

MARKET INSIGHTS

August 2011

US debt crisis: After the downgrade



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Introduction

The deal to raise the debt ceiling, signed into law on 2 August, allowed the US to avoid default. However, the fiscal tightening announced was not sufficient to satisfy Standard & Poor's, with the US losing its AAA credit rating on 5 August.

What will be the consequences of the downgrade for markets? And with data softening in recent months, can the US economy weather the proposed spending reductions?

In this paper, Nicholas Gartside, international chief investment officer for fixed income, and David Shairst, global strategist, discuss the impact of the US debt crisis and credit rating downgrade on the outlook for markets and for the economy.



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Kicking the can down the road

The US debt deal avoided default, but provoked no celebration in the markets, with investors turning instead to the weaker economic data that has largely been ignored while all eyes were on Washington. At an annualised 1.3%, US second-quarter growth was disappointingly weak, and the underlying data was particularly worrying, with consumer spending stagnating. First-quarter growth, meanwhile, was revised down from 1.9% to just 0.4%. July data suggests that the uncertainty resulting from the prolonged debt ceiling negotiation process has further damaged business and consumer confidence, adding to the concerns over growth for the rest of 2011.

The lack of a relief rally also reflected the perception that the US authorities have simply 'kicked the can down the road'. This expression, which has also been bandied around widely with reference to the efforts of eurozone authorities to resolve their own debt crisis, suggests that the problems are not resolved, but merely postponed. Before the accord was reached, Standard & Poor's (S&P) indicated that the US needed to cut USD 4 trillion in spending over the next decade in order to stabilise its debt levels and maintain its AAA rating, so investors feared USD 2 trillion of (as yet largely unidentified) spending cuts may not suffice. On 5 August, S&P delivered its verdict on the debt deal by cutting the US sovereign credit rating from the highest level for the first time in the nation's history, taking it to AA+.

The agreement in brief

Raising the debt ceiling

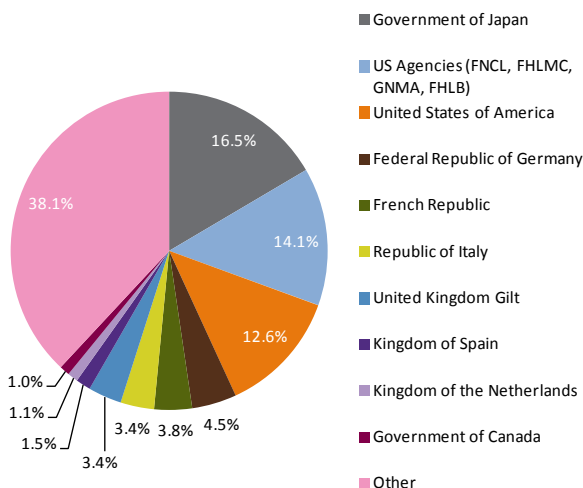
- The deal immediately increased the debt ceiling by USD 400 billion from its previous level of USD 14.3 trillion, allowing the US to pay its bills in the short term.
- The agreement is then that the debt ceiling will be increased by another USD 500 billion by February 2012. Congress can theoretically vote against this increase, but this would largely be a symbolic measure, with President Obama expected to veto such a vote.
- Before the end of this year, the Senate and the House of Representatives must vote on adding a balanced budget amendment to the constitution, requiring that future spending may not exceed revenues.
- If this amendment is passed (which appears unlikely), the Obama administration can request an increase in the debt ceiling of a further USD 1.5 trillion. If not, it can request a further USD 1.2 trillion.
- Importantly, an increase of either scale would be sufficient to last until 2013, avoiding the need for President Obama to request a further increase from Congress ahead of next year's presidential election.

Cutting the deficit

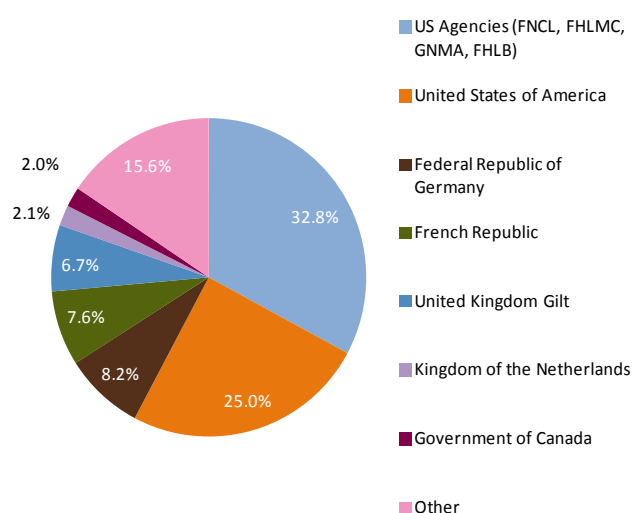
- From October, USD 917 billion of spending cuts will begin to take effect.
- In November, a cross-party committee consisting of 12 members of Congress (not yet selected) will report on its recommendations for up to a further USD 1.5 trillion of deficit reduction measures.
- If these recommendations are not accepted, a set of automatic spending cuts take effect from January 2012. However, these cuts have been designed to be unappealing to both Democrats and Republicans, effectively forcing the committee to come up with a better solution.
- The committee cannot consider increasing taxes, but can propose amending the tax code in other ways to boost revenues.

Exhibit 1 – The scale of the US bond market

Breakdown of issuers in Barclays Capital Global Aggregate Bond Index



Breakdown of AAA issuers in Barclays Capital Global Aggregate Bond Index (pre-downgrade)



Source: Barclays Capital as at 29 July 2011

Source: Barclays Capital as at 29 July 2011



The International Monetary Fund (IMF) also thinks the US needs to go much further than the current proposed cuts, over the next decade. To stabilise its debt/GDP ratio, the IMF believes the US needs to tighten spending by around 11% of GDP between now and 2030. And this is without taking into account demographic factors. Incorporating the need to cater for an aging population, the IMF believes the required cuts are closer to 17%.

How bad is the US debt problem?

Debt has become a dirty word in financial markets, but it's a critical component of any economy. Run properly, economies need a combination of debt and equity, with debt serving as the oil of the financial system. As with everything, though, it's possible to have too much of a good thing, and the US now appears to have reached that level.

One way of conceptualising the scale of US debt is to look at the size of the US government bond market in the context of global bond markets (see Exhibit 1). Including agency debt, which is guaranteed by the government, the US makes up 26% of the global fixed income market. In the AAA-rated bond market, it represented a huge 58%.

In fixed income indices, size isn't always a good thing; indeed, borrowers can reach a point at which they have so much debt that their credit quality worsens. This can be seen in the case of Japan, which in 1995 was a AAA-rated issuer. Now the largest single bond market in the world, representing 16.5% of the global market, Japan is rated AA- and is on negative watch for a further downgrade.

Why was the US downgraded?

Given the scale of its borrowing, the US no longer looked like a AAA issuer. Spending has a limit, and ultimately too much debt does damage the borrower's ability – not necessarily its willingness, but its ability – to pay.

To assess the creditworthiness of sovereign nations, we can consider two metrics: the debt/GDP ratio and the fiscal balance. Compared with the remaining AAA issuers, the metrics for the US stand out. Debt currently makes up 92% of GDP, and the IMF forecasts that this will rise to 112% by 2016. This compares with an average for AAA issuers of 60% now, falling to 59% by 2016. Looking at the fiscal balance tells a similar story: the fiscal deficit is currently -10.6%, and is forecast to come down to a still-large 6% by 2016. In contrast, the average deficit for AAA issuers is currently -3.2%, and by 2016 the forecast is for a small surplus.

Exhibit 2 – Fiscal health: How does the US compare?

Country	Debt to GDP (%)		Fiscal Balance (%)		S&P Rating
	2010 (a)	2016 (e)	2010 (a)	2016 (e)	2011
United States	92	112	-10.6	-6.0	AA+
Japan	220	251	-9.5	-7.4	AA-
Italy	119	118	-4.6	-2.9	A+
Singapore	97	83	5.3	4.1	AAA
France	84	87	-7.7	-1.5	AAA
Canada	84	73	-5.5	-	AAA
Germany	80	72	-3.3	-	AAA
United Kingdom	77	81	-10.4	-1.3	AAA
Austria	70	70	-4.1	-2.1	AAA
Netherlands	64	64	-5.2	-0.6	AAA
Switzerland	55	46	0.2	0.9	AAA
Norway	54	54	10.9	11.2	AAA
Finland	48	61	-2.8	-1.3	AAA
Denmark	44	40	-4.9	1.2	AAA
Sweden	40	23	-0.2	2.0	AAA
New Zealand	32	32	-6.0	1.0	AAA
Australia	22	21	-4.6	0.7	AAA
Luxembourg	17	24	-1.7	0.1	AAA
AAA Average	60	59	-3.2	0.5	AAA

Source: IMF. Data is estimated for 2016 as at 2010.

Fiscal Balance: the balance of government's tax revenues, plus any proceeds from asset sales, minus government spending.

What will happen now?

Given the scale and liquidity of the Treasury market, fixed income investors are likely to have little choice but to continue to hold US government bonds. They may seek to diversify more, and to hold fewer, but for reasons of practicality they will still hold them even after the downgrade, suggesting US borrowing costs are unlikely to rise materially.

We think the symbolism of the downgrade could be more important than the price movement. Investors will ultimately adapt to and accept the lower rating. However, politicians will come under huge pressure to take the actions needed to regain AAA status. The long-term fiscal outlook for the US may therefore actually have *improved*.

With the announcement of spending cuts, the US has already indicated a dramatic shift away from its emphasis on stimulus as a means of tackling its economic problems. Both political parties and the president have agreed that a multi-trillion dollar reduction in the deficit is necessary over the next decade. The details will take some working out, but at least the political will is now there.

Will there be a chain reaction?

Some investors have expressed concern that the downgrade for the US will produce a chain reaction, resulting in a series of downgrades for other AAA-rated issuers, and then a knock-on effect further down the rating scale. We don't think this is likely. Bond investors are modern-day moneylenders and, like moneylenders, they are focused on the ability and willingness of borrowers to pay them back. In consequence, they tend to evaluate borrowers in isolation. Given the relatively better fiscal positions of the remaining AAA sovereign issuers, we don't anticipate that the US downgrade will produce a spate of downgrades for other issuers. We may, however, see greater discrimination in bond markets, with investors becoming more selective. Already we are seeing a rise in demand for emerging markets debt, where bond markets are supported by much more favourable financial metrics than in most developed countries. This is also being reflected in credit ratings, with emerging markets seeing a flow of rating upgrades, while developed markets are downgraded or put under review.

What will be the consequences for the US economy?

Historical research from US economists Carmen Reinhart and Kenneth Rogoff shows that countries with gross public debt exceeding around 90% of annual GDP have subsequently tended to grow much more slowly. Median growth rates for countries with public debt above 90% of GDP – a level reached by the US in 2010 – are approximately 1% lower than otherwise, while mean growth rates are several percentage points lower¹.

The proposed spending cuts will undoubtedly serve as a further drag to growth, although the extent of this drag is difficult to evaluate until more is known about the form the cuts will take and whether they are front- or back-loaded. The expiration of payroll tax credits at the end of the year will also represent a substantial withdrawal of stimulus if the credits are not renewed. We may therefore expect that growth will remain below trend while the debt adjustment takes place.

Conclusion

The debt ceiling deal and subsequent rating downgrade look like the beginning of a long road for the US. The market should anticipate more cuts to come as the US tackles its debt burden and tries to regain its AAA rating. This will inevitably have a negative impact on growth in the near term, but is a necessary adjustment that will hopefully lay the groundwork for a stronger future.

¹Carmen M. Reinhart and Kenneth S. Rogoff, 'Growth in a Time of Debt', *American Economic Review Papers and Proceedings*, December 2009.

Nicholas J. Gartside, *managing director*, is the International Chief Investment Officer, within J.P. Morgan Asset Management's Global Fixed Income and Currency Group. He is responsible for leading and overseeing the activities of our international fixed income teams, as well as being the co-manager of our multi-sector fixed income products and serves on the Currency Investment Policy Committee. Prior to this, Nick was at Schroder Investment Management for eight years, most recently serving as the Head of Global Fixed Income. Nick earned a B.A. in History and Politics from Durham University and an M.Phil. in International Relations from Cambridge University. Nick is a CFA charterholder and holds the Investment Management Certificate from the UK Society of Investment Professionals.

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