FISCHER STRALEM

300 Madison Avenue, New York, NY 10017

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Dear Client:

As the calendar flipped from April to May, amidst a regional banking sector crisis and a relentless decline in oil prices, the Federal Reserve nonetheless went ahead and hiked the funds target rate by an additional 25 basis points. This last hike represents a full 500 basis points of rate increases over the trailing year and the impact has begun to take hold on a variety of businesses -- especially smaller entities which comprise the bulk of employment. Federal Reserve data indicates that banks have tightened lending standards, implying that we are nearing a credit crunch. Indeed, according to Bloomberg, the phrases "credit tightening" and "credit crunch" have been uttered an unusually high number of times in recent corporate investor calls. The macro thesis is that firms will be forced to reduce capital spending and trim hiring, causing the labor market to weaken and growth to roll over. Remarkably, this is ***not*** the headline that has garnered the most attention, however. That belongs to the manufactured political theater: the Federal debt ceiling.

The debt ceiling is a legislative limit on the amount of national debt that can be incurred by the U.S. Treasury, thus limiting how much money the federal government may pay on the debt it already borrowed by borrowing more money. Because expenditures are authorized by separate legislation, the debt ceiling does not directly limit government deficits -- it can only restrain the Treasury from paying for expenditures and other financial obligations after the limit has been reached. Many scholars argue that the debt ceiling does not provide the legal authority for the U.S. to default on its debt. When the debt ceiling is reached without an increase in the limit having been enacted, Treasury must resort to "extraordinary measures" to temporarily finance government expenditures and obligations until a resolution can be reached. The Treasury has never reached the point of exhausting extraordinary measures, resulting in default, although, on some occasions, it appeared that Congress might allow a default to take place. If this situation were to occur, it is unclear whether the Treasury would be able to prioritize debt payments to avoid a default on its bond obligations.

A protracted default could trigger a variety of economic problems including a financial crisis and/or economic recession. The 14th Amendment of the U.S. Constitution is pretty clear on this subject, stating that "the validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned" In theory, this clause means that it is unconstitutional for the U.S. to default which, if true, there is no legal basis for the government to default. According to a NY Times report (5/2), the Administration is considering a challenge to the legality of the debt ceiling itself rather than negotiate a deal. If so, it will likely spook markets by injecting a whole new layer of uncertainty into the process.

Looking ahead, there must be a buyer for these yet-unrealized obligations. Fed policymakers spent the last year telegraphing to the market and Congress that the days of Fed balance sheet expansion were over. Instead, the Fed would "normalize" its balance sheet and withdraw the excess liquidity it injected during the Covid years (and during the years of quantitative easing before that). As the implosion of Silicon Valley Bank, Signature Bank, and First Republic highlight, this has turned out to be easier said than done and brings us to the real problem: according to the reported data, if we add the $751 billion of U.S. defense spending to the $4.1 trillion of mandatory spending (Medicare, Medicaid, interest expense, social security), the government's "essential" spending already outweighs the entirety of its tax revenues (and eats up 99% of its total revenues). Meanwhile, because so much of the government's debt has been issued at the short end, its interest costs are now starting to rise parabolically, as debt issued in recent years at 1% is replaced by debt yielding 4% or even 5%. Beyond the short term debt-management implications of higher interest rates, there is a bigger question: can the government continue to increase its debt by US$2 trillion or more every year while the Federal simultaneously shrinks its balance sheet? We won't have to wait long for the story to unfold.

Regards,

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