Will the US Government Default on Its Debt?

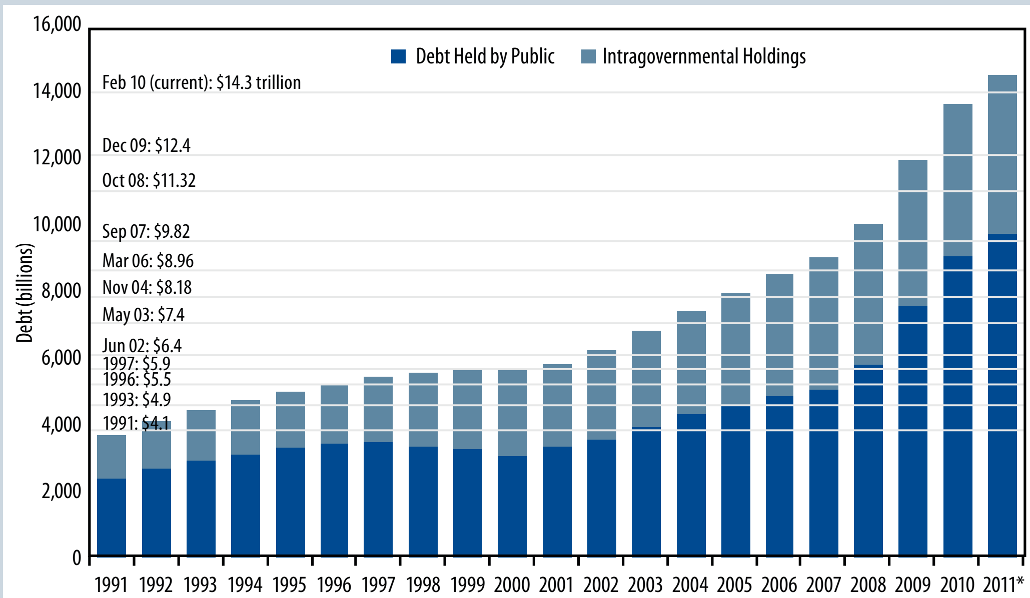
Executive Summary

- The debt limit is the total amount of money that the US government is authorized to borrow to meet its existing legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds and other payments.
- There may be substantial negative repercussions of a default on US Treasuries, such as an increase in the cost of financing the budget deficit and the potential loss of the US dollar's status as the world's reserve currency. We believe it very unlikely that this will actually occur. However, any political process has a risk of mistakes due to political brinksmanship.
- We believe the most likely outcome is the "kick the can down the road" scenario in which the debt limit is raised just enough that it will not be reached until at least 2013, when a new Congress will get to deal with the problem.

There has been substantial coverage of the possible default of US Treasuries (UST) in the media and by Wall Street analysts. This discussion is driven by the need for politicians to raise the limit on issuance of US federal debt (e.g., UST). In 1917, the US Congress[1] created a law that gave it the authority to set a limit on the amount the US government can legally borrow. The debt limit is the total amount of money that the US government is authorized to borrow to meet its existing legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds and other payments.

When the federal debt level approaches the limit, Congress must authorize an increase. The debt limit authorization process is sometimes an occasion for political theater or gamesmanship. However, Congress has always acted when called upon to raise the debt limit. Recently, some politicians have suggested that the US delay interest payments on its debt. Although this is the view of a small minority, it has nevertheless caused concern among investors in the bond market.

US Government Debt Outstanding and Statutory Debt Limit



*Source: Bureau of Public Debt. *As of 30 Jun 11. Debt outstanding includes amounts not subject to the statutory limit.*

The current discussions regarding the increase of the debt limit are driven by both economics and politics. There may be substantial negative repercussions of a default on UST, such as an increase in the cost of financing the budget deficit and the potential loss of the US dollar's status as the world's reserve currency. We believe it very unlikely that this will actually occur; however, any political process has a risk of mistakes due to political brinksmanship. Given that UST yields remain at or near historic lows, this view appears to be consistent with market consensus. We believe the most likely outcome is the "kick the can down the road" scenario in which the debt

[1] Congress is the legislative branch of the US government and includes both the House of Representatives and the Senate.

limit is raised just enough that it will not be reached until at least 2013, when a new Congress will get to deal with the problem.

August 2, 2011 Is an Important Date

The US Treasury Department originally forecast that the government would reach the debt limit on May 16, 2011. Because Congress did not act, the Treasury Department is employing extraordinary measures to create additional headroom under the debt limit. For example, US Treasury Secretary Timothy Geithner suspended investments in federal retirement funds. Those measures are limited and are projected to be exhausted by August 2, 2011, a date that is subject to change based on government receipts. However, unless Congress ultimately acts to increase the debt limit, the government will begin to default on its legal obligations on or near August 2.

Treasury Bill Maturities Coming Due in August 2011

Maturity Date	Amount Outstanding (billions)
04-August	$ 90.794
11-August	$ 59.004
18-August	$ 57.002
25-August	$ 82.005
Total	$288.805

Source: Bureau of Public Debt, Bloomberg

There are a number of creative legal solutions being proposed that are designed to circumvent the August 2 deadline. Some of these involve alternative interpretations of the US Constitution, specifically Section 4 of the 14th Amendment. Some legal experts believe this section might make a statutory increase in the debt ceiling unnecessary and irrelevant. However, it is unclear whether such a legal solution could actually be implemented.

It is important to note the difference between the current debt limit situation and previous US government shutdowns. A government shutdown is generally caused by a temporary failure to enact appropriations bills. Federal government shutdowns have occurred a number of times over the last 30 years; the most recent took place in late-1995 and early-1996. During a shutdown, essential government services continue and interest on the debt is paid. Non-essential services (e.g., national parks and many government agencies) are suspended. While unpleasant, a shutdown does not have a long-term negative impact on the creditworthiness of the US.

In contrast, if Congress fails to increase the debt limit, the government would have to stop, limit or delay payments on a broad range of legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds and many other commitments. Such an event may negatively affect the long-term creditworthiness of the US.

The Credit Rating Agencies May Downgrade US Government Debt

Standard & Poor's rates debt of the US government AAA with a "negative outlook." This means that there is a 33% chance that the credit rating could be reduced over the next few years. Moody's also has US government debt rated as Aaa with a "negative outlook." The rating agencies are concerned about the deterioration in the financial position of the US government.

With respect to the current debt limit debate, Moody's has explicitly stated that if Congress does not increase the Treasury's borrowing authority in the coming weeks, the nation's credit rating may be lowered "due to the very small but rising risk of a short-lived default." Fitch said it would put US debt on watch for downgrade in early August in the event that Congress fails to lift the debt ceiling before other measures aimed at avoiding default are exhausted.

Of course, in the event of an actual default, the ratings on the individual debt issues in question would be changed to "D." We believe that bondholder losses would be minimal or zero, as the default would be cured quickly. If a debt-limit-related default were to occur, the credit rating agencies would likely downgrade the rating on all US government debt to "AA" or "Aa" shortly thereafter.

A downgrade of US Treasury debt would also be applied to obligations of US Agencies. The downgrade would certainly apply to Agency debentures and would likely apply to mortgage-backed securities. Currently, many institutions have mandates to invest only in securities of the highest rating (AAA or Aaa). Unless those institutions make exceptions to the rule, a downgrade could create forced sales of US Treasury and Agency securities. Institutions using UST as collateral for exchange-traded derivatives or over-the-counter (OTC) derivatives might end up purchasing more UST to maintain margin requirements if the "haircut" on Treasuries is increased as a result of a credit rating downgrade.

Although credit rating agencies have gradually moved away from a policy of never rating a private borrower above the sovereign (the "sovereign ceiling"), it appears that sovereign ratings remain a significant determinant of the credit rating assigned to corporations. It is possible, but not likely, that a downgrade of US government bonds could cause a downgrade of US corporate bonds.

Potential Change to the Reserve Currency Status of the US Dollar

The US dollar is the world's reserve currency. This means that most global trade transactions occur in US dollars. For example, if China purchases crude oil from Saudi Arabia, the transaction occurs in US dollars. According to the Bank for International Settlements (BIS), approximately 85% of all foreign exchange transactions in 2010 had the US dollar as one part of the currency transaction.[2] Therefore, there is a natural demand for US dollars, which helps reduce the interest rates the US government pays on its debt. As global trade increases, so does the demand for US dollars.

Once a reserve currency is established, it is not changed easily or quickly. At present, there are no serious alternatives to the US dollar. The potential challengers (Japanese yen, UK pound, euro, Chinese yuan) each has its problems. In the event of a credit rating downgrade, the UST market may not experience a sudden, dramatic change (such as those experienced by Ireland or Greece) in market yields because the US dollar currently enjoys the status of the world's reserve currency.

The Level of the US Government Debt

Total debt of the federal government can increase in two ways. First, debt increases when the government sells debt to the public to finance budget deficits. Second, debt increases when the federal government issues debt to certain government accounts—such as the Social Security,

2 Bank for International Settlements, "Report on Global Foreign Exchange Market Activity in 2010." December 2010.

Medicare and Transportation trust funds—in exchange for their reported surpluses. The Treasury Department labels this Intragovernmental Holdings. The sum of debt held by the public and debt held by government accounts constitutes the total federal debt.

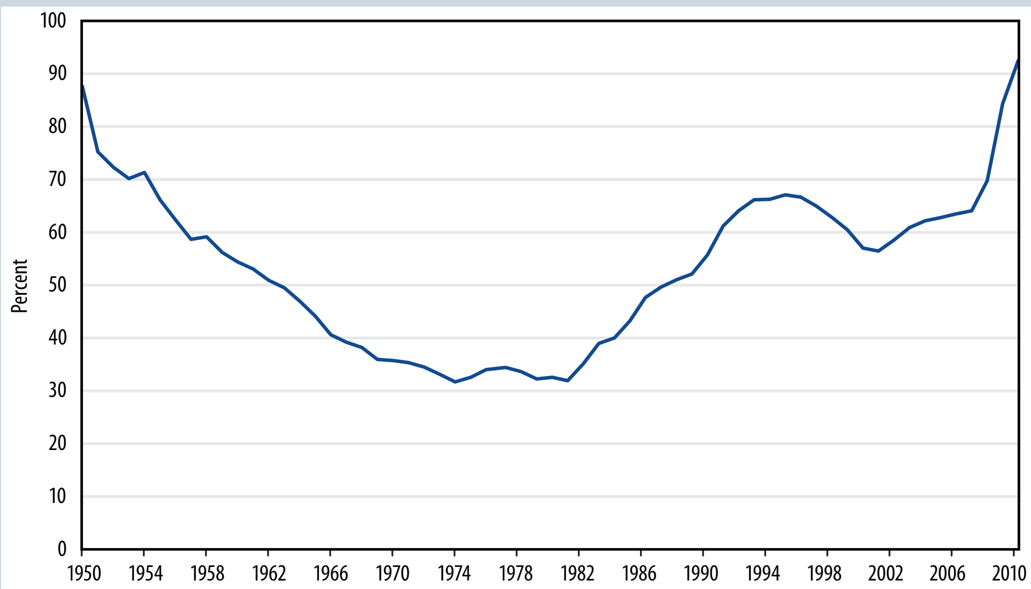
The original intent of the 1917 debt limit law was to help Congress control spending.

	Federal Debt Limit	US GDP	Debt Limit as % of GDP
1917	$11.5 billion	$59.7 billion	19.3%
2011	$14.294 trillion	$15.018 trillion	95.2%
Growth rate	7.9%	6.1%	

The growth rate is the compounded annual growth rate over the 94-year period since 1917. The numbers in the table are not adjusted for inflation.
Source: Bureau of Economic Analysis, Bureau of the Public Debt

Moody's stated that "substantial and credible long-term deficit reduction would imply stabilization within a few years and ultimately a decline in the government's debt ratios, including the ratio of debt-to-GDP." As the graph below illustrates, the debt ratio is still rising.

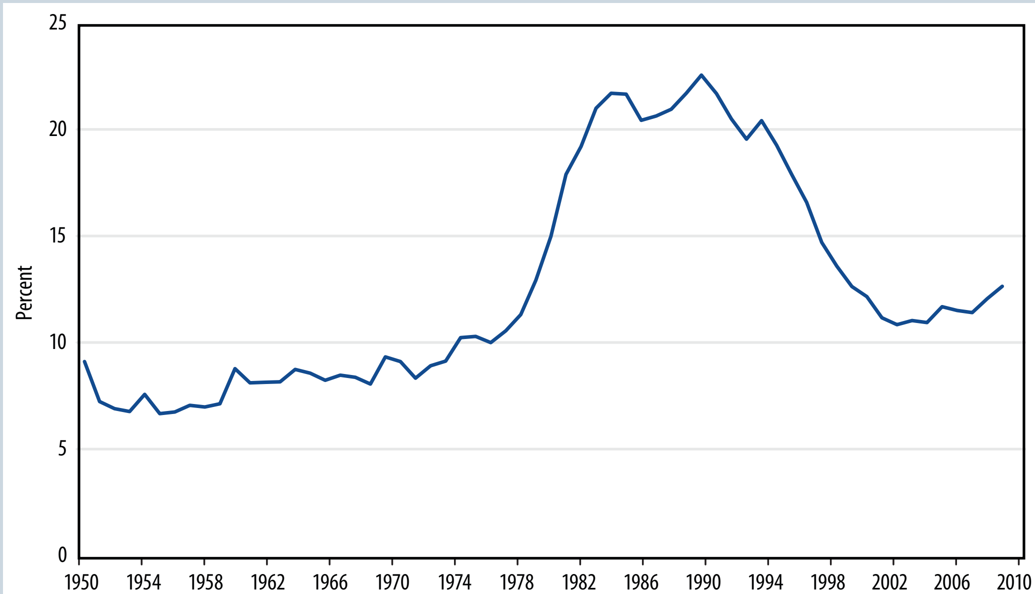
US Government Debt-to-GDP Ratio



Source: Bureau of Public Debt. As of 30 Sep 10

Another common metric in the analysis of a credit is the level of interest relative to the revenue. Since 1975, interest expense as a percentage of federal receipts has been greater than 10%. It peaked in 1991 at 22.5% and has been trending lower due to the historically low level of interest rates. However, the current debt level is 3.9 times larger than it was in 1991, and so if investors demand a higher risk premium on US debt, this credit metric could exceed historic highs very quickly.

Federal Interest Expense as a Percent of Federal Receipts



Source: Bureau of Economic Analysis. As of 31 May 11.

International Comparisons Are Not Simple

Definitions of debt are not straightforward. For example, the liabilities of Fannie Mae and Freddie Mac are not included in the calculation of the US government debt limit. Debt of US states is also not included in the calculation of the US federal government debt limit. The Congressional Budget Office's estimates of future liabilities from entitlement programs like Medicare and Social Security also are not included. Other countries have similar complications, which make international comparisons very difficult.

Nevertheless, it is generally understood that US government debt levels relative to GDP are similar to those in France and the UK, less than in Italy and Japan, but substantially greater than in China or Germany. According to the credit rating agencies, the level of US debt is already beyond what they would ordinarily allow for a AAA rated sovereign.

Potential Scenarios

The first scenario in the debt limit debate is the "kick the can down the road" option. In this case, the debt limit would be raised to a level that would not be reached until at least 2013, when a new Congress would get to deal with the problem. No new taxes or spending cuts would be enacted. A variation of this scenario would involve a modest amount of spending cuts that would generally be deferred over a 10-year period. Capital markets may not be enthusiastic about this approach, but any immediate effect on bond, stock or currency markets would likely be small. Eventually, credit ratings on US government debt may still be cut. We believe this first scenario is the most likely to occur.

The second scenario is the "ideologue" option. In this case, both parties refuse to compromise and the government actually defaults on its debt. Risk assets, such as stocks, would likely decline in price. The US dollar probably would also decline. Agencies, UST and mortgage-backed securities also would decline in price (rise in yield). It is possible that corporate bonds would remain unchanged or even rally as investors see a smaller difference in the risk between issuers like IBM and Procter & Gamble, and the US government. Precious-metal prices would likely rise. Eventually, some compromise would be made, but it would be too late for the capital markets. A risk premium would become embedded in US assets, and their valuations would be impaired for several years.

The third scenario is the "leadership" scenario. Perhaps overly optimistic, this scenario has politicians setting aside their differences and working for the common good of the country. The debt limit would be used as a catalyst for real and lasting change in the financial position of the country. Any such solution would likely include cuts in expenditures, increases in revenue and structural changes to entitlement programs. If this occurs, stocks, bonds and the US dollar would all rally. (Unicorns need not to be present for this scenario to occur!)