Assessing the Potential Impact of a US Credit Event

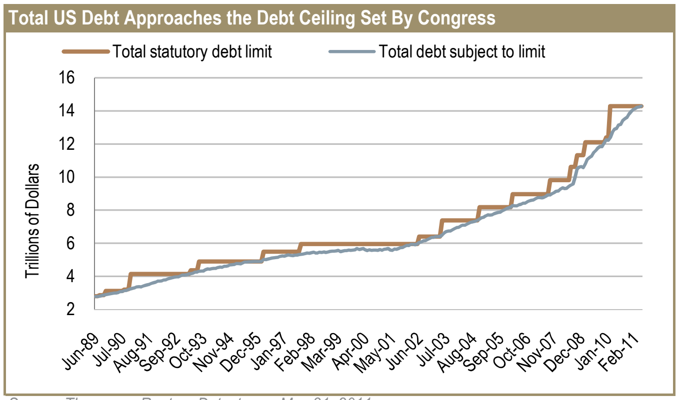
"I fully understand the desire to use the debt limit deadline to force some necessary and difficult fiscal policy adjustments, but the debt limit is the wrong tool for that important job."

– Federal Reserve Chairman Ben Bernanke[1]

The fiscal position of the US government is clearly unsustainable. Today, the federal budget deficit stands at more than 9% of GDP compared with around 1% of GDP before the recent recession. Part of the deficit is cyclical, meaning it is likely to shrink as the US economy recovers. However, it also has a sizable portion related to entitlement programs which, conversely, is structural in nature and will persist long after the economy gets back on its feet.[2]

Democrats and Republicans are divided over the correct mix of tax increases and spending cuts necessary to address the structural deficit. The resulting stalemate has occurred at a time when the US government is already bumping up against its $14.3 trillion statutory limit for federal debt. This so-called *debt ceiling* is the total amount of money that the US government is authorized to borrow to meet its existing legal obligations, including paying interest to existing holders of US Treasuries.[3]

Total US Debt Approaches the Debt Ceiling Set By Congress



Source: Thompson Reuters Datastream May 31, 2011

The US 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 US government would be unprecedented in our history and would have severe consequences for the US economy and global financial markets. Although we believe that such an event is unlikely, the risks warrant an analysis of potential default scenarios.

David Leduc, Chief Investment Officer, Robert Bayston, Head of Interest Rate Strategies and Thomas Higgins, Global Macro Strategist discussed these scenarios, and together have answered a few key questions regarding this topic below:

1 What is the likelihood that the US Congress fails to extend the debt ceiling and the US government defaults?

We view default as a tail risk and place a 10% probability on this outcome. Our base case scenario is that the US 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 US has the ability to service its debts. The longer it postpones doing so, the greater the fallout on the economy and financial markets.

2 What would be the impact of a default on the US 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 amongst other programs. A loss of confidence and a pull back 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 credit worthiness 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 US government which implies a slower pace of US 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 private sector investment and thereby reduce productivity growth. Additionally, high structural deficits could hinder the ability of policymakers to respond effectively to future economic downturns. Overall, we would characterize a US default as a large economic shock that could trigger a relapse into recession.

Assessing the Potential Impact of a US Credit Event

3 What would be the impact on global financial markets?

A default by the US government could trigger a global financial crisis given the widespread holdings of Treasuries by global central banks and their use as the global risk free asset off which most securities are priced. The dollar's role 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 the 2008 global financial crisis. Contagion between asset classes might be driven by money market funds which hold $338 billion in Treasuries. A US default could put at least one fund in a position where it was unable to return principal to an investor.[4] This "breaking of the buck" 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.

Taking a closer look at the impact on specific sectors:

i. **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 situation dragged on, the greater the risk that US interest rates would rise as US Treasury bonds lose their safe haven status.

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

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

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

v. **Credit Default Swaps (CDS):** This form of bond insurance is already being employed by investors as a means of protecting their portfolios against a US 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.

4 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 position our portfolios defensively with an overweight to US Treasuries or German Bunds where possible. Interest rate straddles may 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 underweight credit and the US dollar.

Conclusion

In conclusion, our base case scenario is that the US Congress will extend the debt ceiling and that a technical default will not occur. However, we expect heightened market volatility until this situation is resolved. The tail risks are increased by the ongoing problems in Greece and the threat of a pan-European banking crisis. Therefore, we have hedged some of the risk in portfolios as a precautionary measure. Once we have greater clarity on these fronts, we believe investor focus will return to the underlying cyclical momentum in the US and global economy. We are 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.

[1]Ben S. Bernanke. Fiscal Sustainability. The Annual Conference of the Committee for a Responsible Federal Budget. Washington, DC. June 14, 2011. [2]Congressional Budget Office. [3]Department of the Treasury. Debt Limit: Myth v. Fact. [4]The Economist. The Mother of All Tail Risks. June 23, 2011.

David Leduc, CFA *is Chief Investment Officer of Active Fixed Income responsible for overseeing the management of all single and multi-sector taxable bond portfolios and strategies. Prior to this, he was Managing Director of Global Fixed Income and Senior Portfolio Manager responsible for overseeing the management of all non-US and global bond strategies. David joined Standish in 1995 as a portfolio manager and analyst for US domestic fixed income, moving from structured finance to global strategies in 1999. Prior to joining Standish, David spent seven years as an Investment Officer at State Street Bank & Trust Company. He has an M.B.A. from Boston University and a B.S. from the University of Rhode Island. David holds the CFA® designation and has 24 years of investment experience.*

Robert Bayston, CFA *is Managing Director of Interest Rate Strategies and Senior Portfolio Manager responsible for driving analytics, strategy, and portfolio management for mortgage pass-throughs, derivatives and government bonds, including TIPS. He joined the firm in 1991 as a Quantitative Analyst and then transitioned to the Interest Rate Strategies group as a trader before being promoted to head that team in 2005. He has an M.S. from Boston College and a B.S. from the University of Virginia. Robert holds the CFA® designation and, with 20 years of investment experience, has spent his entire career with Standish.*

Thomas Higgins, PhD *is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. He is a member of both the American Economics Association and the National Association of Business Economics NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. Higgins is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. In 2010, he was the Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has 19 years of experience analyzing financial markets.*

STANDISH

A BNY MELLON COMPANY℠

BNY Mellon Center · 201 Washington Street · Boston, Massachusetts 02108-4408

For additional copies of this document, please contact info@standish.com.