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the debt ceiling issue: thinking about the unthinkable

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The following note reflects the views of Loomis Sayles Chief Economist Brian Horrigan. They do not necessarily represent the views of the firm. Given the volatile nature of US budget developments, views are subject to change rapidly.

It is now one week before August 2, when Treasury Secretary Geithner claims the US debt ceiling becomes truly binding. The Treasury has been playing budget games to keep the government going even after the debt ceiling was formally hit in May. The Treasury may have a few more days of wiggle room after August 2, but probably not much. We need to think hard about how this game could play out.

Here is something to focus your attention. There are good odds of a downgrade of US Treasuries by one or more ratings agencies in the next few months. There is also a small chance of a Treasury default.

The odds of a one-notch downgrade by Standard & Poor's (S&P) are solid, for reasons to be explained below. I doubt that the market would react strongly. Even after a downgrade, Treasuries would still be high-quality investment grade. And those worried about the safety of Treasuries may have second thoughts about parking their funds in the sovereign debt of Japan, the UK, or the euro economies. Personally, my cynical outlook is that a one-notch downgrade of US Treasuries would be ultimately beneficial if it forced politicians to address the long-term budget issues, including entitlements. Ratings downgrades did much the same for Australia in the 1980s and for Canada in the 1990s. With reform, both countries regained their AAA ratings. With reform, the US could get its AAA rating back and deserve it, too.

There is a danger that the debt ceiling won't be raised, the federal government will miss some interest payments and the ratings agencies downgrade Treasuries to "Selective Default."¹ I believe the odds of a default are low, but not zero. My reasoning is that a Treasury default is so frightening that Washington will hatch a deal at the last minute to avoid it, probably with a quick fix that raises the debt ceiling and trims future spending. The final deal will not be a comprehensive fiscal reform, but it will be a start. To an extent, the deal would kick the can down the road, as the saying goes.

The financial and economic impact of a Treasury default, followed by severe downgrades by all ratings agencies, is beyond calculation. There is no precedent to guide us. We should assume the consequences would be terrible. If US Treasuries are downgraded to "Selective Default" just as the sovereign debt crisis in Euroland boils over, the global economy would be under great strain. The world can absorb a Greek default; a US Treasury default is something different.

FISCAL ISSUES HIT MARKETS

We have simultaneous fiscal fights in the US over the debt ceiling and in Europe over how to handle the sovereign debt of the PIIGS (Portugal, Ireland, Italy, Greece and Spain). This isn't political theater; the issues matter a lot for financial markets and the economy.

The belief that the Greek crisis was resolved created a market rally at the start of this July, but the rally faded as the crisis spread in Europe.

¹ *Selective Default: According to Standard & Poor's Ratings Definitions, a Selective Default ("SD") rating is assigned when the ratings agency believes that the debtor has selectively defaulted on a specific issue or class of obligations but will continue to meet its payment obligations on other issues or classes of obligations in a timely manner.*

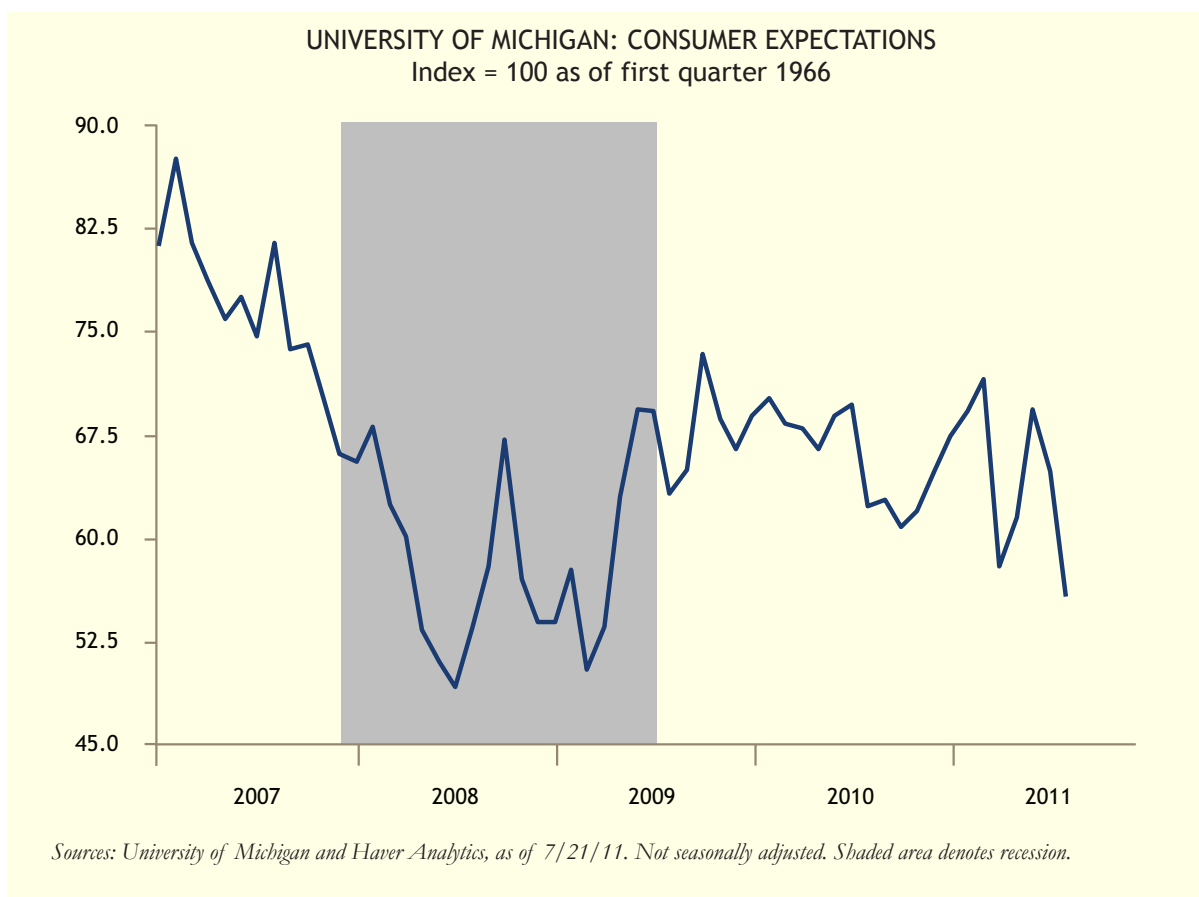


The news that President Obama endorsed the Senate “Gang of Six” fiscal plan sent the Treasury and equity market soaring on July 19.

Markets are paying attention to fiscal issues.

Consumers and investors are also affected by the budget fight. On July 15, the University of Michigan announced that the expectations subcomponent of its Index of Consumer Sentiment posted one of its largest two-month percentage declines on record in June and July. The July level of the expectations index is not much above what it was after the Lehman bankruptcy in the fall of 2008 (see chart below). I think the large drop was at least partially driven by the frenzy of news coverage starting in mid-June over the negotiations about the debt ceiling and the budget. I don’t think the average American pays much attention to economic issues in Greece, but the coverage of Washington politics has been inescapable. A separate question in the Consumer Sentiment survey finds that confidence in policymaking is near a half-century low. Concerns over budget cuts, tax hikes, default, and downgrades have made people anxious so that consumers are less willing to spend and businesses less willing to hire. These concerns have shaken equity markets also.

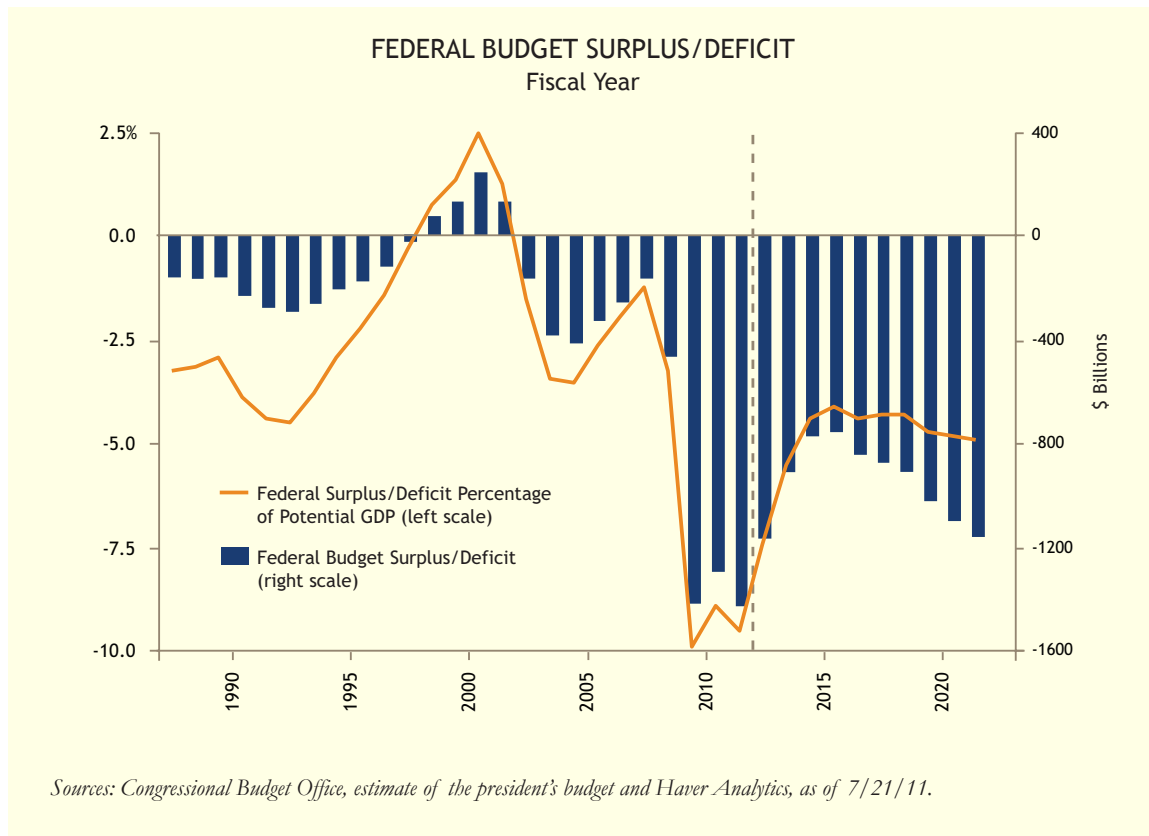
If the budget issue turns into full crisis, the US may suffer another quarter of lousy GDP growth in the third quarter.





THE REALLY UGLY STATUS QUO

President Obama's Office of Management and Budget (OMB) submitted a federal budget in early February that contained 10-year projections of spending, taxation, and deficits, contingent on its economic assumptions. In March, the Congressional Budget Office (CBO) scored the president's proposals by its own methods and with its own economic projections. The chart below gives the CBO projections of the budget balance, in dollars and as a percentage of GDP, for the president's proposed budget. (The vertical dotted line in the chart separates history and projections.)



From fiscal year (FY) 2014 through FY 2021, the deficit would float between 4% and 5% of GDP, year after year. In 2021, it would be (\$1.2 trillion), amounting to 4.9% of GDP. To put that in perspective, Ross Perot challenged President George H. W. Bush in the elections of 1992 over a budget deficit of 4.5% of GDP, which was swollen from a recession. Congressional Democrats condemned President George W. Bush for a deficit of 3.5% of GDP in FY 2004. Large deficits have always been politically controversial, and the current situation is no exception. According to both OMB and CBO, under the president's proposed budget, the gross public debt as a percentage of GDP would rise to over 100% by 2021, the highest since just after World War II ended.

Both CBO and OMB project some improvement in the budget deficit in the next few years as unemployment decreases and emergency fiscal measures fade away, but after 2015, they project steady deterioration in the deficit as a result of swelling "entitlements" spending as baby boomers retire and collect Social Security and Medicare benefits. Under the status quo, budget deficits will likely continually deteriorate in the decades ahead as the retiree population soars, and the debt-to-GDP ratio would rise indefinitely. Such a fiscal policy is not considered sustainable, and if nothing is done, the US federal government eventually will likely look like Greece does now. The increasing awareness of the unsustainability of federal fiscal policy is the backdrop to the current budget fight. Fiscally speaking, the wolf is at the door, and the budget fight is about the future of the country.



If Congress had shrugged and passed the president's budget without modification, Treasuries would likely already have received a downgrade. As it was, Senate Republicans submitted the president's budget for vote seemingly just to make a point; the budget got no "yes" votes. Most have figured out that things must change, but there is little agreement about how they should change.

FISCAL AUSTERITY IN THE BASELINE FORECAST

The fiscal deal hatched last December included a one-year, two-percentage point drop in the Social Security payroll tax on employees, direct expensing of business investment for tax purposes, and an extension of emergency unemployment benefits. Those programs all expire at the end of 2011 under current law.

The Loomis Sayles baseline US economic forecast assumes that those stimuli expire as scheduled. In addition, we project cuts in discretionary spending in 2012. The result would be a significant fiscal drag in 2012 at the federal level. In addition, state and local governments are collectively implementing fiscal austerity.

Fiscal drag is a major reason why we continue to have a below-consensus projection for real GDP for 2012, and higher unemployment rates than consensus. Fiscal drag also helps explain why the Loomis Sayles US Yield Curve Team has taken Fed tightening off the table through the end of September 2012.

We may yet revise our views. There is some discussion about extending—or even expanding—fiscal stimulus in 2012. One reason is that generally people seem to be getting more concerned about the vitality of the economic recovery. A more cynical reason is that politicians are worried about tax hikes in an election year.

So we are talking about stimulus and austerity at the same time. A stimulus is a hard sell when the rating agencies are already questioning Treasuries.

If there is a huge cut in future spending, the US would likely have the fiscal space to implement a moderate short-term additional stimulus. Otherwise, the US does not have the fiscal space.

If current fiscal stimulus were extended for another year without corresponding austerity in later years, Treasuries would likely be downgraded. At the same time, if the current fiscal stimulus were renewed for 2012, we would boost our projection for real GDP and lower our projection for the unemployment rate.

Our baseline scenario does not have a Treasury default and it does not have a partial federal shutdown. If either or both of those happen, the baseline forecast would need an overhaul. (Hint: we wouldn't revise GDP growth up.)

DEAL, OR NO DEAL

With his original budget proposal rejected, President Obama proposed another budget plan. His "Grand Bargain" would reduce the deficit by about \$4 trillion over the next 10 years by slowing spending growth but also by raising taxes. In particular, Obama added his favored tax hikes into the deal, notably, higher tax rates on the top income brackets, the end of the special treatment of carried interest, and requiring businesses to use FIFO instead of LIFO inventory accounting. Additionally, his proposal would end generous depreciation for the purchase of corporate jets, a fix that would generate a whole \$3 billion over the next 10 years.

If Congress accepted this deal, I think the ratings agencies would be pleased, and there would be no downgrade.

But the House Republicans are very much against the tax hikes in that budget. Many of them, I think, could be persuaded to close or limit tax deductions, but most are not willing to raise tax rates.

The original Grand Bargain went nowhere, and it has been overtaken by the Gang of Six proposal (see next page). But in recent days, House Republicans and President Obama are breathing new life into the Grand Bargain by incorporating elements from other budget proposals.



CUT, CAP, BALANCE

In a partisan vote, the House passed a budget that the Republicans called “Cut, Cap, and Balance.”

That budget aims to slash projected deficits entirely with spending cuts and no tax hikes at all. It would raise the debt ceiling, and total spending would be cut \$5.5 trillion over the next 10 years. Discretionary spending in FY 2012 would be reduced below the level in FY 2008 except for Defense, Homeland Security, and Veterans Affairs. The plan places a spending cap after 2012, which could cut entitlement spending. Details about the spending cuts are sparse.

The House also wants to pass a constitutional amendment requiring a supermajority in Congress to raise taxes and the president to submit a balanced budget each year.

If this budget were accepted, I think the US could avoid a ratings downgrade. But the Senate rejected this budget, and in the event that the Senate had passed it, President Obama likely would have vetoed it. It was too extreme for most Democrats.

THE GANG OF SIX

Last autumn, President Obama’s Fiscal Commission—chaired by former Clinton Chief-of-Staff Erskine Bowles and former Senator Alan Simpson, and whose members were handpicked by President Obama—delivered a bipartisan report on how to bring the deficit under control. The president thanked the members, but otherwise made no comment on the report and endorsed none of the recommendations at that time. I don’t think he liked how much spending was cut in that plan.

On July 19, a bipartisan group of senators who refer to themselves as “The Gang of Six” submitted the outline of a budget based on the Bowles-Simpson recommendations. The proposal aims to cut the cumulative budget deficit by \$3.7 trillion over the next 10 years, compared to the CBO March 2011 baseline. Of that amount, \$2.5 trillion would come from cuts in both discretionary and entitlement spending, and \$1.2 trillion would come from higher tax revenues through an overhaul of the tax code. It would stabilize the ratio of publicly held federal debt to GDP by 2014, and that ratio would be 70% in 2021 instead of the 77% under the OMB budget.

President Obama endorsed the plan. The outline of the plan is vague enough that it could mean different things to different people, and the odds of its passage are low enough that an endorsement has no teeth. By endorsing a plan unlikely to pass, Obama can present himself as balanced and centrist. If the plan were actually passed, the president could be in an awkward situation.

I like the Gang of Six proposals. They are not proposals I would have recommended if I had been asked, but in our current polarized political environment, I think it is the best deal that can be hatched.

The Gang of Six submitted the outline of a budget, not an actual budget. To become law, the outline has to be written by teams of legal staff into a budget document, which must then be posted for public and Congressional review. After the budget is written, it would have to be scored by the CBO. The whole process would take weeks, even months. There is no way this proposal can beat the August 2 deadline.

The proposal contains the largest overhaul in federal taxation since 1986. It cuts marginal tax rates but raises revenues by wholesale cuts of deductions, exemptions and tax credits. It is very easy for politicians to condemn “loopholes” used by “fat cat billionaires” to reduce their taxes. It is very hard for politicians to tell voters that they are eliminating the mortgage interest deduction or the deduction for charitable contributions, or taxing capital gains as ordinary income, or taxing employer contributions for health insurance. President Ronald Reagan proposed overhauling the tax system shortly after being inaugurated in 1985, and the new tax system did not start until 1987. The tax overhaul recommended by Bowles-Simpson and the Gang of Six is a huge project that would take at least two years to pass into law. Moreover, President Obama, unlike Reagan, has shown little interest in a tax overhaul. Obama has asked for tax hikes but not for tax reform.



Does the Gang of Six proposal raise taxes or lower them? It depends on your perspective. The CBO baseline uses current law, under which ALL of the Bush-Obama income tax cuts expire at the end of 2012 and the Alternative Minimum Tax (AMT) fix expires forever. (Neither President Obama nor House Republicans endorse the policies in the CBO baseline.) Compared to the CBO baseline, the Gang of Six proposal cuts taxes by \$1.5 trillion over the next 10 years. But consider an alternative baseline that continues current policy, meaning current income tax rates and the AMT fix continue forever. (That is the Republican proposal.) Compared to the alternative baseline, the Gang of Six proposal raises taxes by about \$1 trillion over the next 10 years. The proposal can be considered to raise and lower taxes at the same time.

So far, the reaction in the House to the Gang of Six proposal has been muted. I doubt it will pass the House. The Republicans won't like the tax increases, and the Democrats won't like the spending cuts. But necessity may yet force their hand.

Perhaps there can be a temporary fix if the Gang of Six proposal is accepted as a resolution, and the debt ceiling is increased for, say, two months while a formal budget is prepared. The spending cuts could be passed quickly; the tax overhaul will take a long time.

If the Gang of Six proposal is adopted, I expect all ratings agencies will affirm the AAA status of Treasuries.

THE MCCONNELL-REID "PLAN B"

Senate Minority Leader Mitch McConnell seems to be in despair over the debt ceiling and the prospects of a budget deal. He has essentially given up on a big plan. With Senate Majority Leader Harry Reid, he has come up with a device to raise the debt ceiling and avoid default, which they call "Plan B."

The plan is to pass a law giving President Obama the authority to raise the debt ceiling in three installments for a total increase of \$2.4 trillion over the next 18 months. That would take us beyond the 2012 elections. The gimmick is that the debt ceiling would be raised not by Congress but by an order by President Obama, so he—and not Congressional Republicans—would take the blame for the rise in the debt ceiling. Congress would have the power to pass a resolution blocking Obama's actions, but because the Democrat-controlled Senate would not block Obama, the Congress would likely fail to stop the rise in the debt ceiling.

Plan B would implement \$1.5 trillion in spending cuts over the next 10 years, most in discretionary spending with only minor changes in entitlements. No specific budget details have been released. The plan would authorize no tax increases.

House Republicans are opposed to the McConnell-Reid Plan B. From their perspective, it gives away the whole pie without only minor progress on reining in projected deficits. Many House Republicans ran and won in 2010 on an anti-deficit program; they cannot run in 2012 on a complete fail. Yet if no other budget deal can be achieved, I think some version of the McConnell-Reid Plan B is the best bet for what could ultimately pass. It can pass relatively quickly and raise the debt ceiling, and so default would be avoided.

It could be a face-saving gimmick, but it beats default. Still, a failure by Congress to make significant progress on reducing future deficits would, I think, trigger a ratings downgrade by S&P.

UNSETTLED TIMES

It may be a rocky road to getting a final deal on the debt ceiling and the budget. For example, one chamber of Congress may vote down a budget deal that the leadership had agreed to. That could shake markets substantially. We saw something like that on September 29, 2008 when the House initially voted against the proposed "TARP" bank bailout that had been negotiated by President Bush and House Democrats. Many Congressmen from both parties rejected the deal reached by their leadership. After the surprising rejection,



the Dow Jones stock index fell a record 778 points. Fears of financial disaster persuaded the House to vote for a revised version of the TARP on October 3.

There is a danger that if a compromise budget deal is achieved that raises the debt ceiling, discontented House members from both parties might vote it down. Financial markets could be badly shaken in that event. But, as with TARP, the House could vote for a budget deal on a second pass. The odds are that a budget compromise, distasteful as it may be to many Congressional members, eventually will pass because the alternative is too grim to allow to happen.

IS THE DEBT CEILING LEGAL?

Suppose come August 2, Congress still has not increased the debt ceiling. There may be some escape clauses.

Some law professors have argued that the 14th amendment to the Constitution, which declares that, “The validity of the public debt of the United States, authorized by law... shall not be questioned,” authorizes the president to pay all bills and service all debts of the federal government, borrowing the funds to do so if necessary. In other words, the debt ceiling is unconstitutional to the extent that it would force a default.

It seems to be a good argument, but under that interpretation, the 14th amendment won't allow the president to spend money on, say, NASA or food stamps, but just on servicing the debt and paying bills.

Another legal argument is that Congress has already passed a budget for the current fiscal year which authorizes spending and collecting taxes. That budget is a legal document that overrides any prior laws that conflict with it. Thus, the debt ceiling is invalid insofar as it conflicts with spending already authorized, meaning that the debt ceiling is not binding. That seems a desperate argument: the debt ceiling law is almost 100 years old, and no president has ever argued that the debt ceiling law is invalid. (Congress created it during World War I to control the issuance of war bonds.) If President Obama announced it was not binding, there would be a court challenge, which likely would go all the way to the Supreme Court. Probably by the time it got to court, the issue would be moot.

If President Obama challenges the debt ceiling after August 2 and borrows to keep federal spending going, we don't know how the ratings agencies would react. They might downgrade Treasuries over legal uncertainty even though interest payments would remain current.

The president may be reluctant to discard the debt ceiling. It could hurt his relations with Congress further, and the voters may not appreciate what appears to be a power grab. Nor is it clear that the courts would uphold a rejection of the debt ceiling. Finally, Democrats may like to keep the debt ceiling to constrain the spending of future Republican presidents. Nonetheless, if President Obama ends up facing the likelihood of a Treasury default, he may choose to challenge the legality of the debt ceiling as the lesser of two evils.

Alas, even rejecting the debt ceiling takes us only so far. The president cannot spend funds without authorization by Congress with a budget or a continuing resolution, and the current budget expires when FY 2011 ends on September 30. The political fight is not just over the debt ceiling (which becomes binding on August 2) but is also over the budget for the new fiscal year starting on October 1.

WORST CASE SCENARIO

Let's get glum and discuss a worst case scenario.

We don't view this as likely, but suppose come August 2, there is no budget deal and no increase in the debt ceiling, and further suppose President Obama decides it is unwise to discard the debt ceiling on his own authority. What then?



It is wrong to think that the federal government would not be able to sell bonds. The debt ceiling may not have been increased, but neither was it decreased. The government would be able to roll over existing debt as it matures; it just could not issue additional debt. But the government would have to pay interest on existing debt or it would default.

A binding debt ceiling does not necessarily force a default. The federal government has plenty of tax revenues rolling in every day, but not enough to fund all expenditures. There are enough revenues to fund the interest on the debt, Social Security, Medicare and Defense. I believe the idea that retirees won't get their Social Security checks was a scare tactic. But without the ability to borrow, the federal government would have to undergo a large but partial shutdown. Spending would need to be slashed immediately, probably by about 40%. Many important programs would be halted, and many federal employees would be put on temporary layoff. Contractors would go unpaid. State and city governments that receive federal funds would be cutoff, spreading the fiscal crisis to the local level. The fiscal contraction would amount to about 10% of GDP for as long as it lasted.

If the shutdown lasted just a few days until Congress and the president got something worked out, I don't think it would be a big deal. We had a short shutdown in 1995 and 1996 with no apparent serious harm to the economy. But if it lasted longer, the resulting serious fiscal contraction—dumped on an economy already burdened with a wounded real estate sector, an overleveraged consumer, and high oil prices—could tip the US into another recession.

If the Treasury kept paying interest on the debt but delayed paying its other bills, how would the ratings agencies react? Even with interest current, the rating agencies may perceive higher risk and issue a downgrade, although not necessarily to default status.

While it doesn't seem likely, if the Treasury missed interest payments, the rating agencies would downgrade Treasuries to "Selective Default."

It hurts just to think about the financial consequences of a Treasury default. The debt and mortgage-backed securities issued by the government-sponsored entities would be downgraded, as would the obligations of some states and municipalities. The mortgage market would be undermined as mortgage rates increased. Banks would be questioned as the value of FDIC insurance came under review. Securities that use Treasury bills as collateral would be under review. Money market funds holding a lot of Treasury bills in their portfolios could "break the buck," and we could get a run similar to what happened in September 2008.

Gold and silver prices would explode as investors ran to seek safety, other commodities prices could fall from concerns about economic weakness, the US dollar would plummet, but the impact on Treasuries would be uncertain. Some would run from Treasuries while others might still view them as a safe haven in an uncertain world. We should expect the Fed to start "Quantitative Easing Part 3" in those circumstances. I think the US dollar would eventually lose its status as a reserve currency.

Did you enjoy the financial crisis of 2008? You might see a summer rerun in 2011. This rerun won't be boring. It is precisely because a default would be so dangerous that we think US political leadership will act to prevent it. So we hope.

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