

FFTW OUTLOOK

The U.S. Debt Ceiling Crisis And A Potential Downgrade

Thoughts On The U.S. Debt Ceiling

What is the deadline for raising the debt ceiling?

The August 2 deadline to raise the budget ceiling is somewhat self-imposed. A number of analysts have estimated that U.S. Treasury tax receipts may be sufficient to push back the hard deadline further by one week, maybe even two. One also has to assume that Treasury Secretary Geithner used a conservative date as the deadline. Nevertheless, the Treasury has a number of large payments that need to be made in coming days. At some point, the Treasury's balance at the Federal Reserve will simply drop to zero, and if and when that seems imminent, the Treasury will need to prioritize distribution of incoming tax receipts. It is worth noting that an unnamed administration official yesterday declared that bondholders would be first in line. Thus even if the debt ceiling were not raised, the Treasury could continue to make payments to bondholders at the expense of other obligations, at least for a while. There is, of course, historical precedent for such actions, where Federal employees have been furloughed.

Will we get a budget deal that allows the debt ceiling to be raised?

As tortuous negotiations and political posturing continues in Washington, D.C., we feel that the most likely outcome remains an (inadequate) last minute compromise that permits a lifting of the debt ceiling in return for smaller-than-hoped-for spending cuts. From a political perspective, Republicans appear to be maneuvering for a modest lifting in the debt ceiling to ensure the issue reappears ahead of next year's Presidential election, whilst Democrats are pushing for a more significant increase in the debt ceiling for the opposite reason.

Financial markets, and credit rating agencies are looking for a more comprehensive package of spending cuts, revenue increases and entitlement program reforms. It is the last two components that have been the obstacles to a deal. Standard & Poor's (S&P) has indicated that it wishes to see an improvement in the fiscal trajectory of the United States over the next 10 years of approximately \$4 trillion. Yet the current Boehner (Republican) and Reid (Democratic) proposals are far more modest in scale, consist of only spending cuts, and each proposal looks set to be rejected by the other party. The prospects for a 'grand bargain' of the type put forward by the Gang of Six, therefore, look slim.

What would be the implications of a default?

If the debt ceiling were not raised and the Treasury failed to make a bond coupon or principal payment, the United States would immediately be considered by ratings agencies to be in default. Non-payment on a particular, or particular sub-set of securities, would constitute a 'selective' or 'restricted' default. From the viewpoint of credit default swap (CDS) contracts, which are governed by ISDA agreements, an issuer can be declared to be in default if a payment is delayed by more than three working days, at which point a credit event is declared and the CDS triggered. The market has come to describe a short delay in payment as a 'technical' default. We do not believe that a technical default would be catastrophic - most investors conclude that the debt limit would be raised in short order and bondholders made whole within days. There is no political gain to be had for either political party from allowing such an event. A delay of payment for more than a few days would be a massive risk event, and as a result appears extremely improbable. The full ramifications for risk assets are unpredictable and almost unquantifiable. Economic growth prospects would certainly worsen dramatically and financial markets would witness a flight to quality (maybe even into benchmark conventional U.S. Treasuries), with equity markets likely to plunge, probably led by financial sector stocks. Credit spreads would ratchet wider, while OTC markets would seize up and interbank lending would come to a halt.

Will the ratings agencies downgrade the debt of the United States even if the debt ceiling is raised?

If S&P remains true to its word, even if the debt ceiling is raised, the odds look high that they will downgrade the United States by one 'notch' from AAA to AA+, and leave the United States on negative

watch for a further possible downgrade. The reasoning would be simple - a failure of the U.S. political system to commence addressing its long-term fiscal sustainability. Downgrades by Moody's and Fitch would likely follow in due course.

For the ratings agencies, downgrading the debt of the United States is not a trivial step. Ratings agencies are clearly looking to be proactive in their ratings changes, re-establish credibility after their failure to gauge the risks of sub-prime structured fixed income products in 2007-2008, and regain relevance to investors. But the nationally recognized statistical ratings organizations (NRSROs) enjoy a privileged position in financial markets given their importance in regulatory and investment guidelines. Downgrading U.S. Treasury debt, arguably the bedrock of the global financial system, is therefore, a career defining step for those involved. Some hesitation to downgrade is probable, if a budget deal includes contingencies or promises of further budget committees.

Implications Of A Ratings Downgrade

Given that the United States is already on negative watch and that S&P have been forthright about their parameters for a downgrade, it should be largely anticipated, and thus not constitute much of a 'risk event'. Equity markets could well sell off on the news, but we would anticipate the impact to be temporary. In fact, it is entirely possible that a lifting of the debt ceiling, even if combined with a debt downgrade, could lift risk assets due to the reduction in uncertainty.

But, to be frank, we simply cannot be sure about the full range of consequences, both intended and unintended. NRSRO ratings are so embedded in the regulatory framework and investment guidelines that the repercussions could be significant. Bear in mind that a U.S. Treasury downgrade would also imply an immediate downgrade of GSE debentures and MBS obligations, as well as some (defeased) municipal securities.

Here are some potential problems, and our assessment:

- *Higher GC repo rates:* General Collateral (GC) repo rates have already been rising reportedly as money funds have been facing withdrawals, meaning there is less cash to be lent via GC Treasury repos. Paradoxically, it appears that cash is being reinvested in FDIC-insured bank deposits. This situation could become more aggravated, but a number of regulatory fixes are possible (for example, the Federal Reserve could inject cash, waive FDIC fees, waive liquidity coverage ratios, etc.). While this would not be a pleasant phenomenon for money funds, it would have benefits for banks which would gain cheap funding. The bigger problem could be for those institutions who depend on repo markets for leverage. After all, with greater uncertainty about the quality of both U.S. Treasury collateral and one's counterparty, we could see increases in repo haircuts.
- *Higher margin requirements for futures:* The Chicago Mercantile Exchange already raised margin requirements on U.S. Treasury note and bond futures because of higher volatility. A ratings downgrade and the associated market uncertainty could increase volatility further and prompt additional increases to margin requirements, with negative implications for the leveraged macro investor community.
- *Forced selling (or buying?) of U.S. Treasuries due to guideline restrictions:* Some investors have guidelines requiring a AA rating for investments. We doubt many of those investors would actually choose to become forced sellers. Paradoxically, for some fixed income core accounts that require a minimum average rating, a U.S. Treasury downgrade could mechanically prompt additional buying of U.S. Treasuries as portfolio managers are forced to sell lower rate corporates to maintain the portfolio's average credit rating. Although it is our judgement that few managers are at maximum credit exposure, U.S. Treasuries make up such a large proportion of U.S. core mandates, for example, that a one notch downgrade could still prompt some forced buying of U.S. Treasuries.

Overall, if a default is avoided, we believe that a downgrade should not be a significant downside shock (given that it is largely anticipated). Thus the main driver of U.S. Treasury valuations will remain economic fundamentals, with investor sentiment providing volatility. While we anticipate a lifting of the debt ceiling,

we do not think it will be achieved in combination with a comprehensive fiscal package. Further agreements will need to be reached, meaning that investors will continue to face uncertainty around the fiscal picture. Dramatic and immediate fiscal consolidation would, of course, involve significant fiscal drag on the economy. But delaying fiscal consolidation, with uncertainty about timing, form and magnitude, has the potential to significantly dampen consumer and business 'animal spirits' - an outcome that brings all the downside of fiscal drag without any of the consolidation upside. With some evidence that these negative animal spirit effects are already impacting the economy (witness recent U.S. growth and employment data), it seems inconceivable that the Federal Reserve would even consider tightening financial conditions before 2013 at the earliest. As a result, carry and roll-down strategies would look attractive on any meaningful increase in implied U.S. Treasury forward yields.

Longer term, of course, a ratings downgrade has important ramifications.

- One would expect to see the cost of funding for the U.S. Treasury increase as more sovereign risk premium is priced in. Arguably, investors have already made this assessment, as suggested by the steepness of the 10s / 30s yield curve.
- Furthermore, deterioration in U.S. sovereign credit quality could be expected to dampen the international demand for U.S. Treasuries as reserve assets, putting some upward pressure on U.S. Treasury yields over time and shifting the composition of ownership for the stock of federal debt. Note, however, that deleveraging by the U.S. household and financial sectors, combined with the paucity of issuance in other fixed income sectors means that there will still be plenty of buyers for U.S. Treasuries.
- The depth and liquidity of the U.S. Treasury market will remain unmatched for the foreseeable future (especially if deficits continue to be sizeable), but a gradual erosion of U.S. Treasury debt as a store of value will prompt investors to seek alternatives. Investors will continue to pay relatively more for debt of fiscally sound countries, such as Australia, Canada and the Scandinavians. Unfortunately, the downside of fiscal soundness is that the stock of debt is correspondingly reduced - and there are simply not enough of these alternatives to absorb a significant proportion of the wealth currently invested in the U.S. Treasury market. At the same time, a number of European sovereign alternatives have themselves significantly deteriorated in credit quality (and liquidity). A gradual process of diversification toward emerging market and high-quality developed market debt is therefore underway.
- It is worth considering that in the long run, the United States is far more likely to inflate away an excessive debt burden than actually renege on its promises of payment. Correspondingly, we have already seen longer-dated breakeven inflation rates move to historically wide levels - the 30-year breakeven inflation rate is currently 2.70%. The theme of diversifying investments away from conventional U.S. Treasuries into inflation-protected Treasuries (TIPS) is likely to gather pace, and we would look to strategically buy inflation protection on any significant narrowing.

Conclusions

Unfortunately, it may be that U.S. policymakers need to trigger a financial crisis before meaningful progress can be made on serious fiscal consolidation. In the meantime, policymakers in Washington, D.C. will use the debt ceiling issue as a vehicle for extracting political concessions. The additional uncertainty is harmful for both the real economy and financial markets, though it may be a necessary part of arriving at a solution. We expect the debt ceiling to be raised, though perhaps only by enough that we repeat the process next year. We also anticipate a credit downgrade, though we think the near term implications are modest. In the longer-run, of course, debt sustainability is key and a failure to address the problem would damage the special advantages that U.S. Treasury debt enjoys as the bedrock of the global financial system. While the United States continues to hesitate in implementing a comprehensive solution to its debt problem, we can expect an acceleration of diversification flows out of conventional U.S. Treasury debt into inflation-linked format and other sovereign credits.



DISCLAIMER

Opinions expressed are current as of the date appearing in this document only. This document is confidential and may not be reproduced or redistributed, in any form and by any means, without FFTW's prior written consent.

This document is not to be construed as an offer to buy or sell any financial instrument. It is presented only to provide information on investment strategies and current financial market trends. The analyses and opinions contained in this document are those of Fischer Francis Trees & Watts, and are based upon information obtained by Fischer Francis Trees & Watts from sources which are believed to be reliable. Fischer Francis Trees & Watts provides no assurance as to the completeness or accuracy of the information contained in this document. Statements concerning financial market trends are based on current market conditions, which will fluctuate. Investment strategies which utilize foreign exchange may entail increased risk due to political and economic uncertainties. The views expressed in this document may change at any time. Information is provided as of the date indicated and Fischer Francis Trees & Watts assumes no duty to update such information. There is no guarantee, either express or implied, that any investment strategies work under all market conditions. Past performance is not a guarantee of future results. Readers should independently evaluate the information presented and reliance upon such information is at their sole discretion. Investment advice or recommendations, if any are set forth in this document or elsewhere, may not be suitable for readers or any portfolio.

The information contained herein includes estimates and assumptions and involves significant elements of subjective judgment and analysis. No representations are made as to the accuracy of such estimates and assumptions, and there can be no assurance that actual events will not differ materially from those estimated or assumed. In the event that any of the estimates or assumptions used in this presentation prove to be untrue, results are likely to vary from those discussed herein.

Fischer Francis Trees & Watts, Inc. is registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940.

Fischer Francis Trees & Watts UK Limited is authorized and regulated by the Financial Services Authority. Registered in England No: 979759, registered office: 5 Aldermanbury Square, London, England, EC2V 7BP, United Kingdom. FFTW UK is also registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940, as amended.

Fischer Francis Trees & Watts Singapore Limited is registered with the Monetary Authority of Singapore for the conduct of Fund Management business and is a holder of a Capital Markets Services License. FFTW Singapore is also registered with the US Securities and Exchange Commission as an investment adviser under the Investment Advisers Act of 1940.