

Making Sense of the Debt Ceiling Debate

The debt ceiling has dominated headlines as July winds down and the August 2nd deadline for an agreement nears. There is bipartisan consensus that our country has outspent its means and that action is needed to regain sound financial footing. However, there is political disagreement, of course, on how we resolve the situation, and the debt ceiling offers an important litmus test on the political will to change our nation's fiscal course. Republicans are willing to approve an increase in the debt limit subject to significant spending cuts and no tax increases. Democrats propose a combination of spending cuts and tax increases. Meanwhile, as the debate rages on and the stalemate continues, investors are wondering what will happen to the markets if an agreement is not reached.

Will the U.S. Government default on its debt?

In the near term, we believe the probability of the U.S. defaulting on debt is near zero. The U.S. government's financial position is certainly on an unsustainable path, and tough decisions are going to have to be made now or in the not-too-distant future to rein in the massive deficits and debt. However, despite all of the discussion in the media and political posturing, it is in no one's interest for the U.S. government to default on its debt. The consequences of a prolonged default would have severe economic ramifications in both the U.S. and globally, which could lead to deep recession or even depression. The debt ceiling has been raised 84 times since 1940 and - because of these severe economic ramifications - we strongly believe it will be increased once again. Political agreements are often reached at the 11th hour, which is likely the outcome in this case.

What can be done to avoid default if an agreement is not in place by August 2nd?

In the event that Congress does not reach an agreement by August 2nd, Congress and the Treasury are likely to take one of the following options which have historical precedent in previous debt ceiling standoffs:

1. The Treasury could prioritize revenues and expenses to ensure the payment of interest on the debt. The Treasury was granted this authority in a 1985 GAO ruling after a contentious debt ceiling debate. It is expected to receive enough revenue to cover interest payments, Social Security, Medicare and Medicaid for at least the month of August while delaying payments on some other services. However, this option would be messy, technically difficult to pull off, and may have significant negative economic impacts if utilized.
2. The Treasury holds \$640 billion of financial assets that could be sold to fund the country for a period of time. Of these assets, \$430 billion are in student loans, \$80 billion are agency mortgage backed securities, and \$100 billion are in equities of financial companies left over from the TARP legislation. The student loans would likely be difficult to sell into the private market, and a fire-sale of assets could be destabilizing to markets and hence make this a low probability option.
3. A temporary 1-day, 1-week, or 1-month extension of the debt ceiling could be passed similar to the budget debate in April of this year that avoided a government shutdown.

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4. It could authorize debt issuance that would be temporarily excluded from the debt ceiling calculation. This was the approach used in 1996 during the previously most contentious debt ceiling debate. At that time there was a significant concern that Social Security payments would not be made, and the rating agencies placed a negative outlook on U.S. government debt until the limit was subsequently raised in March 1996.

What happens if we get to August 2nd without an agreement?

If we were to get to August 2nd without an agreement and the Treasury were forced to resort to prioritization of payments and/or asset sales, there would likely be a negative economic impact which would grow by the day, with the potential for unforeseen negative economic consequences even leading to recession. The U.S. government currently runs an annualized deficit of around 10% of Gross Domestic Product (GDP), and an immediate cessation of such spending would be a significant hit to the economy. The turmoil in the equity and credit markets would also likely be significant as consumer confidence would be negatively impacted, leading to a ripple effect throughout other sectors of the economy. If this would occur, however, we believe that immense pressure would be placed on Congress, and a deal to head off these economic impacts would be completed very quickly.

From a market perspective, there will be turbulence if an agreement is not reached. However, history suggests the reaction could be short-lived. In 2009, for example, Congress initially rejected the TARP legislation and the markets swooned. It quickly reversed course and passed the bill, and the markets recouped the loss. Regardless, we know that global "macro" risks are elevated currently given the combination of the U.S. fiscal situation with the well-known problems in Europe. We have been positioning portfolios accordingly - our bond strategy has minimal exposure to U.S. Treasury bonds, and our stock portfolios heavily emphasize quality companies. We have also added exposure to alternative assets that have lower correlations to the traditional stock and bond markets.

Has the U.S. Government ever defaulted in the past?

It is a little-remembered fact that the U.S. government did miss a payment on T-bills maturing on April 26, 1979, along with those on May 3rd and May 10th of that year. The cause was a technical back-office glitch at the Treasury and a failure of Congress to act in a timely manner on the debt ceiling debate in April of that year. Due to the default on these T-bills (but not on all other Treasury debt) interest rates rose 0.60% and were slow to come down even though investors were made whole along with back interest.

What does history tell us about other countries that have been downgraded from AAA?

Most investors believe a downgrade to AA from AAA by one of the ratings agencies could lead to higher interest rates. A look at the history of large country downgrades from AAA to AA in recent years suggests a near-term outcome more benign than most fear, though. For example, S&P downgraded a host of European countries (Belgium, Ireland, Italy, Portugal and Spain) from AAA in May 1998. A week later, 10-year bond yields for those countries were just 0.06% higher on average; a month later they were actually 0.08% lower, and a year later they were almost 1.0% lower. Similarly, Japan lost its AAA rating on February 2001. A week later, its 10 year bond yields were little changed; while they were 0.32% lower a month after the downgrade and just 0.12% higher after a year.

Over the long term it certainly would not be a good thing for the U.S. to be grouped in with the European countries listed above or Japan. The European countries did not make structural changes to their governments' fiscal policies over the last decade and are now facing a financial crisis after their debt was downgraded. Japan has faced over a decade of stagnating growth but with interest rates hovering near 1%. History shows that overly-indebted countries inevitably decline, economically and otherwise. We don't need to look hard to see examples of that in today's world. The challenge for the U.S. is to not simply develop politically safe approaches that essentially "kick the can". Meaningful change is needed now to reverse course, which will require political will and sacrifice from its citizens.

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