The question of raising the U.S. debt ceiling now making the headlines is only the immediate symptom of a longer-term problem—whether the political process can deal constructively with the deficit.

We believe that the potential consequences of not raising the debt ceiling—an immediate contraction of the economy through a government shutdown or defaulting on U.S. government debt—are sufficiently catastrophic to move Washington to action before it’s too late.

Of critical importance to maintaining the nation’s AAA credit rating is how Washington addresses the issue. Credible long-range deficit reduction will go a long way toward maintaining the top rating—if Standard & Poor’s recent reaffirmation of the U.K.’s AAA status after its deficit reduction plan passed Parliament sets a precedent. A stopgap solution, on the other hand, could well risk a downgrade.

The obligations of the U.S. government and its agencies have enjoyed a Triple-A rating since 1941 when S&P first awarded it. The rating has been a key contributor to the liquidity and growth of the U.S. debt markets and has enabled the world’s nations to use the U.S. dollar to fund their reserves and guarantee the value of their own currencies. The U.S. has raised the debt ceiling numerous times throughout history (Exhibit 1), but the current environment is placing greater emphasis on sovereign debt levels and the debt-to-GDP ratio (Exhibit 2).

The debt ceiling debate and the country’s rising indebtedness have caused the rating agencies—Moody’s as well as S&P—to question the nation’s ability to service its debt effectively. On July 13, Moody’s placed the U.S. Triple-A government bond rating on
review for possible downgrade, saying that it “considers the probability of a default on interest payments to be low but no longer de minimis.” S&P warned that, even with some debt agreement, “there is at least a one-in-two likelihood that we could lower the long-term rating on the U.S. within the next 90 days.”

S&P’s July 14 statement clearly states it will be looking at the detail of any agreement to determine if it is credible:

“We may lower the long-term rating… into the “AA” category... if we conclude that Congress and the Administration have not achieved a credible solution to the rising U.S. government debt burden and are not likely to achieve one in the foreseeable future...

If Congress and the Administration reach an agreement of about $4 trillion, and if we conclude that such an agreement would be enacted and maintained throughout the decade, we could, other things unchanged, affirm the “AAA” long-term rating...”

S&P implied clearly that a significantly smaller (e.g., $1−$2 trillion), and/or less credible (e.g., back loaded) deficit reduction plan would be viewed as “inconsistent with a AAA sovereign rating.” Moody’s statements have not provided the same level of clarity, only saying it requires a “substantial and credible” deficit reduction agreement.

Since the United States has never experienced a downgrade from Triple-A, our scenario analyses contain more uncertainty than usual. It seems safe, however, to predict that a result would be higher volatility in financial markets. Volatility could raise borrowing costs for the U.S. government, or it could spur a flight-to-quality into U.S. government bonds. Similarly, stocks and corporate bonds could fall in response to higher volatility, or they could benefit from the movement of capital out of U.S. government debt. It seems unlikely, in any event, that the outcome would be positive for Agencies of the U.S. government or the value of the U.S. dollar versus other currencies.

In summary, we are monitoring the situation closely. The increased uncertainty in the fixed income markets and the continued weak housing and employment markets are reminders that a global view, strong security selection and portfolio management experience across multiple market cycles never go out of style.
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