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Caprin Commentary: The Federal Debt Ceiling Debate

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Highlights:

- Congress continues intense debate over the federal debt limit ahead of August 2nd deadline
- Bond Ratings Agencies threaten U.S. downgrade if agreement is not reached soon
- Default risk remains low; Caprin monitoring the situation closely in the coming weeks

Introduction

Heated debate over the U.S. Federal debt ceiling is not a new phenomenon in Washington. For decades, Congress has argued over the United States' unsustainable spending plans and loose borrowing standards. In the past, legislators on Capitol Hill have mostly used the debt ceiling negotiations as a platform to criticize irresponsible U.S. fiscal policies, only to raise the debt ceiling and permit further borrowing at the 11th hour. However, the political and economic landscape, both here and abroad, surrounding the debt ceiling debate has raised the stakes dramatically – to the point that the situation demands close surveillance and a discussion of potential scenarios and consequences.

Recent Developments

The U.S. Treasury has claimed that short of a deal that raises the debt ceiling by the August 2nd deadline, the United States will not be able to meet its obligations at some point in the weeks that will follow. This statement has led to several important recent developments:

Rating Agencies Revise U.S. Rating Outlook to Negative

In April, Standard & Poor's delivered U.S. legislators their first "shot across the bow" by revising the U.S. credit rating outlook to Negative, while maintaining its AAA rating. S&P cited "very large budget deficits and rising government indebtedness" (S&P) and pointed to the government's lack of a plan to address the mounting issues. For many, this was the first tangible evidence that the United States' fiscal challenges could threaten its global standing as the world's safest asset. On July 14th, S&P officially placed the U.S. AAA rating on watch for possible downgrade due to unproductive deficit negotiations only two weeks ahead of the looming deadline. The rating agency left the door open for a downgrade as soon as this month and further noted that any deal Congress reached that was viewed as only a short-term solution could lead to a downgrade as well.

Earlier this week, Moody's released its own report revising its outlook of the U.S.'s Aaa rating from Stable to Negative. Moody's has maintained a Aaa-rating on debt issued by the U.S. Government since 1917. The last time Moody's placed the U.S. on Negative Watch was in 1996 amidst threats of a government shutdown. The agency's July 13th release cited the small but increasing risk that the debt ceiling will not be raised in a timely manner, "leading to a default on US Treasury obligations" (Moody's). Should the U.S. default on its obligations, Moody's expects it to be short-lived but enough to warrant a revision from Aaa to most likely the Aa-range. Furthermore, even if the U.S. subsequently cures its short term problems, Moody's has warned that a return to Aaa status is not a certainty.

Political Negotiations Intensify

Republicans want to close the deficit by curbing government spending and foregoing tax increases. Democrats want to prevent cuts to the U.S.'s largest social programs (Social Security, Medicaid, Medicare) and are pushing for increases in taxes, particularly on the wealthy. Both parties are using the debt ceiling debate for political posturing in advance of the 2012 Presidential and Congressional races and for emphasizing each party's conflicting stance on economic policy. With control of the White House and both houses of Congress on the line and fundamentally different approaches to closing the deficit, both parties have firmly dug in their heels. It is expected that Congress and the Administration will eventually come to an agreement to avoid a U.S. default, but the particularly fiery negotiations as of late have elevated anxieties over the likelihood and effectiveness of a compromise.

Market So Far Resilient

The U.S. Treasury market has held in fairly well despite the (slightly) increased likelihood of a downgrade or a potential default. Uncertainty over how European sovereign debt concerns may bleed across borders may be one reason why US Treasuries have not seen higher yields on increasingly negative domestic headlines. If stalemates and foot-stomping continue into late-July, the resulting loss of confidence in U.S. leadership could see debt markets begin to finally price in higher risks. As we approach August 2nd without a debt ceiling deal anxiety will increase and so will market volatility. Though the likelihood of default remains small, any increase in the threat of default may cause yields on securities guaranteed or supported by the U.S. Government to rise.

Caprin Portfolio Strategy and Implementation

Financial and political headlines will be dominated with updates, commentary and speculation as this process evolves toward its conclusion. Though we believe agreement will be reached by August 2nd, we are mindful of the significant moving parts and various political calculations driving this debate. If less than an ideal solution begins to gain traction and downgrades of US Government debt seem more likely, we will move closer to implementing our game plan for ongoing compliance with investment guidelines, with particular attention on average ratings. Portfolios owning Treasury or Agency debt and pre-refunded Munis escrowed in Treasury or Agency debt would see average ratings move slightly lower immediately with the downgrades. The ratings agencies have indicated that credit ratings of state and local governments will be evaluated relative to their reliance on or exposure to the Federal government, and ratings adjustments may result. Downgrades that occur will impact the mix of bonds we own in portfolios, but we do not believe there is any meaningful default risk. Our plan, should it be required, will be executed deliberately to capture value and reposition judicially consistent with the new ratings environment. We will provide updates on our assessment and our action plans as meaningful information or decisions become available.