

# U.S. DEFAULT RISK: INVESTMENT PERSPECTIVE

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## INTRODUCTION

As the budget and debt ceiling debate continues in Washington, Moody's recently placed the U.S.' Aaa credit rating on review for downgrade, citing a "small but rising risk of a short-lived default." S&P also responded, indicating its AAA rating on the U.S. is also at risk.

## EXECUTIVE SUMMARY

The Treasury Department has reached the maximum level of debt permitted by law; unless Congress agrees to raise this debt ceiling before August 2, the Treasury faces a risk of missing payments on its outstanding debt.

- Congress will likely act in time to raise the debt ceiling and prevent default; however we cannot ignore the risk that they fail to do so.
- Moody's and S&P have warned that they may downgrade the U.S.' triple A credit rating if a debt ceiling deal is not reached. We see a risk of downgrade even if Congress raises the debt ceiling.
- In the unlikely event of a U.S. default, we expect Treasury yields will rise and "risky" assets such as corporate bonds and stocks will also suffer; however, there will be other unpredictable effects.
- In the event of a U.S. downgrade, while investors will face modestly higher interest rates and declines in stock prices, we believe the markets will prove relatively resilient and continue functioning, albeit with the lower credit rating.

## QUESTIONS AND ANSWERS

### What action has Moody's taken?

Moody's has placed the U.S.' Aaa credit rating on review, which indicates that, unless Congress acts, Moody's will downgrade the U.S., likely to the Aa ratings area. While Moody's has not placed a deadline on its decision, we estimate that Moody's will make a decision as soon as July 26.

### Why does Moody's see a risk of the U.S. defaulting on its debt?

The biggest short-term risk centers around the debt ceiling, a limit Congress places on how much debt the Treasury Department can issue—currently \$14.3 trillion. Since the federal government has an imbalance between spending and revenue, it must borrow (i.e., issue Treasuries) to fill this gap, but the debt ceiling is now constraining the ability to borrow. Without borrowing, the Treasury Department may not have enough cash to pay off maturing Treasuries. The Treasury Department has indicated it will run out of cash on August 2, and the first bond payment due after that is a \$99 billion T-bill maturity on August 4.

We believe that the risk of a U.S. default is limited, as Congress still has the opportunity to act. In addition, any default will likely be short-lived, though there would still be significant market impact from even a short-lived default.

However, these proposals are not surefire solutions, and the only clear way to reduce risk is for Congress to raise the debt ceiling, ideally at least a week before August 2.



We do not believe the U.S. will default on its debt, as Congress will likely raise the debt ceiling in time to prevent such a default. That said, we'd be remiss not to delve into the "what ifs" and consider the risks of an unlikely U.S. default or more likely ratings downgrade on our clients' portfolios.

### **What could remedy this default risk?**

If Congress were to quickly raise the debt ceiling, the risk of a default would decline once again. Some proposals have also suggested that the Treasury Department could "prioritize payments" to stave off default and use its cash, for example, to pay bonds but stop paying on contractor bills and the like. Other proposals have suggested that the Treasury could continue issuing debt, using the wording of the 14th Amendment as cover to do so, despite the Congressional debt limit.

### **Has the U.S. ever seen its ratings downgraded or defaulted before?**

It's a common misconception that the U.S. has never defaulted. In 1979, because of a printing error, the Treasury failed to pay back more than \$100 billion in short-term T-bills. While this default was the result of an error, the markets nonetheless demanded higher interest rates on Treasury obligations of around 0.50% above prior levels.

In 1995, Moody's placed the U.S.' Aaa rating on watch under a similar situation as today's; however, Congress raised the debt ceiling, causing Moody's to affirm the U.S.' Aaa rating. In 1933, the U.S. "repudiated" its commitment to pay off Treasuries with gold, resulting in accusations of default, and in 1790, the newly-formed U.S. did fail to pay debt. In both of these last two cases, the financial markets were very different than they are today, making comparisons difficult.

### **What would be the impact of default (or near default) on the value of Treasury bills, notes, and bonds?**

If the Treasury did in fact default—still unlikely in our view—any bond which has a missed payment will revert to a "D" rating for default,

while the ratings on unaffected debt would be downgraded, most likely to Aa. The rating on debt from government-related issuers such as Fannie Mae or Ginnie Mae would also be downgraded to the new rating.

Although no one can say what would happen for sure, we expect interest rates to rise moderately if the U.S. defaulted, reflecting uncertainty over the quality of all Treasuries. Even in the event of a missed payment, we believe the markets will retain faith in the Treasury's longer-term creditworthiness, resulting in painful, though manageable increases in yields. In other words, the concern is more about the timing of repayment than the Treasury's ability to pay.

For short-term instruments such as T-bills, the increases in interest rates would affect the value of those holdings to a limited degree. For example, a 0.50% increase in yields (similar to that experienced in the 1979 default) on a two year Treasury note is equivalent to a 1% loss in market value. While we would expect interest rates on longer-term Treasuries to rise by a smaller margin, the greater sensitivity to interest rates on longer-term securities equates to a larger potential loss. A 0.50% increase in yields on a ten year Treasury is equivalent to around a 4% loss in market value.

### **What would be the immediate impact of default (or near default) on the value of other investments?**

This question is both the most important one and the one that's hardest to answer. Candidly, no one can know the full extent of market impacts from a U.S. default, though we do have some general thoughts on the issue.

- "Risky assets," such as corporate bonds and stocks, would likely experience greater losses than would Treasury securities. The reason is one of confidence; if Treasuries have more risk, other assets also become more risky by implication. For the stock markets, we would expect a value decline measured in the several percent range, with a high level of volatility.



- Large banks in particular could face challenges, since they rely on financial markets to borrow money on a day-to-day basis. We can't say how a Treasury default would affect these borrowing markets, creating a risk for financial firms.
- Money market funds which hold short-term government investments may face negative impacts. Note that Janney's FDIC-insured sweep program is not a money market fund, but an insured bank deposit, and not directly subject to losses on T-bills or other instruments. Our primary money market fund is a member of the Dreyfus fund family, owned by Bank of New York Mellon. During the 2008 financial crisis, BNY Mellon promised to refund any losses experienced by investors in Dreyfus money market funds, though there's no guarantee they will do so if investors face losses in the current environment.
- Bonds issued by other large Aaa/AAA rated countries would likely improve in value, as investors sought safety overseas. Foreign countries rated triple A include Australia, Canada, France, Germany, as well as others with smaller bond markets.
- Commodities, and specifically gold, should perform well as investors look to "hard assets" rather than stock or bond investments to store value. Industrial metals and energy commodities, while likely to be more stable than many stock and bond investments, will face more uncertainty than gold owing to their relationship with economic growth.
- There will be additional unpredictable spillovers from a U.S. default. As the 2008 financial crisis proved, there are a range of transactions that interconnect many aspects of the global financial system. As a result, no analysis can identify all of the potential risks from a U.S. default or near default.

### What would be the longer-term impact of the current situation?

We see a growing chance that, even if Congress raises the debt ceiling, Moody's or S&P may still cut the U.S. credit rating, based on the risk introduced by the current situation as well as the longer-term budget imbalance. While a downgrade is troubling, we believe the markets will be resilient and, after a price decline on Treasuries, corporate bonds, and stocks, will continue to function largely as they had before. In other words, the impact of a downgrade is manageable, if a short-term negative. In addition, the markets will likely recover from any "knee-jerk" reaction to a ratings downgrade. One way to reduce the impact of this downgrade risk is to focus stock market investments in high quality, multinational firms with "fortress" balance sheets.

### CONCLUSION

In closing, we'd like to emphasize that the risk of the U.S. government defaulting on its debt remains limited. However, if Congress fails to raise the debt ceiling by the end of July, there's a strong probability that Moody's and S&P will downgrade the U.S.' rating. Even if a ratings downgrade comes to pass, we believe that many investments will face value declines, but that the financial markets will remain resilient.

If you have any questions regarding this subject or your investment portfolio, please contact your Janney Financial Advisor, who will be pleased to assist you.

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