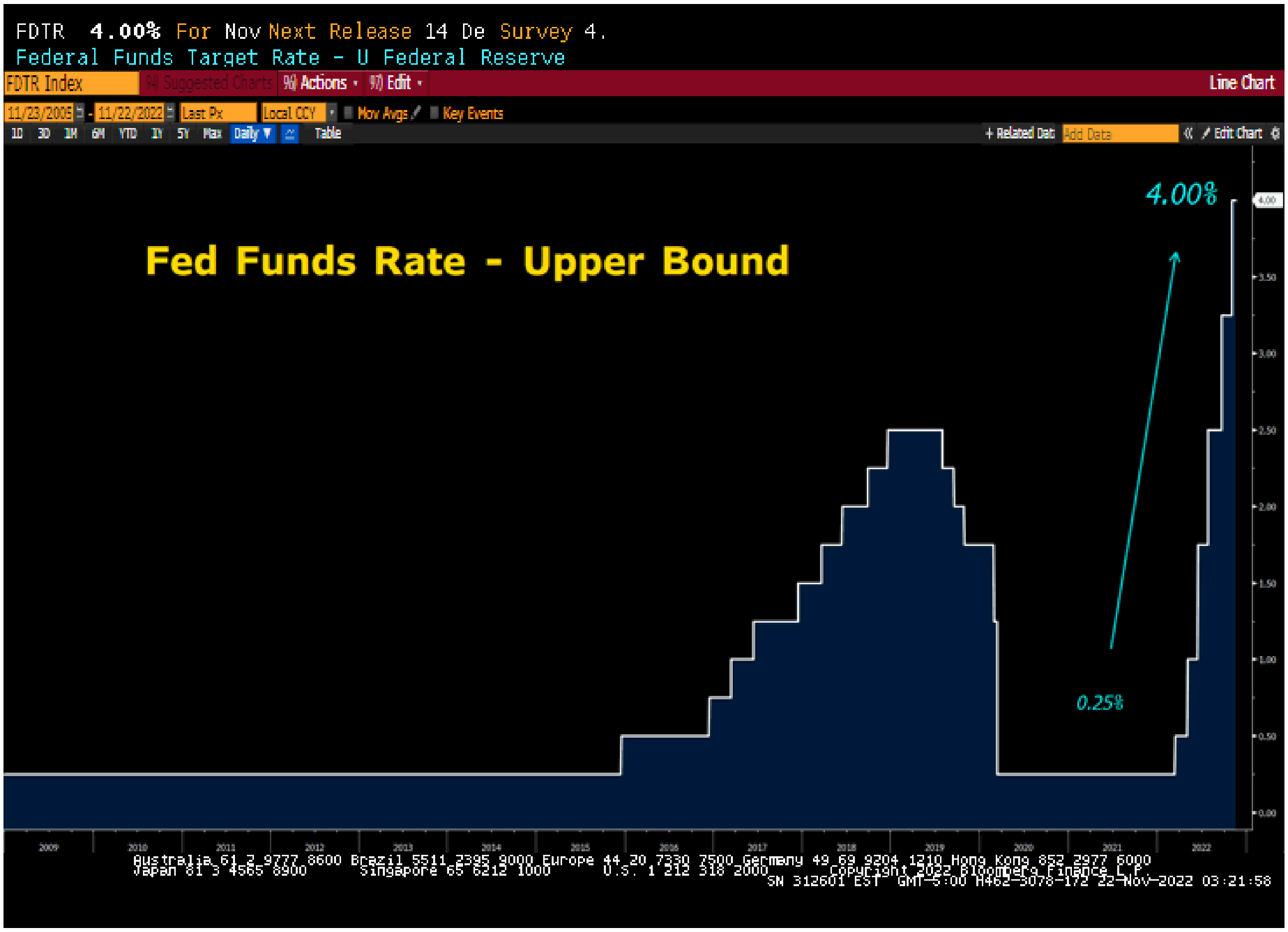
One of the world's leading credit rating agencies, Standard & Poor's, has downgraded the United States' top-notch AAA rating for the first time ever.

The rating agencies went wild - a GOP showdown with the Obama White House on spending cuts offered too much uncertainty for S&P. Of course, Europe´s Grexit crisis was just kicking into gear as well, and this duel-dynamic further fueled equity market volatility. The summer of 2011 was one to remember, the S&P 500 peak drawdown was 18% and U.S.10-year Treasury bond yields plunged 30% in the final weeks around the default deadline. Things are even more complicated now. Republicans, led by the Freedom Caucus, are hellbent on using the debt ceiling to impose fiscal discipline on the Biden administration. Inflation is still a top concern among voters, which emboldens especially the deficit hawks in the Freedom Caucus. Summer of 2011, headline CPI YoY was 3.8% vs. 7.7% today, budget hawks have higher ground for their sales pitch.

"If 10s (U.S. Treasuries) go to 4.9%, U.S. budget interest expense ALONE will be 30% of GDP annually, which is a covid pending emergency spending event every year. At 3.8% across the yield curve, interest on the debt is greater than Medicare spending."

Stan Druckenmiller

Stress Points

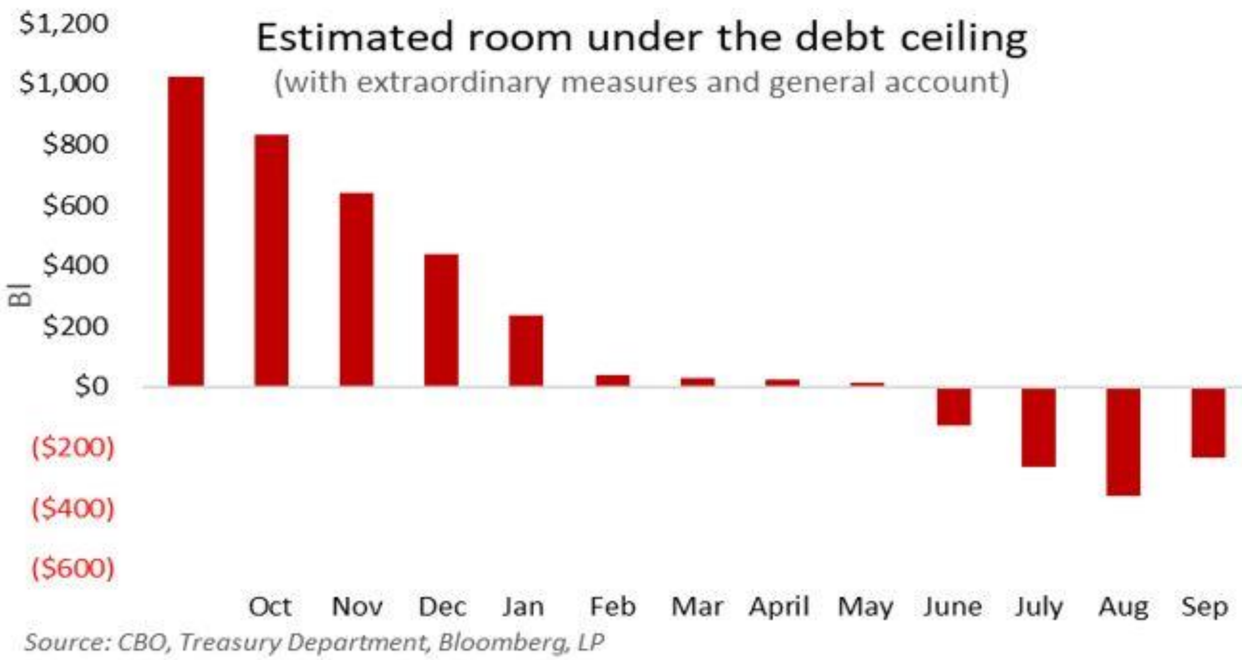


Medicare is projected to become insolvent in just 6 years. Most of the publicly available modeling and assumptions were calculated before the Fed´s dog and pony show - chest-pounding rate hikes. In the coming months, the mathematical unsustainability of higher rates will be on stage for all to see. The politics behind the math will come with high - we mean HIGH drama.

"The Social Security and Medicare Trustees released their annual reports on the state of the trust funds today. The Trustees find that Medicare's Hospital Insurance trust fund ***will be insolvent by 2028****, Social Security's Old-Age and Survivors Insurance trust fund will* ***run out of reserves by 2034****, and the theoretically combined* ***Social Security trust funds will be insolvent by 2035****. Upon insolvency, Social Security benefits will be reduced across-the-board by 20 percent under current law while Medicare Hospital Insurance payments will be reduced by 10 percent."* **CRFB, June 2, 2022**

The assumptions above from the CRFB were released **BEFORE the last FOUR 75bps rate hikes. Social security and Medicare are non-discretionary entitlements. Social Security benefits will be getting a 8.7% raise for 2023, the most significant COLA surge since 1981. The largest ever was in 1980 in the middle of a deep recession. Social Security benefits will increase by more than $140 per month starting in January for 65 million Social Security beneficiaries, most of whom rely on Social Security for nearly all of their income. In 2022, close to 22% of the budget, or **$1.2 trillion**, will be paid for Social Security, which will provide monthly retirement benefits averaging $1,540.*

Cash Burn, Clock Ticking



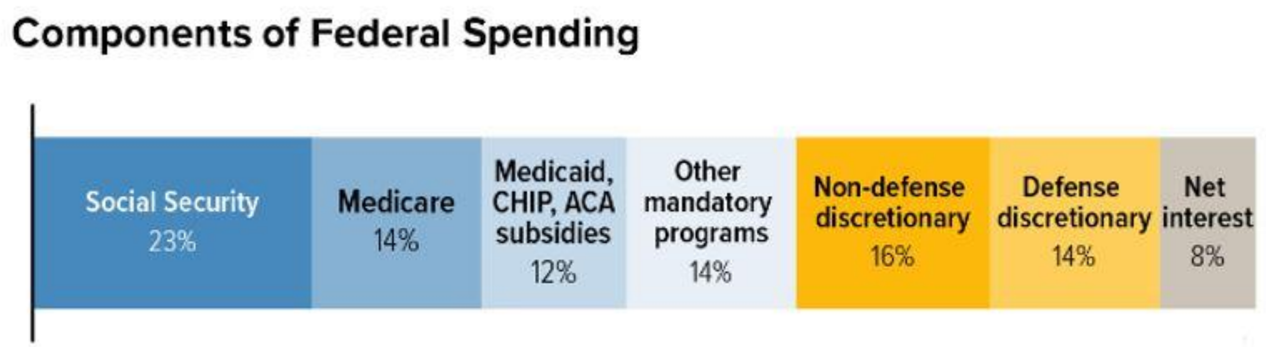
*Because of the surge in interest rates, the U.S. government needs to spend hundreds of billions more next year just to service the debt. This means that they will **run out of money quickly and we expect the ceiling to be breached in June**. It will also make spending cuts much harder to achieve because entitlements are now such a bigger chunk of overall Federal spending. All this suggests that equity market volatility could increase in the spring while it could help long bonds, which will benefit from spending cuts and a flight to safety.*

Interest vs. Entitlements

The federal government last year spent $6.1T.[1] The biggest expense by far has been the entitlements (Medicare, Medicaid, and social security) which took 61% of the budget. The discretionary part of the budget, which includes things like defense, education, and infrastructure, was 30% of total spending or $1.8T. Interest expenses are a separate line item and were just 8% of expenses. However - **warning**, **the soaring interest rates in 2022 will have an enormous impact on government spending in the coming years. The move higher in rates has come so swiftly, the political establishment has NOT fully come to grips with the mathematical realities forming on the ground.**

*Medicare, Medicaid, the Children's Health Insurance Program (CHIP), and Affordable Care Act (ACA) marketplace health insurance subsidies — together account for 26 of the budget in 2022, close to $1.5T. One-half of this amount, or $740B, goes to Medicare, which provides health coverage to around 80 million people who are aged 65 and older or have disabilities.

Entitlements and Interest - Swallowing the Budget



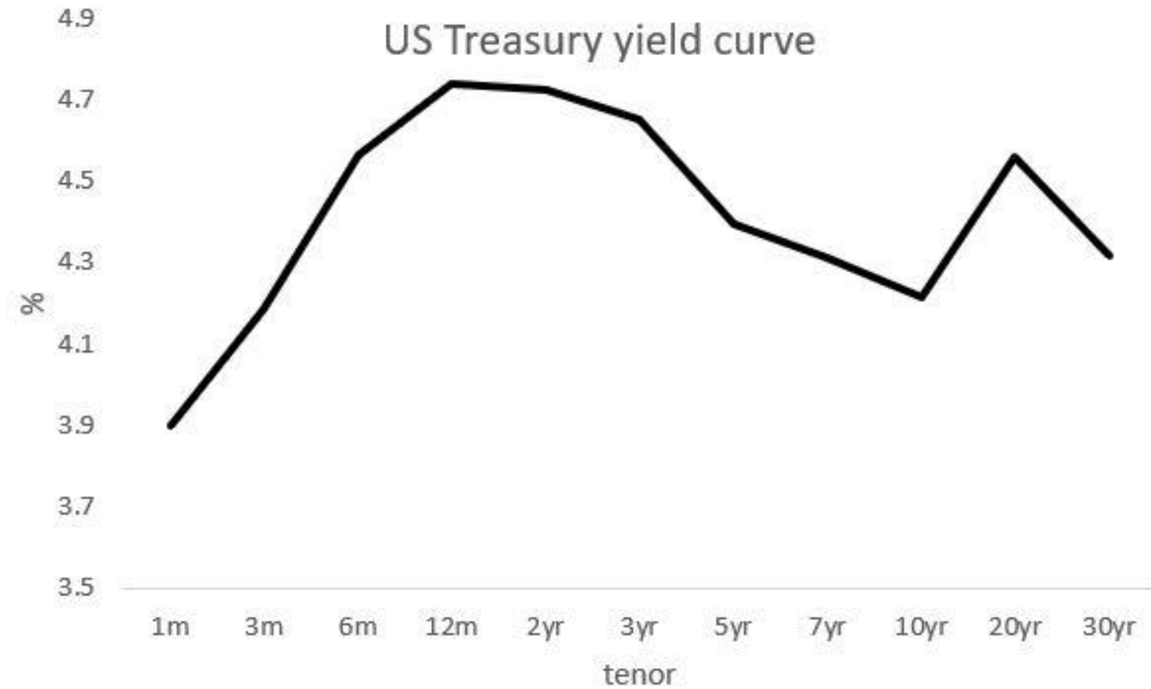
***Mandatory entitlements and interest are up to 70% of the budget**, while discretionary spending (non-defense and defense) is 30%. Interest is starting to crowd out important spending priorities. First off, interest payments will be impacted by the amount of debt that is maturing and that needs to be renewed. Next year $5.6T of marketable debt and $2.6T of government debt held by Social Security (non-marketable debt) matures. **In 2024 more than $3T of debt matures.** **So they need to refinance $11.2T of debt in two years.** But the entire yield curve is now stuck around 4% so there is no way for the Treasury Department to lower their interest bill with neat tricks like issuing more short maturity bills.*

The US Treasury Curve

3 Month: 4.14%
6 Month: 4.64%
2 Year: 4.49%
5 Year: 3.94%
10 Year: 3.79%
30 Year: 3.87%

**In September 2021 (fourteen months ago), the entire front-end of the curve yielded less than 35bps.*

Yield Curve is a Problem for Treasury and the Fed



We estimate that net interest expense will increase from $600B in 2022 to $1T in 2025. This means that interest will become 16% of government spending, from just 7% in 2021. *These interest expenses also include the net interest the government pays commercial banks for their reserve balances at the Fed. To put this into perspective,* ***in 2010 the federal government spent just $280B on servicing its $14T in debt.***

Where is the Debt Ceiling?

In 2021 Congress set the **debt ceiling at $31.4T** and the debt is currently at $31.26T. Last month the Treasury Department said it will borrow $550B in Q4 and $578B in Q1[2] so the total $1.14T in new borrowing is going to breach the debt ceiling. However, in the temporary budget deal this fall, Congress suspended the debt ceiling until December 16. As such, we expect that Treasury will announce it will initiate extraordinary measures to stay under the ceiling by mid-December.

The Freedom Caucus is the New Tea Party

These extraordinary measures will create about $300B of room under the ceiling. Together with about $550B in the Treasury's general spending account, it buys the Treasury department enough time until late May. Congress is likely to start negotiating a deal in the spring, but the House wants spending cuts and Biden has signed bill after bill to increase spending (infrastructure, CHIPs act, inflation reduction act for more green subsidies). The Republicans have only a small majority in the House, and we estimate that they will end up with around 221 seats. **The Freedom Caucus will have 45 of those seats, so they have a lot of influence over House legislation and can make Speaker McCarthy's life very difficult over the debt ceiling.**

If the debt ceiling is not raised in time, the first problem is that the US will not have the funds to pay for the debt that is maturing. Congress will play hardball until the bitter end, but a debt default should still be avoided with an 11th-hour deal. However, in the final weeks, we could see another panic about default risk in the markets before a deal is reached.

Can a Debt Ceiling Showdown be Avoided?

Democrats still have an opportunity to raise the ceiling in the lame-duck session between now and Christmas, using reconciliation. This allows them to pass budget-related legislation with just 50 votes and they could raise the ceiling until at least 2024.

Will They Do It?

The benefit is that it pushes the problem out to 2024 but that would mean a debt ceiling showdown during an election year, which Biden surely wants to avoid. Also, Democrats might see political-strategic benefits in having the Republicans fall on their sword over the debt ceiling and risk a U.S. default and deprive the elderly of social security checks. In other words, Democrats may not want to raise the debt ceiling in the lame-duck session.

Can they do it? There are only three weeks left on the Congressional calendar until year-end. In those three legislative weeks, Congress still needs to pass the NDAA (Defense authorization bill) and an appropriations bill. Reconciliation, assuming it goes off without a hitch would take at least two weeks. But it's entirely unclear if Senate Democrats like Joe Manchin are willing to support such a lame-duck debt ceiling bill. **We are also confident that Democrats will not try to raise the debt ceiling as part of the clean appropriations bill that they will work on and try to pass by December 16.** In other words, time is running out and the Democrats may not even have enough support in their own ranks to pass a debt ceiling bill on party lines.

[1]https://fiscaldata.treasury.gov/americas-finance-guide/federal-spending/
[2]https://home.treasury.gov/news/press-releases/jy1063

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Best Regards,

The Bear Traps Report Team

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