

Goldman Sachs Exchanges: The Markets

Debt ceiling dilemma: Are markets pricing in the potential of a default?

**Candice Tse, Goldman Sachs Asset Management,
Strategic Advisory Solutions**

Sam Grobart, Host

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Sam Grobart: There's really only one thing to talk about today and you know what it is. The debt ceiling.

This is The Markets, a new series from Goldman Sachs Exchanges. Hi, it's Sam Grobart. Today I'm joined by Candace Tse from Goldman Sachs Asset Management to talk about the debt ceiling and what it means for investors.

I also want to note here that we're recording this Thursday morning, and of course a lot can change, but there's a lot of great analysis to dig into here.

Candace, thanks so much for joining us today.

Candice Tse: Sam. Always great to be with you.

Sam Grobart: So let's take a look at equity markets, which

have been pretty resilient in the face of a looming debt ceiling crisis. Why do you think that is?

Candice Tse: Well, if you think about the equity markets, it really hasn't moved much. To put it into context in the last six consecutive weeks, the S&P 500 really hasn't moved more than 1% on a weekly basis. So I would attribute that to having President Biden, Speaker McCarthy, a number of different Congress folks coming out to say that an agreement should be reached. So I think that's the real reason why the markets have really taken the debt ceiling negotiations in stride.

Sam Grobart: Do you think in any way that the market has already begun to price in a default?

Candice Tse: I think it really depends on where you're looking at. If you're looking at the Treasury market, you're looking at yields, particularly yields that set to mature T-bills on June 5th through June 15th. If you're looking at T-bills, that could be impacted by missed payments, then the yields already have breached 6%. But as we're alluding to the equity markets, I don't think default is being priced into the equity markets of late. But if you look at the last

few days, Tuesday was the first negative day in the S&P 500 in the last three weeks. So perhaps the equity market is realizing there's only a handful of days that these negotiations can take place and lead to an agreement and that's why they're actually reacting a little more so than they have.

Sam Grobart: So Candace, just to get into a doomsday scenario here, how would the market react to a missed debt payment? What's the likelihood?

Candice Tse: I'll take the second part of the question first. The default is not our base case from our perspective. I think we get to a short-term agreement that takes us to the fiscal year end and that allows for some more time. And that's especially as we keep going day after day without an agreement.

I think in the event that the U.S. does miss a payment, it's highly likely that the market will have a negative reaction. But overall, the impact is really hard to predict because in the worst-case scenario, a lot of different things can happen. You can miss payments for social security. You can perhaps have a very volatile equity market and perhaps

even lead to a U.S. recession. So that's not our base case, but wanted to share the possibilities.

Sam Grobart: Gotcha. Now moving to a slightly different topic, let's talk for a moment about the US dollar. What do you think are the potential implications on the dollar and its reserve currency status in the event of something like a default?

Candice Tse: I think the debt ceiling dilemma and the potential of default really rests on the political willingness to come to an agreement and less so on the credit worthiness of our U.S. debt.

And if the latter is true and the U.S. debt is still credit worthy, I think from that standpoint, the U.S. dollar will remain the reserve currency of choice. And the reason why. I don't really see any other currency right now, or a basket of currencies taking over the U.S. dollar as a currency of choice is really because if you look at the U.S. dollar, the U.S. has a very deep capital market.

If you think about, trade, we're a huge currency of trade, a store of value. We have elevated demands for our US

treasuries. So for many of those reasons, that's the reason why the US dollar will continue to be the reserve currency of choice. For the future, near future.

Sam Grobart: Candace, you were just talking about U.S. debt. If and or when the debt limit is raised, the U.S. will have a lot of debt issuance to handle more than \$1 trillion according to industry estimates. Can the market digest all of that debt?

Candice Tse: I do think the market can digest it really, because this probably will push T-bill rates higher, especially in a market where they think the Fed may raise rates more. The good news is the vast majority of this will be issued by bills and not coupons.

So from that regard, there's \$2.4 trillion captive and it can actually be funneled through the reverse repo facility. And for that reason, I think it should allow for other areas of the market to be unharmed.

Sam Grobart: Let's take a step back for a moment here, Candace, and tell me where are you seeing investment flows going and what are the potential implications of those

flows?

Candice Tse: Year to date, we've seen a lot of flows into the money market area, to the tune of \$37 billion in flows over the course of the last four weeks, bringing the total for the year-to-date number to \$727 billion. Now, we've also seen flows come into fixed income in the bond part of the market.

It hasn't been quite as much where the total has been about \$20 billion year to date. From the equity side, it's actually been negative. So we've actually seen outflows, to the tune of negative \$7.4 billion over the course of the last four weeks, and that's including sectors that have done really well, including the tech sector.

Sam Grobart: So Candice, if you can put this into some greater context for us, how typical are these flows that you're describing right now?

Candice Tse: The flows that we're seeing predominantly move into money markets is an indication of risk aversion. So typically in times when investors are seeking a safe haven, that's where they tend to invest in, and that's what

we're seeing right now.

Sam Grobart: With all this uncertainty in markets, what do you think investors should be thinking about in regards to their portfolios right now?

Candice Tse: I think investors should be thinking about what will work next for the next 10 years. I think the bottom line is that beta exposure that has worked in the past will probably not work going forward because in this next cycle, what we're seeing is higher rates, higher inflation.

We're seeing more concerns over recession, more volatility. For the investor, I think it's really important for them to realize that it's no longer a beta driven market. Moving forward, it's more so focused on alpha, which is generating return above and beyond your benchmark. And the way to do that is to focus on security selection, focus on tax efficiency going global, and also income generation. And you can. Think about all of these characteristics throughout your portfolio, whether you are thinking about equities, fixed income or alternatives.

Sam Grobart: Okay. So last question. What is one non-debt ceiling data point that you think investors will be focusing on next week?

Candice Tse: I think there's so many economic data points coming out. The labor market data points are really important, but also personally I'd like to take a look at what the market is pricing in terms of what they think the Fed will do. Because in May it went from 0% hikes to now about 30%. So that's probably something else that I'd like to keep an eye out on.

Sam Grobart: Candace, thanks so much today.

Candice Tse: Thanks for having me.

Sam Grobart: That does it for another episode of The Markets. As of June 16th, we'll be leaving the exchanges feed, but we have our own new feed, so subscribe to Goldman Sachs, the markets, wherever you get your podcasts. I'm Sam Grobart. Thanks for listening.

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