

## Understanding and Responding to the Debt Ceiling Debate

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Ever since the government shutdown was averted, market participants have been increasingly focused on the issue of whether the government will increase the debt ceiling. Most of the blow-by-blow details of the situation, including the debate and the political positioning, have been and are being exhaustively covered by the popular press and so we will not detail them here. We will focus and provide our views on the major issues, their likelihood of occurring, and the potential impact should they occur.

It is important to remember that even though we believe the worst of the scenarios described below is unlikely, they could have broad implications for the optimal investment strategy that we pursue. We are watching the situation closely as it evolves and may reposition exposures in active strategies should the need arise. Already, to minimize operational or near-term market dislocations, market participants have been inclined to reduce exposure to Treasury debt that is maturing in the very near term. Also, as we discuss below, a U.S. downgrade could trigger a wave of downgrades of other non-U.S. Treasury, AAA-rated paper. Client guidelines often allow continued holding of downgraded paper where liquidity and other considerations warrant doing so. Mellon Capital will consider market conditions and other factors, at such time, in determining a course of action.

It is also important to remember that even with the elevated attention to the blow-by-blow details and the “deal-on, deal-off” news out of Washington, the capital markets have, so far, responded with surprising calm. Treasury bond yields and even equity markets have responded with a “business as usual” attitude. However, no matter how unlikely any of these scenarios appear, nothing can be ruled out. In this environment, we continue to monitor the situation and remain prepared to take action as the situation evolves.

We believe that there are four key issues, and we have been following and evaluating them:

1. If the debt ceiling is not raised, will the U.S. default?
2. Will the debt ceiling be raised?
3. Will there be significant deficit reduction legislation?
4. Will the U.S. be downgraded?

All of these issues are interrelated, have different probabilities of occurring, and will clearly result in different impacts should they occur. Let’s look at them in turn first focusing on the likelihood of happening, and then focusing on the ramifications.

### **1. If the debt ceiling is not raised, will the U.S. default?**

Most of the discussion and language surrounding a possible U.S. default speak of the U.S. defaulting on its “obligations.” The August 2<sup>nd</sup> deadline is positioned as the deadline because

at that point the U.S., according to the Treasury Department, will not be able to pay all of its obligations. However, it appears to us to be extremely unlikely the U.S. would default on its debt security obligations that come due in August. There are two Treasury bill maturities occurring in early August which could be simply reissued (the maturing obligations would theoretically create room under the ceiling to permit payment and reissuance). Additionally, the Treasury could prioritize payments to meet the August 15th interest payments. So again, we believe the near-term risk of an actual default on the U.S. debt obligations is extremely small. Even so, investors have begun avoiding at least the early maturities so there has already been some small impact on the markets.

If the U.S. did default on its official debt securities, like Treasury bills, the impact on the global financial system would be so large and widespread that it is impossible to project the ramifications. Treasury securities, especially Treasury bills, function as secure investments and as collateral for repurchase agreements (repos) and futures margin accounts. If they suffered a significant loss in value, or if expected cash flows did not occur because the Treasury was not making payments (and presumably would not be able to provide any certainty on when payments would resume), it would directly affect numerous markets from money market funds who may experience sudden investor redemptions and have to deal with the impact on portfolio values, to global investors who rely on those cash flows with certainty. Because the effects would likely be so large and widespread and uncertain, and because the Treasury can take steps to avoid it, it does not seem likely to us, that this will happen.

## **2. Will the U.S. raise the debt ceiling?**

We think it is very likely that the U.S. will raise the debt ceiling because the impact of not doing so would be so severe, and the immediate economic cost of agreeing to pay debts previously legislated is so minimal. In the unlikely event that the debt ceiling is not raised, the impact would be quite large even if the official Treasury debt obligations were met. We have heard estimates that, with existing revenues, the Treasury could meet a little over half of its obligations, including interest and principal payments, Social Security payments, Medicare and Medicaid payments, and then a little more. But this would mean other obligations could go unpaid, such as government employees and contractors. The Treasury has been asked to make contingency plans; what and who would get paid will likely be a part of those plans.

Thus, without additional borrowing, we think this would be somewhat similar to a partial government shutdown. Large segments of the government would not be paid and would shut down. This would have ripple effects to government contractors and suppliers. The impact could be similar to a large negative fiscal shock that would impact the U.S. and, by extension, the global economy. This unexpected fiscal contraction would, we believe, quickly be discounted in the global markets. Again, given these large negative ramifications, and the minimal economic cost of raising the debt ceiling, it seems quite likely, in our view, that it will be raised.

## **3. Will there be deficit legislation?**

We believe it is likely that an agreement will be made, but the scale and scope and timing are, of course, the subject of the debate. Both sides of the aisle want deficit legislation to be a part of the debt ceiling legislation. We believe legislation that includes, at a minimum, a relatively small set of cuts and a mechanism to continue negotiations will be the most likely result. The numerous groups and gangs and commissions and discussions have thus far failed to come up with a “grand bargain” that will be able to pass the both the House and the Senate and be signed by President Obama. The political interests and core beliefs of the majorities in the House and the Senate are so unaligned that anything substantial that could be passed by one house of Congress would likely have difficulty passing the other. Both sides of the aisle have the ability to block the others’ big agenda items, and since it is in their interests and beliefs to do so, it seems likely that they will

continue to do so. However, we believe, even if a formal “grand bargain” on deficit reduction is not struck, a smaller package of cuts will likely be produced, and/or a mechanism (e.g. “super committees” in the congress) implemented, designed to help remove some of the operational legislative barriers to getting deficit legislation passed or getting the debt ceiling raised.

Not addressing the long-run deficit in a meaningful way would, in our view, eventually have a negative impact on inflation and growth. However, the more immediate effect could be on the ratings of U.S. debt, as the rating agencies have indicated that they are looking for meaningful and credible long-run deficit reduction.

#### **4. Will there be a downgrade?**

One component of the “negative watch” is that a credible plan be developed to address the growing debt. The implications have been for a plan along the lines of the Simpson-Bowles commission, which called for roughly \$4 trillion in debt reduction over ten years. The increasingly low probability of something of that magnitude occurring makes it, in our judgment, somewhat more likely that the U.S. could be downgraded, or at least remain on watch.

If the U.S. is downgraded the impact can be thought of in two ways: market impact and operational impact. On the operational side, a downgrade may affect portfolios which are constrained to holding AAA-rated assets, or have a minimum rating requirement on the overall portfolio (and hold a high percentage of Treasuries). For portfolios restricted to holding AAA-rated assets, often the ratings restrictions apply at the time of purchase, and may give the manager time and discretion about how and when to correct the violation. These portfolios may find themselves either amending the guidelines, or rebalancing over time. If the portfolios choose to rebalance the question becomes: rebalance into what? If the U.S. is downgraded, it will likely have a ripple effect to other previously AAA-rated assets, such as federal agencies and agency mortgage backed securities. Additionally, the implications of the “sovereign debt ceiling” on other securities is unknown, but to the extent that a company has significant operational exposure in the U.S., the sovereign rating can impact the company rating as well.

The direct market impact on Treasuries is unclear, but we think it is unlikely to be significantly negative. Of course, a downgrade is not a positive development, but through the entire debate and the placement of Treasuries on negative watch, and even as recent deficit “deals” have fallen apart, Treasury rates have remained extremely low. Also, lower credit ratings do not necessarily translate directly in high yields. Many government bond yields in Japan have been less than 2% for years, even with a non-AAA rating. So from a market perspective, it appears to us that the long-run inflation and growth expectations will likely continue to have a much greater impact on yields than the credit rating and that, operationally, steps would likely be taken to allow portfolios that could previously hold Treasuries to continue to hold them.

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