



Flash Report

THE U.S DEBT CEILING CRISIS AND ITS AFTERMATH

Introduction

The US National Debt is the sum of all outstanding debt owed by the U.S Federal Government. Over two-thirds of US government debt is held by the public, including the Federal Reserve, private individuals, overseas governments and central banks. Most of this is in the form of marketable treasury securities. The remaining debt is held by government trusts set up to fund programs such as Social Security, Medicare or highway construction

The U.S. Treasury has borrowed trillions of dollars over the past decade, much of it from foreign investors, to help finance two long wars, rescue its financial system, and promote economic growth through fiscal stimulus. The government must be able to issue new debt as long as it continues to run a budget deficit - the current shortfall is about \$125 billion per month.

What is the current level of U.S National Debt?

According to the U.S Treasury Department, the U.S National Debt was \$14.27 trillion at the end of June 2011. Of this, \$9.66 trillion was held by the public and the balance \$4.61 trillion was held by government accounts. At the end of 2007, the National Debt was equivalent to 64.4% of U.S GDP. Today, it is estimated at 100% of U.S GDP, a share not seen since the aftermath of World War II.

What is the U.S Federal Debt Ceiling?

The debt limit or "ceiling" sets the maximum amount of outstanding federal debt the U.S. government can incur by law. The current debt ceiling of \$14.29 trillion was set in February 2010. In the last 30 years, the debt limit has been raised 35 times. Each increase needs to be passed by the U.S Congress and signed into law by the President of the United States. Raising the debt limit does not authorize new spending commitments. It simply allows the government to finance existing legal obligations. Since the Federal Government runs deficits, issuance of debt bridges the gap between its revenues and expenses.

Hitting the debt ceiling would hamstring the government's ability to finance its operations, like providing for the national defense or funding entitlements such as Medicare or Social Security. Under normal circumstances, the government is able to auction off new debt (typically in the form of U.S. Treasury securities) in order to finance annual deficits. However, the debt limit places an absolute cap on this borrowing, requiring congressional approval for any increase (or decrease) from this statutory level.

Why Have A Debt Ceiling?

The debt limit provides Congress with the strings to control the federal purse, allowing Congress to assert its constitutional prerogatives to control spending. The debt limit also imposes a form of fiscal accountability that compels Congress and the President to take visible action to allow further federal borrowing when the federal government spends more than it collects in revenues.

The Crisis

With the current level of U.S National Debt at \$14.27 trillion and the ceiling at \$14.29 trillion, had the ceiling not been raised, the Treasury would have been unable to pay its obligations from August 2, 2011. If Treasury is unable to issue new debt or take further emergency actions to bridge the deficit, the government would be forced to default on some of its financial commitments, limiting or delaying payments to creditors, beneficiaries, vendors, and other entities. Among other things, these payments could include military salaries, Social Security and Medicare payments, and unemployment benefits.

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The Controversy

The legislative arm of the US government - known as the Congress - consists of two houses, the Senate and the House of Representatives. A bill to raise the debt ceiling has to be passed in both houses before it can be enacted as law. In the past the statutory debt ceiling has been raised whenever needed by Congress. The present controversy arises due to party differences: Democrats have a majority in the Senate, and Republicans have a majority in the House of Representatives.

Republicans wanted major spending cuts that would ensure more sustainable deficits in the future; caps on future spending, and a commitment to a balanced budget. They oppose tax cuts favoured by the Democrats. This resulted in a stalemate with each rejecting proposals of the other. The final deal to increase the debt ceiling by \$2.4 trillion was reached on August 1, 2011. The assent of both houses has now been obtained, and the US President signed to it legislation on August 2. However, in exchange Mr. Obama agreed to more than \$900 billion in immediate spending cuts.

Consequences Of A U.S Debt Default

An actual debt default would have had serious consequences for US and other economies. Risk premiums on US government borrowing would have risen, leading to higher borrowing costs, and lower savings and investment activity. US economic growth would have fallen further.

A Congressional gridlock would also have sown significant uncertainty in the bond markets and placed upward pressure on interest rates. The increase would not only have hiked future borrowing costs of the federal government, but would also have raised capital costs for struggling U.S. businesses and cash-strapped homebuyers. In addition, rising interest rates would have diverted future taxpayer money away from much-needed capital investments such as infrastructure, education, and healthcare, towards interest and debt repayments. Estimates suggest that even an increase of twenty-five basis points on Treasury yields could cost taxpayers as much as \$500 million more per month.

Historically, the U.S. Treasury market has been driven by huge investments from surplus countries like Japan and China, which view the United States as the safest place to store their savings. A loss of confidence in the debt market could have prompted foreign creditors to unload large portions of their holdings, thus inducing others to do so, and causing a run on the dollar in international markets. In the last week of July, fears of US default led financial markets and investors to modify their asset allocation strategies.

- The yield on one-month US treasuries went up sharply as treasury managers moved out from short term treasury bills to cash holdings. However, the yield on long-term debt such as 10-year treasuries were not significantly impacted.
- Global equity markets sharply declined due to concerns about a possible economic slowdown in the US and potential job losses for linked economies. Most markets recovered when the debt deal was agreed upon on August 1, 2011.
- Gold prices hit record highs as investors flocked to gold as a 'safe haven' asset.

Looking Ahead

Now that the rise in debt-ceiling has been legislated and there is no longer the fear of the U.S defaulting on its debt obligations, the question being asked is how the U.S would manage the deficit, going forward. The legislation recommends \$2.1 trillion in spending cuts spread over 10 years and a congressional committee to recommend a deficit-reduction package.

In order for the US to balance its budget in the future, growth rates have to move up. The moderation of growth this year (U.S GDP grew by 0.4% in the first quarter of 2011 and 1.3% in the second quarter) and the persistence of high unemployment rates, makes it tough to assume that economic growth would cure the deficit over time. Persistently high unemployment rates will make the spending cuts more painful, while keeping inflation low due to repressed wages.

Therefore higher inflation rates that tend to lower the deficit are not immediately probable. Currency depreciation may then be the only possible route to reducing the deficit. Asset class performance therefore will be primarily determined by the changing probability of these three alternatives.

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Global debt markets had already factored in a downgrade for US credit rating. This, along with the crisis in the European Union, has led to higher benchmark yields and losses to debt market investors. Many have begun to pare their holding of US treasury bills, pushing the prices down and creating mark-to-market losses.

Money market funds may be the first to be impacted, since they have a high proportion in US Treasury bills, but borrowing costs for the long term may also go up.

Equity markets are worried more about the projected sluggishness in growth rates and the fears of another recession. Emerging equity markets expect a liquidity-driven flow of funds, though the increase in risk aversion from another global risk, might result in portfolio flows being cautious and slow. Emerging markets with export-led growth may find it tough to deal with another possible slowdown in demand, resulting in re-allocation of direct and portfolio flows going forward.

The Impact On India

India is in a better position than other countries to manage the impact of an uncertain global situation as the country's fundamentals are still strong. Despite a series of interest rate hikes, the economy is still expected to grow at around 8% in the current financial year.

There will be a short-term impact in India since near-term capital flows into the country could suffer as FIIs unwind their holdings and move to 'safer' assets across the globe. But, it has to be understood that, in the short-term, sentiment will dictate the performance of the stock markets while in the long-term, fundamentals dictate its performance.

The softening of international commodity prices, especially oil, will help check inflationary pressures in the economy and will also help in managing the fiscal deficit for the current financial year. Every \$10 rise or fall in the price per barrel of oil has an impact of \$8 billion on the current account. Clearly, falling oil prices are a bigger boon than the threat of capital outflows. Also, the expected depreciation of the dollar could reduce India's import bill (for oil and fertilizers) which, in turn, can strengthen India's fiscal condition by reducing the subsidy bill significantly. Moreover, a sell-off will tighten the liquidity in the domestic system, easing the job of the RBI in contracting liquidity for taming inflation. Which means: The RBI is unlikely to continue to raise interest rates going forward.

The P/E multiple for the Sensex on a one-year forward basis currently stands at 15.28, substantially lower than the 23.56 of December 31, 2010. Although, in comparison to the valuations of other large markets, it still looks expensive, a high growth rate for the economy points to a higher P/E multiple. As hedge funds unwind their position further, a further drop of 700-1000 points in the Sensex cannot be ruled out in the coming weeks. However, such a drop will only make investing in India a much more attractive proposition for the medium to long-term.

Once the initial panic recedes, we could well see strong FII inflows, similar to what was witnessed in 2008, into the stock markets in India. Goldman Sachs has just upgraded the Indian markets to 'marketweight' status after keeping an 'underweight' status for over a year, citing among other things, an improving macroeconomic situation and attractive stock market valuations. Goldman Sachs has also found support on its stance on India by Merrill Lynch. In a note, Merrill Lynch has said, "We would advise investors to ignore inevitable chatter about India's 'external vulnerabilities' as the world becomes a more and more volatile place. In our view, the RBI has sufficient fire power to fend off contagion as any other emerging market."

Therefore, although the next few months could be tumultuous, investors who are willing to ignore the short-term gyrations of the stock markets and buy stocks of companies with a strong domestic consumption story, will make tremendous gains over the next 2-3 years.

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