

Potential Implications of Debt Ceiling Negotiations

In lieu of our normal recap of weekly market and economic events, this week we are providing insights into the potential investment implications of the ongoing and as yet unresolved negotiations to raise the debt ceiling.

Equity and fixed income markets remain on edge today with the political theater playing out in Washington regarding the negotiations to raise the debt ceiling. Most market participants assumed not too long ago that despite the heated rhetoric from both Democrats and Republicans some type of compromise would be forged that would raise the debt ceiling on even a short-term basis and avert a U.S. government debt downgrade by the various ratings agencies. However, the high-stakes game of “chicken” is now coming down to the wire, and both sides still seem far apart. Nevertheless, in our view it still remains likely, even at this late hour, that congressional leaders will craft a compromise measure to raise the ceiling that will be able to pass both houses of Congress. However, even if legislation does not pass by the August 2nd deadline, it seems highly unlikely that the U.S. will default on Treasury obligations, even though it may need to restructure other payments. Whether any measure passed by Congress will be enough to stave off a rating downgrade is difficult to handicap at this point. The potential impacts on the financial markets of such a downgrade are also hard to predict, but with the markets seemingly having discounted an eventual resolution, a downgrade is likely to result in continued high volatility for both equity and bond markets. Irrespective of the outcome, the reserve status of U.S. Treasury obligations will likely remain, and while some investors obligated to hold AAA-rated securities may be required to divest their Treasury positions, widespread selling of Treasuries is doubtful.

Where Negotiations Currently Stand

There are multiple debt plans currently being worked on by various congressional leaders, with both Republicans and Democrats trying to craft measures that have a chance of passing both houses. Bipartisanship in developing a plan has not worked up until this point because neither side will budge from their respective core positions: the Democrats and the Obama administration want deficit reduction to come through both spending cuts and revenue increases (higher taxes). In addition, the Democrats want a plan that extends beyond the 2012 elections so that this is not a distraction to their efforts to reelect President Obama. The Republicans, particularly House freshmen aligned with the tea-party movement, are staunchly against any form of tax increase, and want any increase in the debt ceiling to be offset by sweeping spending cuts. They are more open to a short-term solution if it ensures that significant deficit reduction is eventually a result.

The Boehner Plan

House Speaker John Boehner has drafted a two-stage plan that would immediately raise the debt ceiling limit by \$900 billion, to be accompanied by \$917 billion in spending cuts. The plan establishes a special committee that would then recommend further spending cuts of \$1.8 trillion over the next 10 years, and if those cuts were adopted, the debt ceiling would be raised again by \$1.6 trillion.

Speaker Boehner has had an extremely difficult time rallying conservative Republicans to support his plan because they believe it does not cut spending enough, and because there is no guarantee that the special commission won't recommend that taxes be increased. In addition, the Obama administration is

opposed to the plan because it would involve continued discussion of the issue in an election year. Senator Majority Leader Harry Reid has said that the Boehner plan will be dead on arrival in the Senate.

The Reid Plan

Majority Leader Reid has been working on a separate plan that would raise the debt ceiling limit by \$2.4 trillion which would be accompanied by \$2.2 trillion in deficit reduction over the next decade. Democrats like the plan because it would raise the debt ceiling by enough so that it would not have to be raised again until after next year's election. Republicans oppose the plan because of the quality of the proposed cuts, which they say are in part comprised of savings from military drawdowns in Afghanistan rather than real cuts.

There are other plans being worked on behind the scenes by Senate Minority Leader Mitch McConnell, Vice President Joe Biden and others. It seems likely that despite all of the wrangling and rhetoric a compromise measure that includes elements of both the Boehner and Reid plans will emerge this weekend that will be able to garner enough votes to pass in both houses. It is possible that today's disappointing 2Q GDP report will spur legislators to get a deal done quickly.

Implications of a U.S. Credit Downgrade

While it is possible that a debt ceiling deal gets done in time to avert a credit rating downgrade, ratings agencies have indicated that a downgrade could occur even if a deal is in place. At this point the market seems to be assuming that a downgrade is inevitable. The implications of a downgrade are hard to determine at this point, but are not likely to be catastrophic. Some analysts predict that by losing its AAA rating the U.S. would find that its financing costs would rise by as much as 25 basis points, which in itself does not seem like much, but would cause the deficit to increase. In addition, financing costs could rise by more, depending on supply and demand conditions.

A credit downgrade would have implications on asset classes beyond U.S. Treasury obligations. Treasuries are the "risk-free" component used in asset valuation models – including the Capital Asset Pricing Model – and if this risk-free status of Treasuries is lost it becomes more difficult to value other risky assets. It is possible that a higher discount rate would be applied, resulting in lower valuations. At the very least, pricing of securities becomes much more difficult and inefficient.

Some investors are worried that a credit downgrade would mean that Treasuries would no longer enjoy reserve status. But at \$13.5 trillion, the Treasury market dwarfs the combined size of the remaining major countries with AAA credit ratings such as Germany, Australia, Canada and France, meaning that it would be difficult to replace the Treasury market's reserve status, particularly if any credit downgrade is temporary. Some institutional investors required by policy to hold only AAA-rated securities may be forced to liquidate Treasury positions, but selling is not likely to be widespread.

Portfolio Positioning Possibilities

The market volatility experienced this week in the lead-up to the August 2nd deadline is likely to continue until a concrete debt ceiling resolution is in place and clarity is obtained on the credit rating front. In the event that a passable measure is in place this weekend that satisfies the rating agencies so that no downgrade is forthcoming, look for a rally in equities since market sentiment reflects the belief that a downgrade is inevitable. In this context, the following are some thoughts regarding portfolio positioning:

- Maintain strategic target allocation
- Within the fixed income allocation, shorter duration is preferable in order to minimize interest rate risk. High-quality issues should be the focus of the portfolio. Prudence would dictate an

underweight to, or complete avoidance of, Treasuries, but do not be surprised if Treasuries perform better than expected due to anemic economic growth and the potential for further Fed intervention.

- Equities remain likely to outperform fixed income as the economy picks up in the second half of the year. Large cap issues with strong balance sheets have the potential to outperform small cap stocks. Look for U.S. domestic stocks to marginally outperform international developed markets. Maintain exposure to a broad basket of emerging markets. If a deal is struck this weekend on a debt plan, and no credit downgrade follows, a rally in stocks is likely to ensue.
- Be wary of commodities, particularly precious metals, over the near-term, as gold and silver prices have the potential to decline precipitously if a debt ceiling agreement is reached in the next few days. Crude oil is likely to be buffeted by conflicting forces, with a weakening economy depressing demand for gasoline confronting a declining dollar which boosts the price of oil, which is priced in dollar terms.

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