



July 14, 2011

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## Update on US Debt Ceiling Issue

Moody's Investors Service has announced it is putting the U.S. 96-year-old Aaa credit rating under review for a possible downgrade. Moody's also announced reviews on financial institutions and securities linked to the government, including some municipals. The move comes in the wake of Wednesday's apparent breakdown in talks over lifting the debt ceiling, and ratchets up the pressure on the parties to bridge their apparently still-wide differences. Until now at least, the Republicans have made legislative support for a rise in the ceiling contingent on wide-ranging spending cuts to rein in the deficit. Moody's action follows earlier steps by some other agencies, including a change in the outlook to "negative" from "stable" by Standard & Poor's in April, due to fiscal concerns.

The US government hit the current \$14.3 trillion debt limit in mid-May (see Table), but has been relying on extraordinary measures to keep operating. Treasury Secretary Geithner has said, however, that unless the debt limit is raised by August 2<sup>nd</sup>, the government will exhaust its cash, leaving it unable to pay creditors. President

### Debt Ceiling Timeline

Date	Event
Nov-96	Treasury Sec Rubin, Congress "play chicken" with Congress over debt ceiling
18-Apr-11	Standard & Poor's affirms US AAA rating but changes outlook from "stable" to "negative" on quality concerns
16-May-11	US hits the formal \$14.29 trillion debt ceiling, starts burning cash, financial juggling
2-Jun-11	Moody's threatens to review US Aaa rating by mid-July if progress not made
23-Jun-11	Talks chaired by VP Biden founder, Obama/Boehner step in
13-Jul-11	Moody's follows through on threat to review US rating
22-Jul-11	Last day for Congressional agreement according to Obama to prevent early August default
2-Aug-11	Treasury Sec Geithner's deadline for raising ceiling to avert default
4-Aug-11	\$91 billion US T-bill matures

Obama has stated more recently that the broad outlines of a deal would likely have to be agreed upon by July 22<sup>nd</sup> to leave time for Congressional enactment and meet Geithner's early August deadline. As a practical matter, the Treasury Secretary gets to decide who gets paid and who doesn't in a liquidity squeeze. The government might, in consequence, be able to fend off default for a time beyond August 2<sup>nd</sup> by withholding salaries or other payments to free up cash for coupon and principal payments to public debt holders.

The White House has been pressing until now for a 'Grand Bargain' which would raise taxes by \$1 trillion and cut spending by \$3 trillion over the next 10 years.

The Republicans—who remain adamantly opposed to tax increases (though not to closing a few "loopholes")—have instead favoured a more limited package that would allow the government to continue operating through the next fall's election, or potentially some shorter period of time. Signs of economic fragility, including June's weak payrolls report, have reportedly hardened opposition among Democrats to front-loaded spending cuts.

Senate Minority Leader Mitch McConnell (R-Kentucky) proposed a complicated back-up plan to break the deadlock this week, which would see President Obama formally request an increase in the \$14.3 trillion debt ceiling, which Congress would reject through a "resolution of disapproval". If Congress failed to muster the two-thirds vote needed to override a Presidential veto of that resolution, the debt ceiling would rise by the requested amount. Whether the McConnell proposal ultimately flies or not, the desire of politicians on both sides to avoid the fallout if things go badly wrong, means that prospects are growing for some sort of interim solution. This could well aim at tiding things over for the next few months or quarters, deferring action on serious long-term issues over which of the two parties remain deeply split until later.

## Forecast and Market Implications

Markets have assumed that politicians would ultimately do the “right thing” on the debt ceiling and have consequently paid the issue less attention than it merits. While we continue to believe a default is unlikely, the almost universal view is that such a development would have serious and potentially lasting repercussions. Bernanke testified to Congress this week that a US default would slam investor confidence and raise borrowing costs in critical sectors of the economy (e.g. consumer loans, mortgage rates, etc.). The Fed Chairman also suggested that a repeat of the 2008-09 severe recession was a possibility. Turning to asset class implications, the US dollar would likely lose ground in such an event, along with equities, as risk-averse investors sought out alternative havens. While the curve would flatten in this case—perhaps even inverting out to a year or so—the more likely outcome from a political perspective appears to be an interim agreement that averts default, but leaves serious longer term fiscal challenges unresolved. That would be curve-steepening based on intensified longer-term concerns about the debt-to-GDP ratio and fiscal outlook.

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