

The Debt Ceiling: Assessing the Risks

July 13, 2011

Without Congressional action, the U.S. Treasury is expected to reach its statutory debt limit Aug. 2nd. Although Eagle's Fixed Income team views a government default as extremely unlikely, assessing the systemic risks that may result from a failure to raise the debt limit is an important part of risk management.

James Camp, CFA and Joe Jackson, CFA, explore the consequences and alternatives to default in the discussion below.

Q: Treasury Secretary Timothy Geithner has expressed confidence that the debt ceiling will be raised before the government is scheduled to run out of money. Debt negotiations are far from over, however, and a final deal on the debt reduction package will still need approval by Congress. What options are available to keep the government operating if a deal can't get done in time?

A: First of all, it's clear that both Republicans and Democrats agree the debt ceiling must be raised. The parties are really at odds over what needs to be done now to tackle federal expenditures, the deficit and to raise revenues. We don't debate whether these issues ought to be part of the conversation for increasing the debt limit; we are focused solely on examining the alternatives open to the Treasury if political leaders can't strike a deal by the deadline.

One course of action is a partial government shutdown. This would most likely involve the Treasury only paying legal obligations of the government; interest on Treasuries, Social Security, Medicare and Medicaid benefits, unemployment insurance and defense vendor payments. A partial shutdown most certainly raises the political stakes and there are implications for the economy, but this move could buy the government some time. A

partial shutdown puts the government in a technical default but not large scale default.

Treasury does have the option of selling assets to try and buy more time. Student loans, agency mortgage backed securities and remaining TARP holdings for instance. The downside is that these sales would put additional pressure on an already weak market.

Either of these options could keep the Treasury afloat for a few weeks.

Q: You mentioned that a partial shutdown would put the government in technical default. What do you mean by that?

A: We would view a technical default as a situation where the failure to raise the debt ceiling causes the Treasury to miss a coupon or principal payment on an outstanding obligation, but where the delay is quite short-term (less than a few days) and is not viewed by the market as reflecting a real deterioration in the solvency of the United States.

Now, none of the points we make here are intended to imply that we're unconcerned with America's long-term structural solvency problems. These problems need to get rectified but, in the short term, a default is avoidable.

Q: Should investors be concerned now about short-term market reaction in advance of any actual default?

A: A common concern that is raised is that if the government does technically default and ratings are lowered, would there be massive outflows from money market funds? While it's true that there are strict guidelines for money market funds regarding defaulted debt, there are specific exceptions that allow funds to

avoid sales if it would cause a market disruption or harm investors. Additionally, we would expect the Fed to step in and support any money market funds that experience runs in order to prevent another liquidity event.

Q: Is the soft economy enough incentive to push a deal through before the deadline?

A: While a partial government shutdown would help buy time, there are some negatives including risk to the economy. Fed Chairman Ben Bernanke, speaking to a House committee Wednesday, acknowledged recent economic stress as he cautioned lawmakers against allowing a default. By most accounts about 35 percent-45 percent of government obligations would not be paid. In real terms, that is a potential contraction in monthly government spending on the scale of \$81.5-\$93.2 billion (based on May expenditures of \$233 billion), an amount that could reduce GDP growth by up to 10 percent in a negative scenario. Put another way, the Bipartisan Policy Center estimates that a reduction in federal spending by 44 percent could mean reducing federal jobs by a third (between 600,000-700,000 jobs).

Q: No doubt, a deal will get done. However, until it is put into law, we can't completely rule out even a technical default. What do you see for the markets in the unlikely event that political leaders fail to reach agreement before the deadline?

A: In a default environment (with continued gridlock on the debt ceiling topic), risky assets would likely underperform. It seems strange to say, but U.S. Treasuries would probably benefit from uncertainty in the event of a U.S. default. There aren't many options out there for investors. The euro zone isn't the most stable investment environment out there at the moment and, outside of the United States, not many countries are capable of absorbing excess global capital flows.

Q: We know you are constantly evaluating market conditions. Has the potential for technical default changed the construct of your taxable fixed income portfolios, e.g., duration or composition?

A: Our stance remains defensive and we maintain our sector weightings from the beginning of the second quarter. We remain overweight utilities and industrials and place emphasis on businesses with predictable cash-flows and modest leverage.

Currently, the market doesn't seem to be pricing in a material risk of the U.S. government defaulting August 2nd. As of this writing, the 10 year Treasury is trading at 3 percent and the auction of 4-week Treasury bills on July 6th priced at 0 percent. A look at Treasury yields by coupon date doesn't show a material difference between those payments due prior to Aug 2nd and those payments due soon after August 2nd.