
Bumping Up Against the Debt Ceiling: What's an investor to do?

We remain optimistic that an agreement can be reached to increase the nation's debt ceiling before August 2nd, the approximate date by which the Treasury estimates it will no longer be able to borrow under the current \$14.3 trillion limit. The recent proposal put forth by a bi-partisan group of Senators (the "Gang of Six") and supported by President Obama is encouraging, but much work remains, including many of the details of their plan and getting enough support from House Republicans.

Treasury officials have warned that if the Treasury can no longer borrow money, the U.S. might default on its existing obligations--in other words, be unable to make payments it already owes, whether those be for Treasury securities or government programs. President Obama, Treasury Secretary Timothy Geithner, and Federal Reserve Chairman Ben Bernanke have warned that not raising the debt limit would have severe consequences. Leaders of both parties have said that the issue must be addressed, and have put forward proposals for tying any increase in the debt ceiling to tackling the country's budget deficit. However, they differ on how to begin to reduce that deficit.

In some respects, it is like individuals who have consistently spent beyond their means. They have accumulated significant credit card debt and are now bumping up against their credit limits. If they can't get their credit line increased, they will not be able to keep up with all of their bills; the income they earn will only cover so much of their expenses. What's being debated is whether the credit card company will raise their credit limit without a game plan to get the borrowers to live within their means. And if a game plan is put in place, what expenses will be curtailed and how might income be raised.

While the debate is taking place right now, here are some answers to frequently asked questions that add some perspective on the issues involved.

What is the debt ceiling?

The debt ceiling represents a limit on the amount the U.S. Treasury is allowed to borrow to manage the national debt (the total amount currently owed by the U.S. government). Before World War I, Congress often approved the terms of individual debt instruments issued by the Treasury to pay for spending authorized by Congress, including maturities, interest rates, and the types of financial instruments used. Eventually, members decided in 1939 to set an overall limit on the total amount the Treasury could borrow to pay the nation's bills without congressional authorization.

An increase in the debt limit does not authorize additional governmental spending; only Congress can approve future spending. However, Treasury officials have said that if the limit is not raised, the government would not be able to pay bills that have already been incurred. According to the Congressional Research Service (an arm of Congress), the debt ceiling has been increased 78 times since 1960 (10 times just since 2001), under both Democratic and Republican administrations.

The national debt has two aspects. Debt held by the public occurs when investors buy debt instruments sold by the Treasury to finance budget deficits and pay bills; it represents almost two-thirds of the current debt. Debt held by government accounts is created when the Treasury borrows from government accounts such as the Social Security, Medicare, and Transportation trust funds.

Haven't we survived government shortfalls in the past?

Governmental funding gaps have occurred more than a dozen times in the last three decades, according to the Congressional Research Service. The most recent was in 1995-1996, when the Clinton administration and the Republican-led Congress failed to reach agreement on a spending bill led to a temporary government-wide shutdown. However, never in the country's history has it failed to pay its legal obligations – which is one reason why Treasury securities have historically been considered one of the safest investments in the world.

So why is this particular debt ceiling increase under so much debate?

There are a myriad of potential answers here, but a primary factor is that previously, votes to increase the debt ceiling have not been tied to budget negotiations. As Raymond James Chief Economist Scott J. Brown notes: “It’s important to remember that the debt ceiling crisis is a manufactured problem. The U.S. must address its long-term budget situation and the debt ceiling has to be raised, but these are separate issues. Lawmakers can raise the debt ceiling right now if they want to, and worry about the long-term budget deficit later.”

What would happen if the debt ceiling isn't raised?

There's no way to know the precise or full impact, since a default on the country's obligations is unprecedented in U.S. history. However, the Treasury is responsible for payment of a broad range of obligations that include not only Treasury bonds, notes, and bills, but also Social Security and Medicare benefits, military salaries, interest on the current national debt, and tax refunds, to name only a few. Technically, the \$14.3 trillion ceiling was exceeded in May. However, the Treasury has been able to use certain accounting measures to temporarily extend the nation's ability to borrow.

Bond rating agencies have already warned that an interruption in or curtailing of payments owed by the U.S. government would harm the nation's credit rating, which is currently among the highest in the world. If that happened, or if the country actually had to default or restructure payment schedules, greater uncertainty about the United States' ability to pay its bills would mean that both domestic and foreign investors would likely demand higher interest rates for buying Treasury securities.

Those higher interest rates would increase the country's borrowing costs, making the national debt problem even worse in the long term. They might also result in higher interest rates for other, nongovernmental loans such as mortgages, which some observers worry could hamper economic recovery. Stocks and the US dollar could also experience a sharp decline. And even if there were technically no default, the mere absence of an agreement that addresses the issue before August 2 would likely raise the global anxiety level substantially.

So if a big decline in stocks is possible, why don't we get out of stocks until we know what will happen?

Some of you may already know our answer to this...precisely because we don't know what will happen. And even if we did, there is no guarantee the market will respond as we would expect. We think back to the bear market of 2008 and 2009, when some people were using the potential bankruptcy of GM as another reason to stay out of the market after the initial recovery started. Over the six months following GM's bankruptcy announcement in June 2009, the S&P 500 advanced more than 20%.

More recently, individuals were concerned about the ramifications when the U.S. was projected to initially hit its debt ceiling in May of 2011 and wanted to get out of equities as early as October 2010 to wait it out. In the six months leading up to May, the S&P 500 advanced more than 16%. Since then, the Treasury Secretary has been able to extend the debt ceiling deadline to August and the index is down just over 2%.

The point is not that we think the markets will necessarily advance in the face of this uncertainty as there have certainly been times when the fears have been justified. Rather, we acknowledge that we cannot predict market outcomes with certainty and do not believe we need to take action based on our near-term concerns. We have addressed the potential for shocks to the markets and your portfolio a long time ago – when we laid out a well developed game plan to reach your goals. Your asset allocation is designed to provide for your shorter-term cash needs without exposure to the volatility of the equity markets – taking on risk only in places you can afford to take it.

As Liz Ann Sonders, Chief Investment Strategist for Charles Schwab points out: "I don't disagree with that pessimistic assessment [that stocks could drop meaningfully if the U.S. defaulted on its debt], but I still wouldn't attempt to handicap or forecast moves by any asset class." She goes on to say "we continue to preach the benefits of diversification among and within asset classes, both domestic and international."

If there is no agreement, how would a default affect the daily life of the average American?

Assuming the U.S. did default on its debt (which we believe is still extremely unlikely), interest on the national debt will likely be the top priority and paid first so as to not to default to domestic and foreign bondholders. After that, it is possible there would be a delay in entitlement payments. Social Security recipients may want to make sure you have enough cash in the bank to cover expenses in the event there is a delay in government benefits. If you are debating whether to file for Social Security, there probably is no need to rush to do it. Any changes to benefits will likely affect all retirees (past and future) or those farther away from eligibility.

It is also possible there would be another government shutdown except for essential services (e.g., prisons). If you are a federal employee or your organization gets federal funding, you may be forced to take a furlough. Make sure you have enough cash in the bank to handle going without a paycheck for a few months. Other services that are funded independently (e.g., Postal Service) will likely have no interruption in service.

While we do not yet know what decisions will be made, we believe that legislators will decide it is in the country's best interest to avoid defaulting on obligations. We also believe in having a long-term strategy that can weather crises and will help you stay disciplined during trying markets. We continue to monitor events closely to better gauge their potential impact on you, our clients, especially any tax increases or any entitlement cuts that are ultimately a part of the agreed upon legislation. Please let us know if you have any questions about these ongoing events or how they may impact you.