

US debt ceiling: How many say I

Economic research note

3 August 2011

- On the very day the US Treasury would have had to start prioritising payments to avoid a debt default, the US debt ceiling has been raised by \$US2.1tr.
- The new limit of just under \$US16.4tr should be sufficient to take the government beyond the November 2012 elections.
- In return for the debt limit increase, the budget deficit path over the next decade will be cut by \$US2.4tr. However, only \$US900bn of this happens immediately, with the further \$US1.5tr to be decided upon by a bipartisan committee that is due to report by 23 November.
- While the immediate risk of default has been averted, the risk of a credit rating downgrade in the future remains real – especially if excessive political brinkmanship returns and/or the extra \$US1.5tr in budget cuts are not forthcoming.
- Markets will now also be challenged by the economic consequences of a tightening of fiscal policy at a time when economic data is showing a clear loss of momentum in the US recovery.

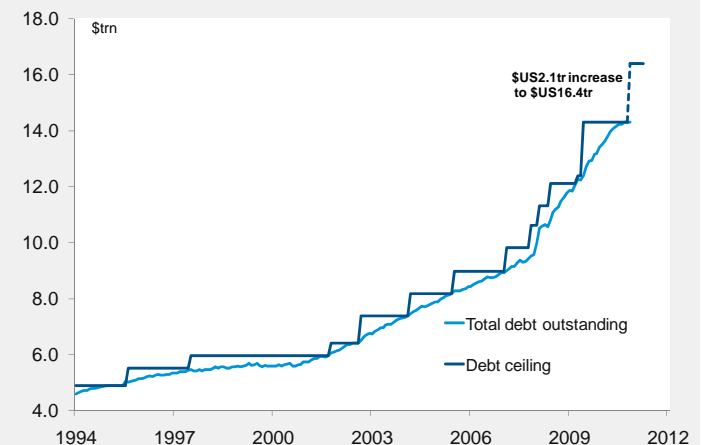
US debt ceiling:

On the very day that the US Treasury would have been required to start prioritising payments to avoid a debt default – a potentially very destabilising event for both the US and global markets - the US government has passed a \$US2.1tr increase in the official debt ceiling, which now stands at \$US16.394tr.

After a 269-161 vote in the House of Representatives yesterday, the US Senate has voted 74-26 to pass the increase in the debt ceiling in return for a \$US2.4tr reduction in the budget deficit over the next 10 years. Full details of the plan are below.

While markets should be relieved that a 'deal' was (finally) done, and that the increase in the debt ceiling will take the Treasury beyond the November 2012 elections, the fact that the largest share of reduction in the budget deficit will come from the recommendations of a, as yet-to-be-established, bi-partisan committee suggests that we have not heard the last of this highly politically-charged debate. Indeed, since the debt ceiling increase, markets have refocused on the US economic data and they do not like what they see.

US debt ceiling and debt on issue



Source: Bloomberg

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In addition, the US AAA credit rating may remain under threat if the rating agencies consider the reduction in the budget deficit insufficient to stabilise key US debt/GDP ratios and if the political bickering returns in the months ahead. Moody's has suggested that it expects to see a stabilisation of this key ratio not too far above the projected 2012 ratio of 73%, before declining around the middle of the decade.

Impact on financial markets:

While the deal to raise the US debt ceiling will see the markets avoid the nightmare scenario of a partial government shut-down and/or a bond default, financial markets may still have to deal with a potential credit rating downgrade for the US and the obvious signs of economic slowdown.

As a result, equity markets and the USD remained under pressure even as the debt deal was announced; while Treasury prices have rallied significantly (ie. yields have fallen). As noted, uncertainty over the pace of economic growth in the US, which has clearly slowed, is now returning as a key focus for markets.

In terms of the US credit rating, both Moody's and Fitch have made comments post the increase in the debt ceiling. Fitch has stated that the risk of a sovereign default in the US remains extremely low, commensurate with a AAA rating. A full review will be released by the end of August.

Moody's has confirmed the Aaa government bond rating of the US, but has retained a 'negative' outlook.

Moody's has also commented that the debt ceiling agreement "is a first step toward achieving the long-term fiscal consolidation needed to maintain the US government debt metrics within Aaa parameters over the long run". However, given the negative outlook the risk of a downgrade still exists if:

1. "there is a weakening in fiscal discipline in the coming year;
2. further fiscal consolidation measures are not adopted in 2013;
3. the economic outlook deteriorates significantly; or
4. there is an appreciable rise in the US government's funding costs over and above what is currently expected"

In terms of the risks going forward, one key area to focus on would be the economic outlook, given recent weaker economic data in the US, and also the impact the new round of fiscal tightening will have on the US economy.

As of Wednesday 3rd August, no comment had been made by Standard and Poor's. Prior to the debt deal, S&P was the most forthright in terms of a possible downgrade to the US AAA credit rating, indicating that unless a cut to the budget of \$US4 trillion over 10 years was introduced, the credit rating could still be downgraded.

With the risk of a credit rating downgrade still hanging over the US, it is instructive to look at who owns US Treasury securities. One fear for markets is that a credit rating downgrade for the US may trigger forced selling by a large holder of Treasury's. However, this does not look like it would be the case.

Of the top 5 holders of Treasury securities, three are US sectors that would not be forced sellers (social security trust funds, the Fed and US households), while the other two are China and Japan, both of which have no interest in selling Treasuries in sufficient quantity to cause a sharp fall in the USD.

Going further down the list we have to get to the seventh largest holder, private pension funds (at 4.7%) and the ninth largest, money market mutual funds (at 3.1%) before the risk of forced selling comes into play.

That is not to say that a downgrade for the US AAA rating would not be a medium-term negative for US markets, but it is unlikely to force an immediate sell-off in Treasuries. In fact in recent days post the deal, US Treasuries have rallied, largely due to concerns over the economic outlook.

A possible downgrade could be expected, however, to slow the accumulation of Treasury securities in the future by these large holders, with international central banks likely to accelerate their reserves diversification that has been evident over a number of years. This in turn is likely to continue to favour the AUD.

Holders of Treasury securities

	\$USbn	% of total
Social security trust funds	2,670	24.6
Federal reserve	1,630	15.0
China	1,200	11.1
US households	960	8.8
Japan	912	8.4
State, local govts	506	4.7
Private pension funds	505	4.7
UK	345	3.2
Money market mutual funds	338	3.1
State, local, Fed retirement funds	321	3.0
Commercial banks	302	2.8
Mutual funds	300	2.8
Oil exporters	230	2.1
Brazil	211	1.9
Taiwan	153	1.4
Caribbean banking centre (hedge funds)	148	1.4
HK	122	1.1

Source: Bloomberg

Impact on the economy:

As detailed below, the largest part of the spending cuts are due to kick-in from 2013 onwards and will be spread out over 10 years. This has been done to “avoid harming the recovery.”

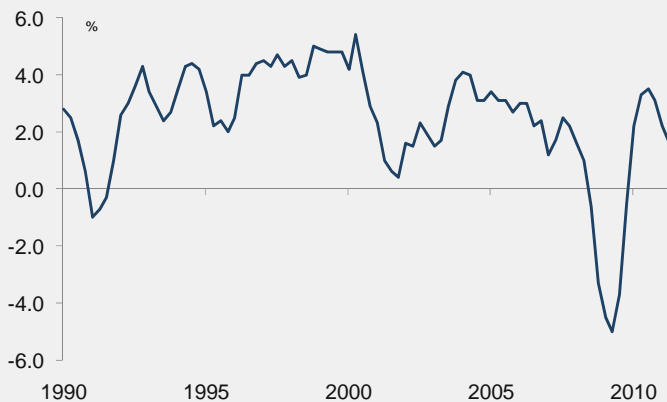
However, data released on Friday confirmed that the US economy is struggling to make further gains, with the pace of economic growth coming in at a modest 1.3%saar in Q2 11, with sharp revisions downwards to past data.

There is a growing risk, therefore, that the US economy grows at a pace slower than that assumed in the budget forecasts for the years ahead (current assumptions from the Central Budget Office made in June are for GDP growth of 3.3% in 2012) and indeed that the spending cuts in the budget could further slow the pace of economic growth in the years ahead.

This could, perhaps ironically, lead to a worse budget outcome in the years ahead, or a further rise in debt/GDP ratios.

Any further signs of significant weakness in the US economy, especially if they are matched by a deceleration in the pace of inflation, could bring the Federal Reserve back into play with the third round of quantitative easing (QE3). In any case, any potential monetary policy tightening from the Fed remains a long way into the future.

US annual economic growth



Source: Bloomberg

The plan in detail:

- The US debt ceiling will be raised by \$US2.1tr, taking the ceiling to just under \$US16.4tr.
- This increased debt limit will likely last until 2013, ie. until after the November 2012 Presidential election.
- In return for this increase in the debt ceiling, the budget deficit over the next 10 years will be cut by a total of \$US2.4tr.
- The \$US2.4tr in budget cuts will be split into two components.
- There will be an ‘immediate’ reduction of just over \$US900bn, split between defence and non-defence spending.
- Defence spending will be reduced by \$US350bn over 10 years, but this needs to be seen in the context of a current defence bill of \$US700bn per year, ie. \$US7tr over 10 years.
- The non-defence spending cuts will be in ‘discretionary’ spending projects that are authorised by Congress, and will not be in entitlements, such as for social security or health.
- The second round on budget cuts will total \$US1.5tr over 10 years.
- The exact details of these budget measures will be decided by a bi-partisan committee to be set up with 6 Republicans and 6 Democrats. This committee will hand down its proposals – which could include savings in entitlements and tax reforms – by 23 November 2011.
- Congress will then be required to vote on these measures by 23 December.
- If this Committee fails to come up with concrete plans that can be agreed by the Congress, then an enforcement mechanism “will trigger spending reductions beginning in 2013 – split 50/50 between domestic and defence spending.” This enforcement will protect social security, Medicare beneficiaries and low income payments from any cuts.”

For further information

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