U.S. Debt Implications

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U.S. Debt Implications

As I write this, Congress has not made a deal on extending the U.S. debt limit. The limit is supposedly Tuesday, but now there are rumors that it may be a little longer. Regardless, the purpose of this note is to outline the various debt scenarios, their portfolio implications, and what may happen if U.S. debt is downgraded by the rating agencies.

As a general statement, the U.S. must get its fiscal house in order. Real reform (i.e. spending cuts) will produce many long-term benefits, but will likely come with short-term pain. Given the severity of the problem, it is difficult for me to disagree with those representatives that say "it is now or never". Washington does not have a good track record of coming back to difficult decisions -- the issues must be forced, which is being now. Below I list possible scenarios:

No Debt Limit Deal

If the debt limit is not increased, the Treasury will not be able to issue more bonds. The U.S. will then have to prioritize who will get paid first (the U.S. still has money coming in). I cannot imagine a scenario that the U.S. would actually default on its debt by not paying interest and principal to bondholders. So bondholders will be

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paid first. The Treasury will then determine who and how much other "recipients" will get paid. This could be government agencies, vendors, and/or entitlement program recipients. In short, there will be a severe spending cut by the U.S. government. The government currently represents about 25% of the U.S. economy. Having the largest employer massively cut spending will ripple through the U.S. economy. A recession will follow and I would expect the stock market would go down. The length of the recession and magnitude of stock market decline would be dependent on the length of time there is no debt extension deal.

Under this scenario, I'm not sure if U.S. debt would be downgraded. While there would be forced spending cuts, which improves the U.S.'s creditworthiness (over the short term), the fact that our political leaders cannot agree and are at gridlock would be a negative factor.

The longer there is no deal, the greater the pressure will be on both Democrats and Republicans. When Social Security payments begin to be skipped, the politicians will have sealed their electoral fate. I suppose the maximum time the "no deal" scenario could go on would be about 16 months (until the next election is over), but I would expect some type of resolution before that. If the issue is not decided by election time, the voters will decide.

The result of the "no deal" scenario is really what we need (forcing Washington to reduce spending) for the long-term economic health of the country. It is unfortunate that our leaders cannot agree on a path forward.

A Debt Limit Deal With Significant Spending Cuts

We heard of a "grand bargain" where spending would be cut by $4 trillion over the next 10 years. Under this scenario, I do not believe the U.S. debt would be downgraded. Since spending cuts would occur over time, the U.S. economic impact would be more muted. Short-term economic growth would be negatively impacted. However, over the long-term, we would be setting the foundation for a much more economically stable U.S.

A Debt Limit Deal With No Significant Spending Cuts

Given all of the rhetoric, this does not even seem like a plausible solution, even if the debt limit is only extended for a year. While a recession may be avoided, there would be an increased probability of a debt downgrade.

What Happens If U.S. Debt Is Downgraded?

I'm not sure whether U.S. debt will be downgraded -- even if Washington "kicks the can" past the next election. Unless there is a major deal, the U.S. will likely remain on credit watch. But would a 1-year debt extension, for liabilities that are extremely long term, force a downgrade? I simply do not know.

If U.S. debt were downgraded, there are a whole host of dire predictions about rising interest rates and negative economic implications. Do not get me wrong, the prospect of a ratings downgrade is almost unfathomable and is very serious.

However, if a downgrade were to occur, I'm not sure interest rates would change that much (at least over the near term). Maybe interest rates go up a little, but offsetting that pressure could be a possible recession. In addition, while the U.S. has serious fiscal issues, we are still the economic engine to the world. Where are investors going to go for safety? Europe? The emerging markets? Over the short term, I do not see a mass exodus from the U.S. Treasury market or another viable alternative. On a longer-term basis, there will likely be more viable alternatives, and a downgrade will cost the U.S. more in the way of interest expense and credibility. Higher interest costs will further exacerbate the budgetary problems.

Portfolio Implications

Up until this week, the markets were fairly well behaved expecting a resolution to the debt limit. That started to change and, if no deal is reached, I expect further market weakness -- particularly among risky assets (stocks and high yield bonds).

While I will likely raise some cash and re-balance the portfolio, history tells us that making dramatic allocation changes during a crisis is usually not the wisest course of action. Most likeley changes will be a reduction (or elimination) to high-yield bond, preferred stock, mid- and small-cap stocks, with a increase in large-cap stocks.

Summary

Households, businesses, and governments cannot effectively operate under a mountain of debt. The U.S. has simply been living beyond its means for too long and must change direction.

While the final resolution may contain tax increases or closing of tax loopholes, it most certainly will include spending cuts. All Americans will likely be asked to sacrifice. These will be difficult adjustments. But for the sake of our children and grandchildren's economic future, the time to act is now.