US Daily: Debt Limit: What (and When) Is the Deal? (Phillips/Krupa)

- The Treasury's "early June" deadline looks very accurate, in our view. Over the last few days, the outlook for Treasury's room under the debt limit has deteriorated slightly, though this might also reflect daily fluctuations in tax receipts that could reverse in coming days. That said, at the moment our central scenario is that by June 2 the Treasury's room under the debt limit will barely exceed $30bn (the minimum cash the Treasury has targeted in prior debt limit projections) and that funds will run dry by June 9.
- Treasury Sec. Yellen indicated on May 24 that the Treasury will soon give Congress a more precise date than the "early June" and "as early as June 1" timing provided so far. Given our projections, it seems likely to us that Treasury will signal that Congress needs to raise the debt limit either by June 2 or June 5. It is unclear when this update might come, but Treasury might prefer to wait until early next week (e.g., May 30) once a deal has been reached rather than ahead of the weekend, in order to keep urgency behind debt limit talks.
- Negotiators appear to be closing in on an agreement. While it is hard to predict when an announcement could come, we think the odds are highest that a deal is announced late Friday (May 26) or on Saturday (May 27). If so, this would likely allow a House vote late Tuesday (May 30) or Wednesday (May 31). The Senate also needs to pass the deal, though procedural obstacles there are unlikely to be what prevents timely enactment.
- Last week we put the odds of a full-fledged agreement by the deadline at 70% and a short-term fix at 15%, with a 10% chance that Congress fails to act in time and a 5% chance that the deadline is postponed. We are incrementally more optimistic (80%) on a full-fledged deal and believe a short-term patch is less likely (10%) to be needed. We still think there is a 10% chance that Congress fails to act in time, but think the odds that the deadline is pushed back are close to zero.
- The core of the debt limit deal is likely to be spending caps. We estimate that the real reduction in spending next year would vary from around -0.1% of GDP (under a freeze at 2023 levels) to -0.5% (under the House-passed bill). A compromise that sets 2024 spending at the 2022 level indexed for inflation would result in modest cuts of around -0.2% of GDP in 2024. Regardless, the spending cuts under consideration do not appear likely to meaningfully affect the macroeconomic outlook.

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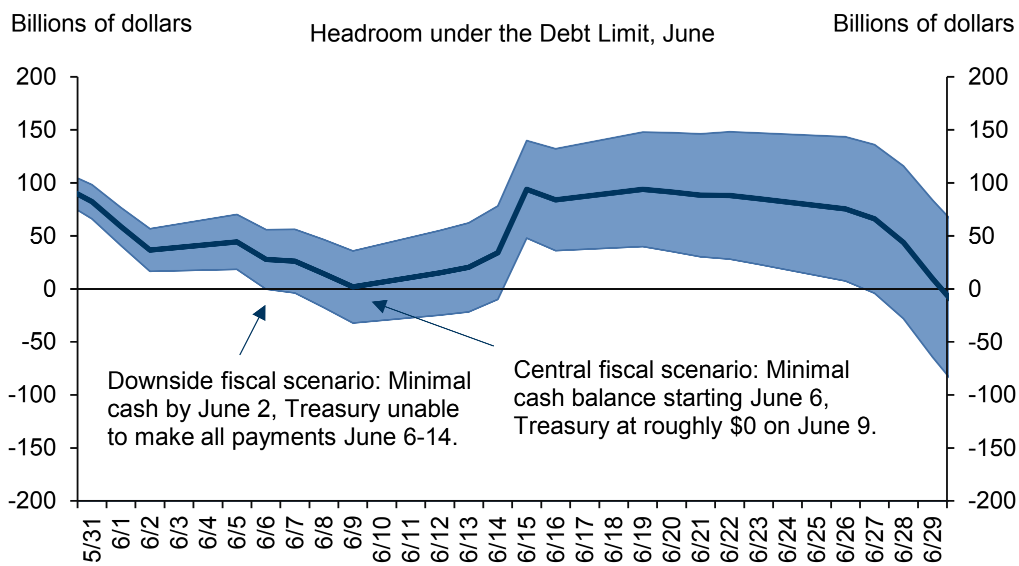
Debt Limit: What (and When) Is the Deal?

The Clock Is Ticking

The Treasury's "early June" deadline looks very accurate, in our view. Over the last few days, the outlook for Treasury's room under the debt limit has deteriorated slightly, though this might also reflect daily fluctuations in tax receipts that could reverse in coming days. That said, at the moment our central scenario is that by June 2 the Treasury's room under the debt limit will barely exceed $30bn (the minimum cash the Treasury has targeted in prior debt limit projections) and that funds will be exhausted entirely by June 9. In a downside scenario in which withheld tax collections slow slightly, the Treasury would run out of funds as soon as June 6 (Exhibit 1).

Exhibit 1: Our Current Central Scenario Is That the Treasury's Room Under the Debt Limit Will Barely Exceed $30bn by June 2



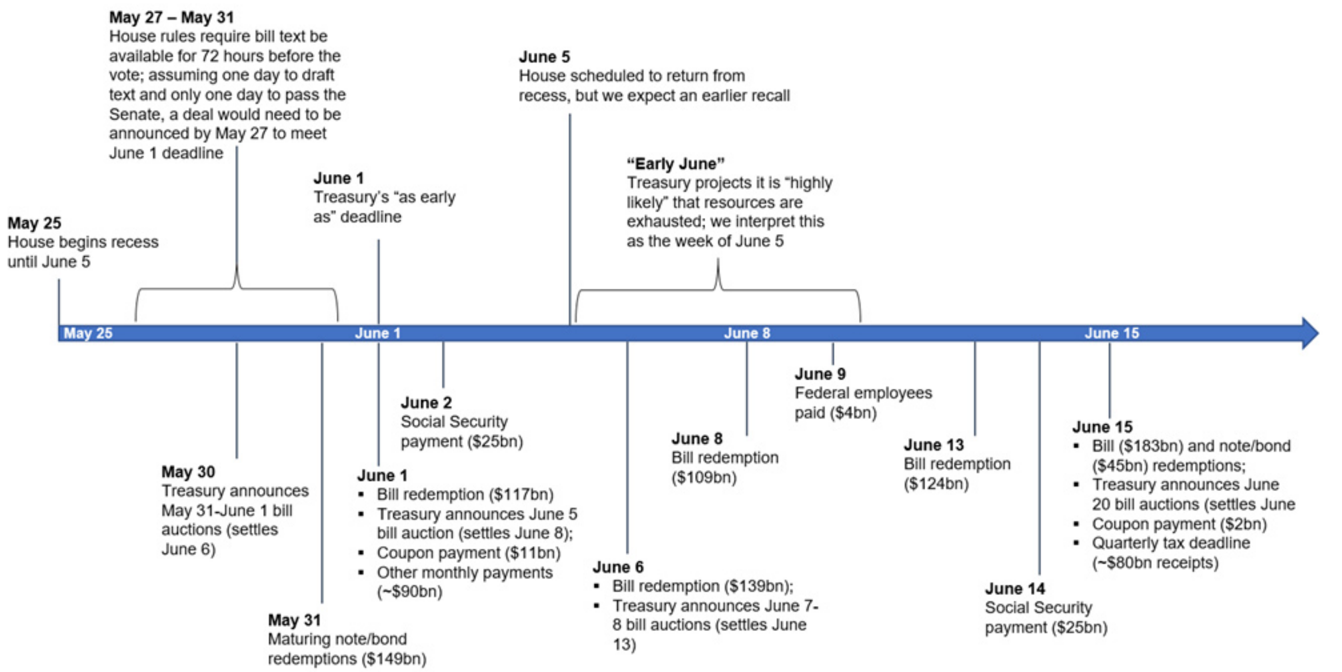
Source: Treasury, Goldman Sachs Global Investment Research

Treasury Sec. Yellen indicated on May 24 that the Treasury will soon give Congress a more precise date than the "early June" and "as early as June 1" timing the Treasury has provided so far. Given our projections, it seems likely to us that the Treasury will signal that Congress needs to raise the debt limit either by June 2 or June 5. It is unclear when this update might come, but Treasury might prefer to wait until early next week (e.g., May 30) rather than ahead of the weekend, in order to keep urgency behind debt limit talks.

Exhibit 2 provides a timeline with key procedural dates (top) and Treasury cash flows (bottom). The timing of a deal announcement is hard to predict, but the incentives are greatest to announce a deal late Friday May 26 or on Saturday May 27, we think. The House is on recess until June 5, but will reconvene to vote on the debt limit deal once ready. However, Speaker McCarthy has indicated that he intends to follow House rules requiring that a bill be available for 72 hours prior to the vote. Assuming a day to convert the deal into text and at least a few hours to vote on it, a deal would be needed by May

27 in order to pass the bill by May 31, leaving the Senate to pass it on June 1 (consideration of a bill in the Senate can often take more than a week, but we do not expect procedural obstacles in the Senate to prevent the bill from becoming law before the deadline).

Exhibit 2: A Timeline of Key Procedural Dates (Top) And Treasury Cash Flows (Bottom); We Think Incentives Are Greatest to Announce a Deal Late May 26 or on May 27



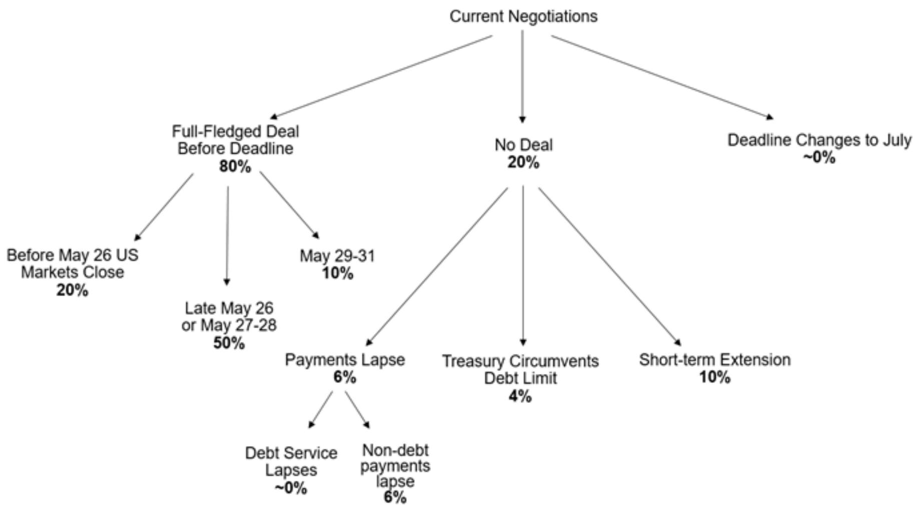
Source: Treasury, Bloomberg, Goldman Sachs Global Investment Research

A Higher Probability of a Full-Fledged Deal

Last week we put the odds of a full-fledged agreement by the deadline at 70% and a short-term fix at 15%, with a 10% chance that Congress fails to act in time and a 5% chance that the deadline is postponed. We are incrementally more optimistic (80%) on a full-fledged deal and believe a short-term patch is less likely (10%) to be needed. We still think there is a 10% chance that Congress fails to act in time, but think the odds that the deadline is pushed back are close to zero.

In the event that Congress fails to act, it is hard to predict what the White House would do, but we think it is slightly more likely (6%) that the Treasury would delay non-debt service payments, though it is possible that the Administration could circumvent the debt limit through a judicial ruling or through technical means (e.g. issuing high coupon/low par value notes or disinvesting internal trust funds). Exhibit 3 provides subjective odds of different outcomes.

Exhibit 3: We Are Incrementally More Optimistic on a Full-Fledged Deal and Believe a Short-Term Patch Is Less Likely



Source: Goldman Sachs Global Investment Research

What's the Deal?

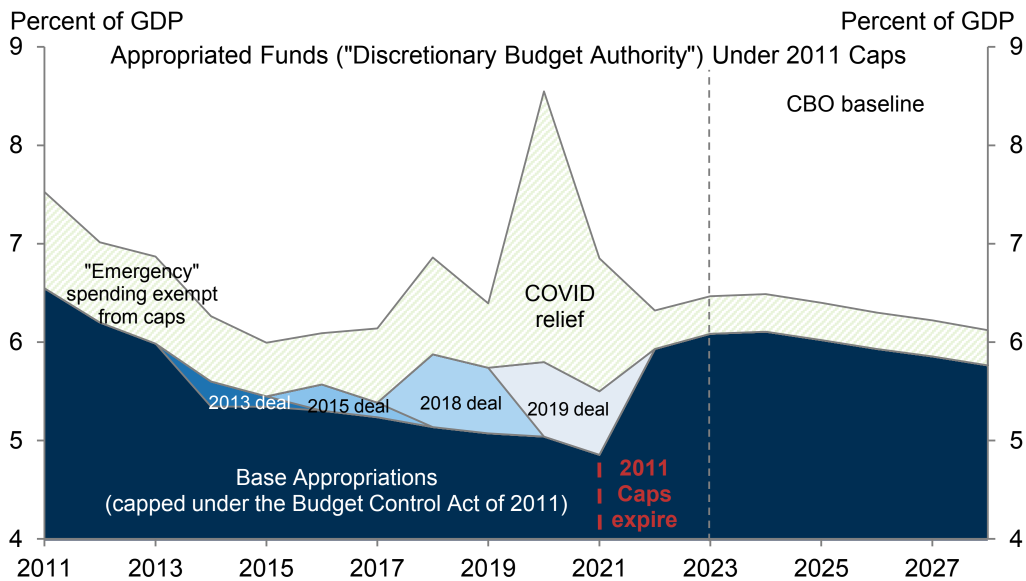
There is not much detail available regarding the potential compromise. That said, we expect the deal to include 4 or 5 things:

- A calendar-date suspension of the debt limit (as opposed to a dollar amount) that puts the next debt limit increase in mid-2025
- Caps on discretionary spending
- Work requirements on benefit programs (primarily Temporary Assistance for Needy Families, formerly known as "welfare benefits", and possibly the Supplemental Nutrition Assistance Program, formerly known as "food stamps")
- Rescission of unused covid funds
- Energy permitting reform

Of these, we view the debt limit suspension and spending caps as the core of the deal, with rescission of unused covid funds also very likely, work requirements likely, and energy permitting reform uncertain.

Similar to the 2011 debt limit episode, spending caps look likely to be central to the debt limit deal. The 2011 agreement capped discretionary funding for 10 years, but Congress did not wait long before raising the caps. Roughly every two years after enactment, Congress passed legislation to allow for more spending (Exhibit 4). These increases were relatively minor during the Obama Administration when Republicans controlled one or both chambers of Congress, but became larger under the Trump Administration. "Emergency" spending exempt from caps also increased later in that period (before but particularly during the pandemic).

Exhibit 4: The 2011 Deal Capped Discretionary Funding for 10 Years, but Congress Passed Legislation to Allow For More Spending



Source: Treasury, Goldman Sachs Global Investment Research

There is also a key difference with 2011 that likely makes this situation somewhat easier to resolve: there is no particular deficit reduction goal. In 2011, congressional Republicans insisted that each dollar of debt limit increase be matched with a dollar of spending cuts (measured over ten years). With a $2.1 trillion debt limit increase needed to last through the coming election, this meant finding $2.1 trillion in spending cuts. This year, the debt limit is likely to be suspended, rather than increased, so there is no specific dollar figure involved (extending the debt limit to mid-2025 will likely take an increase well over $3 trillion). This, along with a general lack of public attention to the fiscal outlook, has meant very little debate over the total amount of deficit reduction that needs to be achieved in any deal.

That said, negotiators still need to reach some type of spending agreement. In the current debt limit negotiations, at least four parameters regarding spending caps need to be decided:

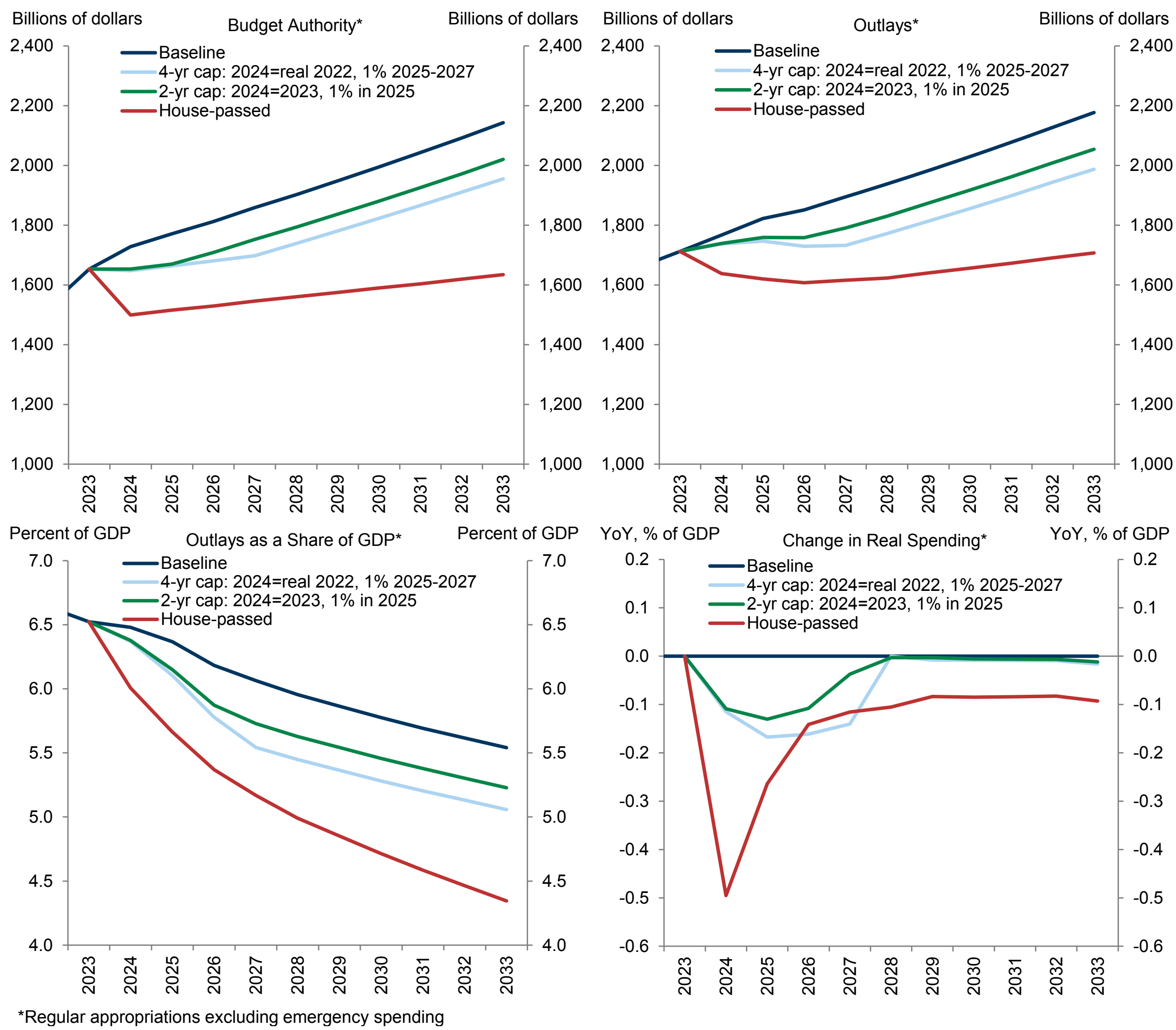
- **Spending level for FY2024:** The White House has reportedly offered to freeze spending at the 2023 level. The House passed Republican bill would reduce it to the FY2022 level, a 9% nominal reduction. The middle ground could be to set 2024 spending to the 2022 level adjusted for inflation. This would allow both sides to claim a win (spending would go down slightly in nominal terms, but would be no lower in real terms than what President Biden and Democrats in Congress agreed to in late 2021).
- **Length of caps:** The White House has reportedly agreed to cap spending for at least 2 years. The House Republican bill would have capped spending for 10 years, but that position has reportedly been shortened to a 6-year cap. The middle ground here is clear, though the final decision will depend on other aspects of the deal, particularly the growth rate of the caps.

- **Spending growth under caps:** The House Republican bill proposed to grow caps by 1% (nominal) per year. The White House reportedly agreed to a 1% growth rate in the caps, though this would have applied for only one year. A 1% growth rate could be hard for the White House to agree to if the caps lasted 4 or 6 years. That said, it is likely to be lower than CBO's baseline, which assumes discretionary funding grows at around 2.5%.
- **Allocation between defense and non-defense:** Democrats are likely to insist on separate defense and non-defense caps, as most Democrats support robust non-defense spending while there is greater overall support (among both parties) for defense spending. A plausible scenario is that defense could rise slightly for FY2024 while non-defense falls in FY2024, but that caps on both grow at the same rate thereafter.

Exhibit 5 shows the effect of three spending cap scenarios with the CBO baseline for comparison: (1) the House-passed bill, which cuts 2024 spending to the 2022 nominal level and raises the cap 1% annually for the next 9 years, (2) a 2-year cap that freezes spending for 2024 and raises it 1% for FY2025, and (3) a potential compromise 4-year cap that sets the 2024 level at the 2022 level adjusted for inflation and then grows it at 1% for the next 3 years.

Budget authority refers to the amount of funding that Congress approves in appropriations bills. The pace of spending (outlays) differs by program, but in general it takes a few years for a given change in funding to be fully reflected in spending. If the cuts apply mainly to non-defense, a drop in funding would result in a slightly faster drop in spending. Regardless, with the exception of the cuts in the House-passed bill, these scenarios look unlikely to produce a year-on-year reduction in spending of more than around 0.2% of GDP.

Exhibit 5: Spending Cap Scenarios Look Unlikely to Produce a Year-On-Year Reduction in Spending of More Than Around 0.2% Of GDP

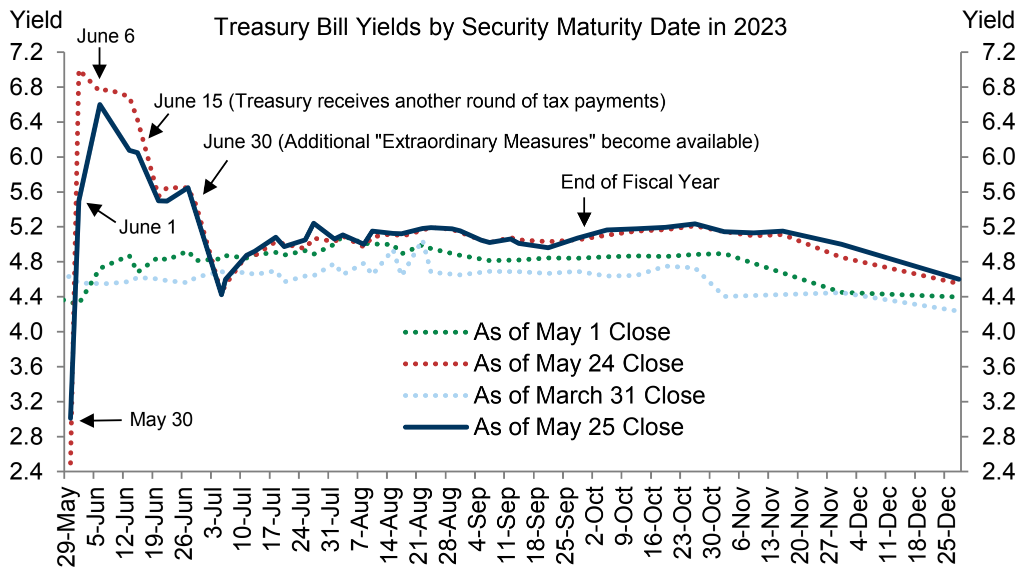


Source: Congressional Budget Office, Goldman Sachs Global Investment Research

A Few Parts of the Financial Markets Reflect Debt Limit Concerns

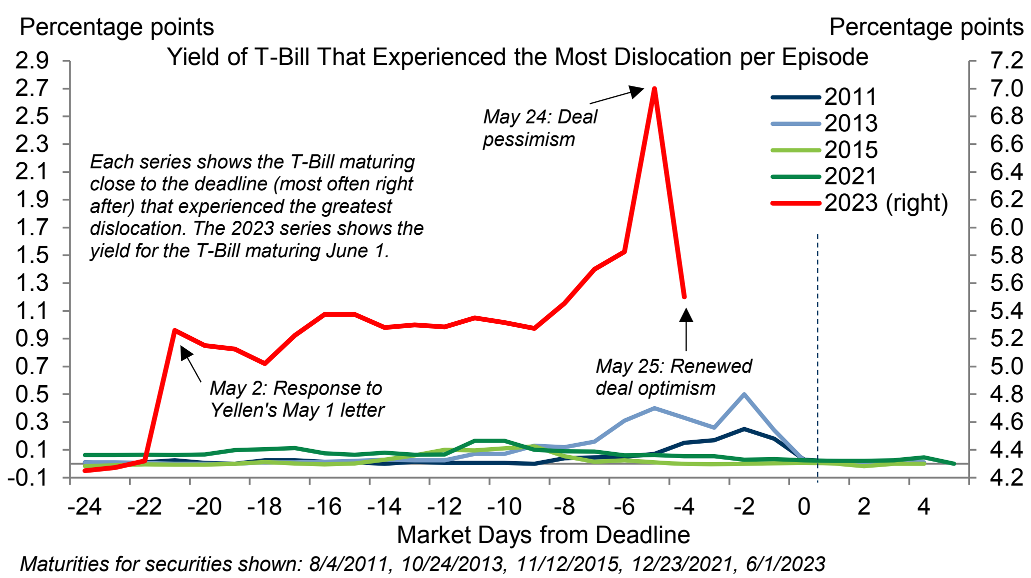
Debt limit-related concerns seem limited to a few markets, primarily the short end of the Treasury curve and sovereign CDS. Yields on bills maturing on June 1 and the days that follow have cheapened substantially (Exhibit 6). That said, recent positive headlines have understandably led to some recovery (Exhibit 7).

Exhibit 6: Treasury Bills Maturing Just After the Expected Deadline Have Cheapened Substantially...



Source: Bloomberg, Goldman Sachs Global Investment Research

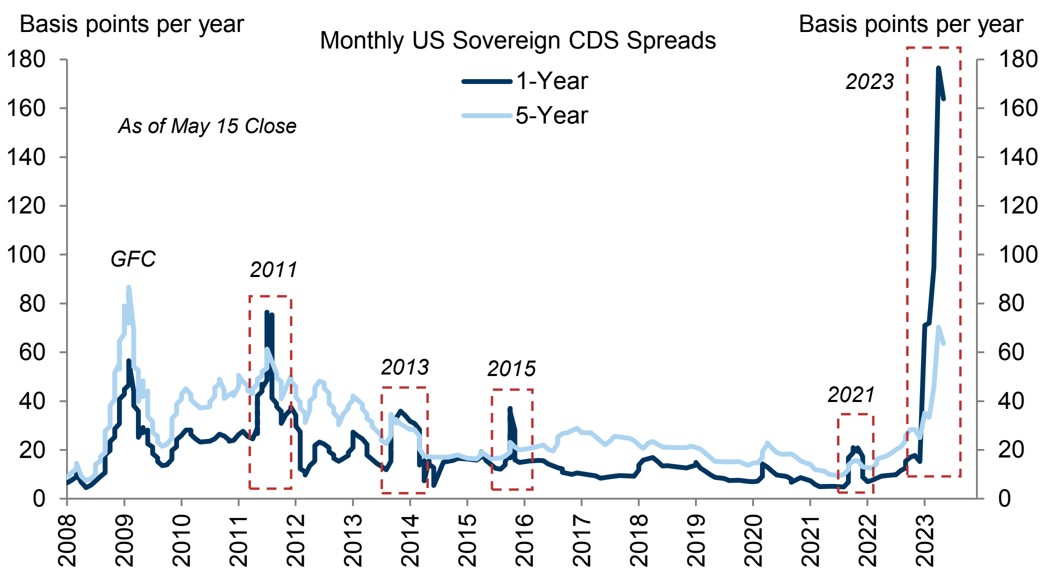
Exhibit 7: ...But Recent Positive Headlines Have Led to Some Recovery



Source: Bloomberg, Goldman Sachs Global Investment Research

Sovereign CDS continues to reflect an elevated probability of debt default (Exhibit 8). This is hard to reconcile with what we believe are low odds that the Treasury is unable to make all payments and even lower odds that the Treasury fails to make timely debt service payments.

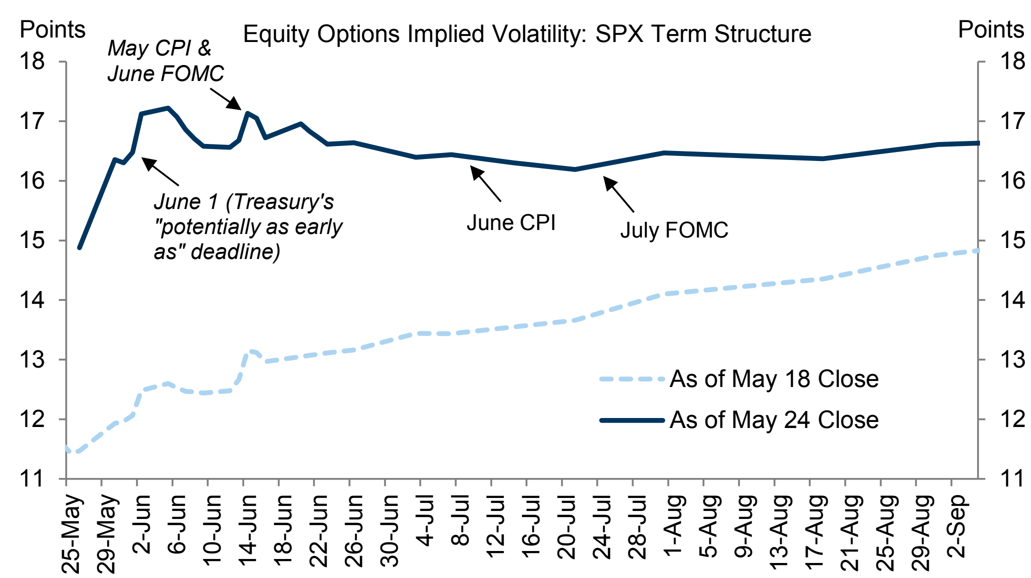
Exhibit 8: CDS Remains Elevated, but We Believe the Odds That Treasury Fails to Make Timely Debt Service Payments Are Very Low



Source: Bloomberg, Goldman Sachs Global Investment Research

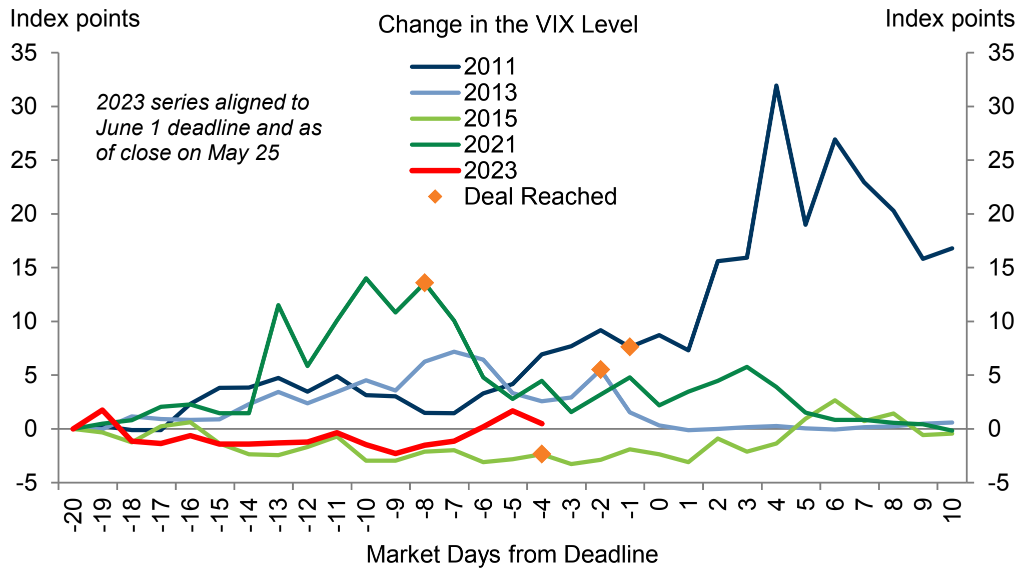
Equity market implied volatility reflects modest risk around the debt limit deadline (Exhibit 9). The rise in volatility ahead of this debt limit deadline has been milder than prior episodes (Exhibit 10). Although the VIX rose as the deadline approached in those prior years, negotiators did not announce a deal in those episodes until a couple of days before the deadline.

Exhibit 9: Equity Implied Volatility Is Pricing Modest Risk Around the Deadline



Source: Goldman Sachs Global Investment Research

Exhibit 10: Volatility Remains Relatively Low



Source: Chicago Board Options Exchange, Goldman Sachs Global Investment Research

Alec Phillips

Tim Krupa

Disclosure Appendix

Reg AC

We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Joseph Briggs, Ronnie Walker, Tim Krupa and Manuel Abecasis, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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