Debt Ceiling Debate

With the deadline for raising the U.S. debt ceiling looming, several questions are at the forefront of our minds. How did we get to this point? What are the possible scenarios that could play out? What effect will this have on the markets and on our clients' portfolios?

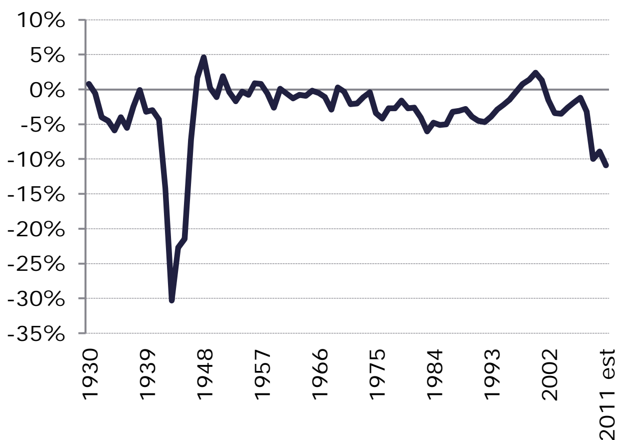
The Debt Ceiling and U.S. Credit Quality

The debate on raising the U.S. debt ceiling from its current $14.3 trillion by August 2nd has focused attention on how the U.S. has built up this large budget deficit and raised questions about U.S. credit in the future. Although the debt ceiling has been raised 74 times since 1962, the trajectory of the U.S. deficit is such that raising it again without budget reform is not a reasonable option. By contrast, state and local governments almost always have a hard debt limit which is achieved by voter approved bonds, stated policies, tax-based limits, constitutional provisions or some combination of all of these factors.

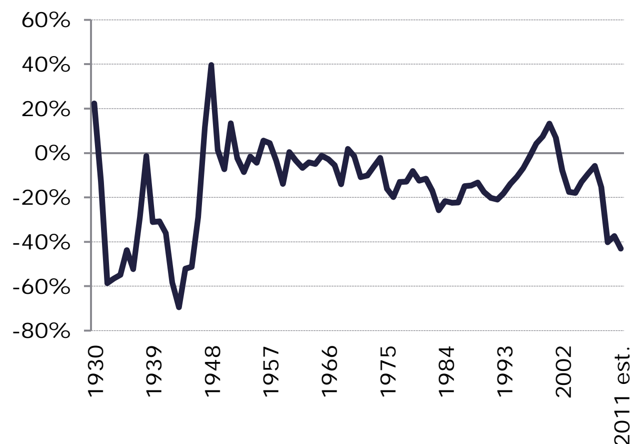
While there are many political and budget causes of this immediate crisis, we can highlight the key economic trends in two ratios – deficit as a percent of GDP and deficit borrowing as a percent of annual federal expenditures.

The first chart below shows the surplus or deficit as a percent of the gross domestic product. Since only 13 years have had a surplus, and the median deficit has been 2.6%, which is structural but manageable. This period includes depressions, recessions, wars, and shifts in expectations of the federal government's domestic and international roles. The 2011 deficit is the highest in 81 years (excluding 1942-45, when World War II deficits reached 30% of GDP). The rapid increase in this ratio since 2009 is dramatic and coincides with the financial crisis and the consequent stimulus spending.

Surplus/Deficit as a Percent of GDP



Deficits as a Percent of Federal Outlays



Source: OMB

The second chart above shows the deficit as a percentage of outlays. Deficit borrowing was just 6% in 2007, 15% in 2008. Then it nearly tripled to 40% in 2009 and has reached 43% in 2011. These levels have only been exceeded during the Great Depression and World War II. Since 1930 only 13 years have seen sufficient revenues to cover federal expenditures, and the median percent of the budget borrowed was 12.9%. The rating agencies have noted this ratio as a major concern, in both the scope and trajectory of the use of borrowing for expenditures, in the absence of economically generated revenues.

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Could There Be a Downgrade?

Standard & Poor's and Moody's have both placed the triple A rating of the United States of America on review for downgrade. S&P has outlined the three following scenarios and their respective results on the U.S. rating:

Scenario	Government Action		S&P U.S. Rating Impact
	Debt Ceiling	Debt Reduction	
1	Raise	Reduce	Affirm AAA, remove from credit watch
2	Raise	No credible plan	Lower to AA+ with negative outlook as soon as early August
3	No agreement	No agreement	Lower to Selective Default rating upon default

Moody's has said that "If, as expected, the debt ceiling is raised in time to avoid a default, the government's rating is likely to be confirmed at Aaa, and its rating outlook will either be stable or negative… Without a substantial and credible agreement on long term deficit reduction, the debt trajectory may prove to be incompatible with a Aaa over the next two years." Moody's has also declared that 177 cities, counties, school districts and housing finance programs (representing $69 billion in outstanding debt) could lose their triple A ratings along with the U.S. government.

Even if a default is avoided, Pandora's box has been opened, and market participants are now questioning whether the U.S. can maintain its triple A rating.

What Does it Mean?

The basis of fundamental credit analysis is assessing the ability and the willingness of the borrower to repay its debts, and the breach of this trust has implications that none of us can fully understand or project at this time. Over time, a U.S. rating downgrade could negatively impact the ratings and interest costs of thousands of state and local borrowers, educational and health care institutions, and many other participants in the municipal bond market. In addition, other capital market participants, including banks and federal agencies could see their ratings downgraded.

In the meantime, T-bill yields on short dated securities have begun to rise sharply:

- The 8/4 Bill, which yielded 0% just days ago, now trades at nearly 26 basis points.
- The 8/25 Bill, which also yielded 0% just days ago, now trades at 15 basis points.

We believe this is the beginning of the debt crisis rippling through the short term market and perhaps a preview of the effects on the rest of the Treasury market if the debt ceiling is not raised, or if the U.S. becomes a AA credit.

Yet, the short end of the curve is not the only place where we can see a steady rise in the risk premium being built into the market. The slope of the Treasury curve from 10 to 30 years also is revealing. We have seen a steady flattening of the 2 to 10 year part of the curve since the start of the year, which may have reflected a decline in inflation and growth expectations. However the longer, 10 to 30 year part of the curve has steepened since the beginning of 2011. The steepening was most apparent since the beginning of the 2nd quarter as budget talks took center stage and entered the psyche of the market.

To date, intermediate rates have remained low because of weaker than expected economic activity and the perception that a default may also be negative for the economy

We continue to manage our clients' portfolios conservatively. Our target interest rate exposure has been defensive, to protect portfolio values against a rise in rates. Samson focuses on large, high quality, frequently traded issues which we believe will retain liquidity in stressed markets and are in better position to weather a widening of credit spreads.

Just as the U.S. Treasury is on review for a credit downgrade, so are prerefunded and escrowed to maturity municipals, which are backed by U.S. Treasuries. While these instruments remain very safe, we believe they offer less compensatory value and we have made modest reductions in recent weeks in our prerefunded municipal allocations.

Looking Forward

Since the markets have never confronted an actual downgrade of the United States, no one can say with certainty what will happen. It seems reasonable to think that the term structure of interest rates for a AA sovereign should be different from a AAA sovereign. In the context of economic theory, it is perfectly reasonable to expect a higher risk credit has to pay higher interest rates to borrow money.

Yet, many other factors may come into play that will influence the term structure of U.S. rates. Japan serves as a good example. Once a AAA nation, Japan has had its credit rating downgraded a number of times over the past decade. Yet, for a variety of factors, including the fact that Japan is a nation of savers and its economy has been mired in a slump for years, it has the lowest rates of any G-10 country. In the context of this discussion, it becomes clear that a decline in America's credit rating may lead to a rise in rates, but that is simply one of a number of outcomes.

A downgrade may lead many to reconsider the role of U.S. Treasuries in their portfolios. Certainly, as long as the Treasury market remains the most liquid bond market in the world, it will retain certain aspects of its safe haven status, ironic though that may seem. Again, Japan is an instructive example. The yen, like the dollar, retains a role as a safe haven currency for reasons related to history, the size of its economy, and the breadth of its markets. We believe a weakening America will similarly retain such qualities even if in a muted fashion.

However, the comparison between America and Japan diverges as Japan is a nation of savers while America is not. Japanese rates are low because savers need investment vehicles. Who will invest in Treasuries as the credit profile declines, and if domestic savers do not materialize? Much has been written about foreign central bank holdings of U.S. Treasuries, and for good reason. While these holders may be disinclined to sell, as it would only hurt the market value of their remaining holdings if such selling pressure contributed to a wholesale rise in rates, all they need to do is buy much less to shift the trend in rates from an orderly decline towards an orderly rise.

Nonetheless, it seems reasonable that a decline in the credit rating of the U.S. will cause investors to reconsider what a safe investment means. For bond investors, Treasuries will be one of many AA rated choices. In that context, there will likely be more sector diversification in portfolios, greater sector rotation based on changing credit fundamentals, and less willingness to hold Treasuries just because they are large part of a comparative performance benchmark.

Any statements regarding future events constitute only subjective views or beliefs, are not guarantees or projections of performance, should not be relied on, are subject to change due to a variety of factors, including fluctuating market conditions, and involve inherent risks and uncertainties, both general and specific, many of which cannot be predicted or quantified and are beyond our control. Future results could differ materially and no assurance is given that these statements are now or will prove to be accurate or complete in any way.