

Potential Implications of a U.S. Credit Event

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Executive Summary

As debate heats up in Washington, D.C., over raising the country's debt ceiling, investment professionals from Standish Mellon Asset Management Company LLC discuss the potential implications of a U.S. credit default on the U.S. economy and global financial markets. Their base case is that the U.S. Congress will ultimately raise the debt ceiling, thus avoiding a technical default. Until then, however, they expect heightened market volatility with additional market uncertainty stemming from Europe's ongoing sovereign debt problems and a potential pan-European banking crisis.

At Standish, we believe the fiscal position of the U.S. government is unsustainable. Today, the U.S. federal budget deficit stands at more than 9% of GDP compared with around 1% of GDP before the recent recession that began in December 2007.¹ Part of that deficit is cyclical, meaning it is likely to shrink as the U.S. economy recovers. However, there is a sizable portion related to entitlement programs that is structural and will persist long after the economy gets back on its feet.

Democrats and Republicans are divided over the amount of tax increases and spending cuts necessary to address the structural deficit. The resulting stalemate has occurred at a time when the U.S. government is already bumping up against its \$14.3 trillion statutory limit for federal debt.² This so-called debt ceiling is the total amount of money the U.S. government is authorized to borrow to meet its existing legal obligations, including paying interest to existing holders of U.S. Treasuries.

The U.S. Congress needs to extend the debt ceiling by August 2, 2011, or it risks triggering a technical default on the federal debt. A default by the U.S. government would be unprecedented and would have severe consequences for the U.S. economy and global financial markets. Although in our view such an event is unlikely, we believe the risks

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¹ U.S. Congressional Budget Office.

² "Debt Limit: Myth v. Fact," U.S. Department of the Treasury.

We view default as a tail risk and place a 10% probability on this outcome. Our base case scenario is that the U.S. Congress will extend the debt ceiling and that a default will not occur.

warrant an analysis of potential default scenarios. The following comments reflect the combined views of David Leduc, our Chief Investment Officer, Robert Bayston, head of Interest Rate Strategies, and Thomas Higgins, our Global Macro Strategist, on the main implications of a putative default.

What is the likelihood that the U.S. Congress fails to extend the debt ceiling and the U.S. government defaults?

We view default as a tail risk and place a 10% probability on this outcome. Our base case scenario is that the U.S. Congress will extend the debt ceiling and that a default will not occur. If a default were to occur, we would expect it to be short-lived, given that the U.S. has the ability to service its debts. In our view, however, the longer the U.S. government postpones a solution, the greater the fallout on the economy and financial markets.

What would be the impact of a default on the U.S. economy?

Failing to raise the debt limit would require the federal government to delay or renege on payments for a broad range of legal obligations. These include interest payments on outstanding debt as well as checks to recipients of Medicare, Social Security, and food stamps among other programs. A loss of confidence and pullback in aggregate demand would likely follow. Even a short suspension of payments on principal or interest on the Treasury's debt obligations would cause severe disruption in global financial markets. Ratings downgrades from Standard & Poor's, Moody's and Fitch would raise fundamental doubts about the creditworthiness of the United States. This could lead to large losses in investor portfolios and a negative wealth effect.

In the long term, Americans would likely face higher borrowing costs due to an increase in the perceived credit risk of the U.S. government and a slower pace of U.S. economic growth, all other things being equal. The situation could be aggravated by a failure to address growing structural deficits associated with long-term entitlement programs. These deficits have the potential to crowd out productivity growth. Additionally, high structural deficits could hinder the ability of policymakers to respond effectively to future economic downturns. Overall, we would characterize a U.S. default as a large economic shock that could trigger a relapse into recession.

What would be the impact on global financial markets?

A default by the U.S. government might trigger a global financial crisis, given the widespread holdings of Treasuries by global central banks and the role of Treasuries as the global risk-free asset used to price most securities. The dollar's position as a global reserve currency would be called into question, since Treasuries are really just a measure of demand for future dollars. We would anticipate high correlations between financial markets similar to what happened during the 2008 global financial crisis when many markets fell together. Contagion among asset classes might be driven by money market funds, which hold \$338 billion in U.S. Treasuries.³ A U.S. default could put at least one fund in a position in which it is unable to return principal to an investor. A similar "breaking of the buck" scenario resulted in a broader run on money market funds during the 2008 financial crisis, leading to forced selling of other financial assets to meet investor liquidity demands.

³ "The Mother of All Tail Risks," *The Economist*, June 23, 2011.

If a default were to become our base case scenario instead of a tail risk, we would argue for positioning portfolios defensively with an overweight to US Treasuries or German Bunds where possible.

The following summarizes our views on the potential impact of a possible default on specific sectors:

U.S. Treasuries: A convincing case could be made that Treasuries may actually rally in the short term as concerns about fiscal retrenchment undermine prospects for economic growth. Yet, the longer the default situation dragged on, the greater the risk that U.S. interest rates would rise, as U.S. Treasury bonds would lose their safe haven status.

Volatility: Both stock and bond market volatility would likely pick up due to an increase in perceived market risk. The fact that U.S. Treasuries are the global benchmark for risk-free assets could add to global financial market volatility.

Investment Grade (IG) and High Yield (HY) Credit: Both IG and HY spreads could widen due to concerns about a downturn in the U.S. economy and a probable increase in interest rate volatility that would accompany a default.

U.S. Dollar: The dollar would likely weaken as central banks accelerated their pace of reserve diversification away from the U.S. currency. The primary beneficiaries would likely be the Swiss franc, the euro, the Australian dollar, some emerging market currencies and gold.

Credit Default Swaps (CDS): Investors are already using this form of bond insurance to protect their portfolios against a U.S. default. The closer we move to August 2 without some agreement on extending the debt ceiling, the more expensive this form of insurance is likely to become. If a default is triggered and the counterparties have to pay out obligations under the CDSs, that could have a separate and broader negative impact on the global financial markets.

How would a default affect our portfolio positioning?

If a default were to become our base case scenario instead of a tail risk, we would argue for positioning portfolios defensively with an overweight to US Treasuries or German Bunds where possible. Interest rate straddles might also be a way to take advantage of an increase in volatility without taking a position on the direction of rates. Lastly, we would also argue for underweighting credit and the U.S. dollar.

Conclusion

In conclusion, our base case scenario is that the U.S. Congress will indeed extend the debt ceiling and a technical default will not occur. However, we expect heightened market volatility until this situation is resolved. The tail risks are increased by ongoing problems in Greece and the threat of a pan-European banking crisis. To us, this suggests that a continuing correction in financial asset prices has not yet run its course and argues for hedging risk in portfolios. Once we have greater clarity on these fronts, we believe investor focus will return to the underlying cyclical momentum in the U.S. and global economy. We continue to be optimistic that financial market performance will improve as the temporary drags from higher energy costs and supply disruptions associated with the Japanese tragedy fade from the economic data.

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