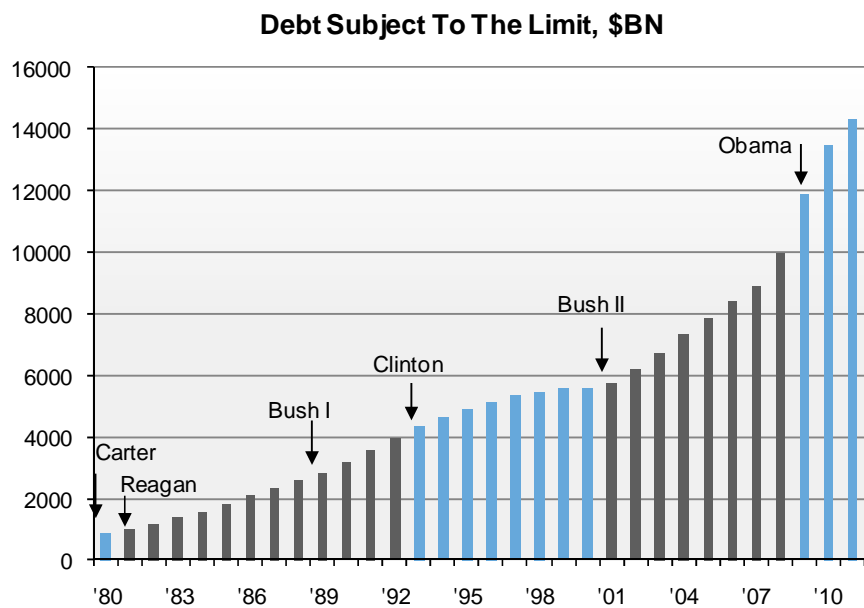


What to expect when you are expecting an increase to the debt ceiling

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Abigail Huffman,
Director, Research

Mike Dueker, Chief
Economist



Under each administration, the debt ceiling has been raised with little fanfare. Chart: Strategas

On Monday evening, July 25th, two leaders presented their perspectives on how to raise the debt ceiling above its current \$14.29 trillion level and offered their visions on how to address the US debt and deficits over the next ten years. President Obama appealed for a balanced approach that would cut spending and raise revenues over the next ten years. House Speaker, John Boehner (R., Ohio) presented the Republican plan to raise the debt ceiling in two installments. As of this writing, Harry Reid, Senate Majority Leader, has presented the Democratic plan which includes no revenue (aka taxes) increases. The broad outlines of the plans are shown below:

WHAT YOU NEED TO KNOW:

	Democratic	Republican
Raising the debt ceiling	By \$2.4 trillion all at once (Should last until 3/2013)	\$1 trillion now (should last 6 months) \$1.8 trillion later, increase is linked to budgetary cuts of the same amount
New tax revenues	None	None
Spending cuts	\$2.2 trillion from discretionary spending and military cuts	Less than \$1 trillion first stage, a further estimated \$1.8 trillion by Nov (specific cuts to be clarified in Nov)
Timing of vote	Target Thursday, July 27 th (after vote on Republican plan)	Target Thursday, July 27 th
Probability of vote	Not enough votes	Not enough votes
Key differences	No cuts to entitlements	Reform to entitlements and taxes; enforcement mechanism by Congress links future cuts to debt ceiling increase

While the situation is very fluid, we note that the deadline for raising the debt limit is August 2nd, less than a week away. We expect a resolution to the “stalemate” among policy makers and that the debt ceiling will be raised. However, we will be watching closely to see if the US government goes into a technical “default” or whether Standard and Poor’s downgrades US debt.

One might put “default” in quotation marks because perhaps it should be called a repayment disruption event. Our thesis is that a debt-ceiling-induced repayment disruption event would harm the feature that makes the U.S. Treasury market the jewel in the crown: it is by far the most liquid debt market in the world. For this reason, central banks around the world hold their reserves in the form of Treasuries. They know that if they want to increase the money supply this week and take much of it back the next, they can do this round-trip transaction with minimal seepage into bid-ask spreads. Thus, the liquidity of the Treasury market is closely tied to the dollar’s role as the world’s reserve currency. Even a short-lived RDE could trigger a lasting reduction in the perceived liquidity of Treasuries.

In such an illiquidity regime, Treasury prices would lose some of their pricing premium and yields would rise in relation to other investment-grade debt. This point is important because many claims are that interest rates would rise in lockstep across the board under the assumption that all quality spreads would remain the same. If there were a repayment disruption event, it would be hard to disentangle its direct effect on quality spreads from its indirect effect on those same spreads from the weaker economy we would expect in the wake of a repayment disruption

event. The direct effect would be to narrow the corporate-Treasury yield spread, but a weaker economy would widen it.

How would a repayment disruption event threaten to weaken the economic expansion? The most telling impact is not the direct effect of the government not paying its suppliers on time. Instead, a repayment disruption event could trigger a Lehman-type distrust of counterparties event that could gum up the plumbing of the payments and credit system. These plumbing problems would be worsened if there were forced selling of Treasuries by banks and insurance companies who would be scrambling for AAA-rated assets that have a zero risk weight in calculations of capital requirements. Such a scramble would likely exacerbate counterparty distrust issues as promises are made to deliver AAA-rated securities that cannot be honored. To avoid many of these problems, we would expect that a government edict would be issued to keep Treasury securities as a zero in risk-weighted capital requirements for banks and insurance companies even if there were a ratings downgrade from AAA. In areas where an edict is not feasible, regulatory forbearance could help. These steps would stem panic in a similar manner to the Treasury guarantee of money-market funds on September 19, 2008, in the wake of Lehman's default on financial commercial paper.

The world simply does not have a sufficient supply of alternative AAA-rated assets. The next biggest issuer is Germany. But the use of German Treasury bills as AAA-rated collateral for upcoming dollar-denominated obligations presents its own difficulties. One would have to hedge the currency risk, but the forward currency markets are priced off of Libor and are subject to counterparty risk involving banks that are not AAA-rated. For this reason, we would expect a government edict that would call for continued use of Treasury securities as a risk-free asset, regardless of any ratings agency downgrade.

Another question is to what extent we would expect a material jump in Treasury bond yields in the event of a repayment disruption event. In this event, Treasury yields might spike up and then gradually recede. If Treasury bonds are viewed as being riskier in the short run due to a debt-ceiling debacle, then bondholders could be compensated for this risk through capital gains from a gradually declining yield. Of course, this requires an initial spike in the yield from what it otherwise would have been, but the spike is not necessarily long-lasting either. As with the quality spread, however, it would be hard to discern the level of such a spike in yield, given the simultaneous downward pressure on yields that would accompany expectations of weaker economic growth.

While the entire episode continues to be unsettling to witness, as a practical matter we cannot at this stage recommend that clients implement tactical changes to attempt to anticipate or exploit a spectrum of outcomes that are frankly impossible to forecast. Nor is it clear that all debt-ceiling debacle scenarios would lead to negative outcomes for investors in actively managed bond funds – or other related asset classes, especially commodities. The most hopeful outcome, and which -- as of this writing -- seems most likely given the largely nonplussed market response to date, is that debt ceiling brinkmanship will amount to just one more nerve-rattling chapter in the broader story of a plodding and mediocre US economic recovery.

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