

Debt Ceiling Issues

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2011 Outlook

GDP GROWTH:
2.5 percent

UNEMPLOYMENT:
9.0 percent

INFLATION:
1.75 percent

FED FUNDS RATE:
0.35 percent

Through a Glass, Darkly

When thinking about the potential economic and political ramifications of our government leaders to raise the authorized level of outstanding federal debt, it reminds me of the phrase “through a glass, darkly.” However, the issue of debt ceiling increases and the great debate of “what do we want from our government” is coming to some kind of head. It is appropriate at this time to truly speculate and bring some thoughts to the table regarding this very important issue. Visibility is very limited. However, as the talks in Washington drag on, we need to attempt an understanding as to what *may* occur – not specifically what *will* occur.

The “science” of economic forecasting is one of odds. What are the odds of different economic outcomes, given certain types of stimuli, or input? During most circumstances, we have some degree of historical precedent on which to fall. Because of the lack of precedent in this situation, we don’t have a significant amount of historical data on which to base assumptions or to test concepts. So, making statements regarding what might happen to the overall economic environment if the debt ceiling is not raised is a little like looking into the night’s darkness – you can’t really tell what you are looking at, you can only guess.

With that background in mind, this discussion will attempt to address five issues.

- Overall economic impact of a government spending reduction.
- Heading towards a credit-rating downgrade?
- Banking system impact of debt rating downgrade.
- Potential political fallout due to inaction in Washington.
- Potential equity and bond market reaction to a downgrade or default.

Overall Economic Impact

First, if the debt ceiling is not raised, it is highly unlikely actual “defaults” will occur in the Treasury markets. Roughly 56.0 percent of government spending is accounted for by tax receipts. These receipts will continue.

So a “pecking order” will need to occur as to what bills will be paid by the government and what bills won’t be paid on a timely basis. It is widely anticipated that interest on existing debt would continue to be paid. It appears, due to existing surpluses that Social Security payments would continue to be paid. It is anticipated that many other areas of government spending could be “delayed,” including funding of federal pensions, payments to contractors of various sorts (defense, health care, education, etc.). Creating a laundry list of areas which would see a delay in payments would probably be long and unproductive.

As far as economic impact, much of the actual impact is hard to assess. The exact nature of what payments are delayed and which are paid will have an impact on overall economic performance. However, from a numerical standpoint, if government spending were to decline by 44.0 percent (which once again, is the amount of spending which is paid by borrowing), the U.S. economy would contract by roughly \$106 billion monthly. If this contraction would occur over a 30-day period, third quarter GDP would be reduced by roughly 3.0 percent (annualized). We expect third quarter GDP to grow in the 2.5 to 3.0 percent range – in other words, if government were to cut spending by 44.0 percent, the economy would be growing at roughly zero percent during the third quarter.

Our analysis assumes the reduction in government spending would occur over a one-month period. It is further assumed that there is a 1.0x “multiplier” factor in the spending reduction to overall economic growth. The “multiplier” factor would be determined by the actual spending which would be reduced – some types of government spending have less or more impact on the “multiplier” effects. Consequently, it is necessary to make some broad-based assumptions, many of which will not prove to be accurate.

That being said, it appears the economy would not fall into an outright “contraction” due to the slowing of overall governmental payments. Additionally, it is assumed that the delayed payments will eventually be made, and the non-payment represents a payment “deferral” rather than outright payment elimination.

Heading Towards a Credit Rating Downgrade?

According to a recent report, the rating agencies need to see projected deficits reduced by \$4 trillion for the U.S. government to maintain its “AAA” credit rating. Moody’s and Standard and Poor’s are saying they need to see this type of proposal over the next 90 days. Is a downgrade going to happen? Perhaps, but we doubt it. There would be severe political fallout for both parties if this were to actually occur. The politicians in Washington understand this. If the U.S. loses its “AAA” credit rating, borrowing costs could rise fairly quickly, further intensifying the need to reduce spending and/or increase taxes. **It is anticipated that a short-term fix may indeed be in the offing. We would not be surprised to see a short-term package passed through Washington, followed by a longer-term workout solution over the next 90 days. If this comes to pass, it is reasonable to assume that the U.S. government would maintain their “AAA” credit standing.**

Banking System Impact of Debt Rating Downgrade

Let’s assume for the moment that a credit-rating downgrade were to occur. One area which may be impacted rather dramatically is the banking system; not only within the U.S. but around the world. The U.S. (through our debt instruments) dollar serves as the world’s “reserve” currency. Most central banks hold vast amounts of U.S. credits in reserve to back up their own banking systems. Within the U.S., most banks hold significant positions in treasury credits and at times are used as capital to shore up capital requirement levels. We don’t expect the banking system to sell treasury paper due to a downgrade. From a size and liquidity standpoint, there are few other avenues which the world’s banking system is able to turn. According to our friends at Capital Economics, **there is no real credible alternative to the dollar as the world’s dominant currency, which means it is almost as good as the home currency for many central banks.**

That being said, given a credit-rating downgrade, we envision a period of time where yields would probably rise in the treasury market, which indeed may drive other rates to the upside.

Additionally, many financial business models (banking, risk arbitrage, asset allocation to name a few) include as a “bogey” an assumed “risk-free” return. Historically, U.S. treasury yields serve as this proxy. If a credit-rating downgrade were to occur, a number of these “models” would be thrown into a cocked hat. The ramifications of this type of activity are not known, and would vary in intensity and severity.

Potential Political Fallout Due to Inaction in Washington

Perhaps one of the more disheartening aspects of this entire saga is the inability of our leaders in Washington to make decisions on a timely, well thought out basis. Even when the economic prospects are dire, they display an inability to act. Is this surprising? No. Is this disappointing? Yes.

We have long been saying a national “debate” is occurring, which will lead to the citizens of our country demanding what we expect from our government. This “debate,” or dialogue, has been ongoing for some period, and it is quickly coming to a head. We believe this process, while loud and frightening, is necessary. The size, scope and purpose of our government is being defined before our eyes. This is a historical time, and one which bears close watch.

At the end of the day, as we have said before, we don’t expect the U.S. will default and our credit standing to be lowered. If we do default and our credit ratings are lowered, we would hope that the citizens would take this seriously. Many politicians in Washington could be in dire jeopardy of losing their positions at the next election. We expect nothing less from the citizens of our country.

Potential Equity and Bond Market Reaction to a Credit Rating Downgrade or Default

While bull markets “climb” a wall of worry, investors and markets in general don’t like uncertainty. A credit-rating downgrade, if it were to occur, signifies an increase in uncertainty, no matter the magnitude. This in itself would be cause enough for volatility to increase and put equity values within the U.S. at risk of decline.

From a “numbers” standpoint, corporate profit growth rates would be reduced specifically due to the negative impact to the overall economy of reduced government spending. Potentially, interest rates may increase. This activity would probably pressure stock market P/E ratios to the downside. **So, we could see a “double negative” occur – earnings growth rates declining along with P/E ratio compression which would lead to lower equity prices overall.** The portion of the decline attributable to slower earnings growth would potentially be short-term in nature. The portion which would be attributable to higher interest rates may have a longer duration.

Final Word

The work of thinking through a possible credit-rating downgrade (not even thinking about an absolute default) of U.S. Treasury obligations is somewhat mind-numbing. There are so many factors to consider and so many unknown variables due to lack of history. We can certainly look at other countries and the ramifications of credit downgrades. Other countries have experienced credit downgrades – Japan, Australia, Canada – and the financial world shuddered, but didn’t collapse. Could a similar fate occur in the U.S.? Are we too pessimistic in our assumptions?

While it is true other countries sovereign debt credit-ratings have been reduced, no other country has served as the world’s reserve currency and experienced a downgrade. Also, those other countries are small in size and importance to the world’s economy when compared to the U.S. So the complexity and potential ramifications of a credit-rating downgrade in the U.S. are much more severe than in any country which can be held up as an “example.”

At the end of the day, we don't expect the U.S. credit-ratings to be downgraded. We expect our leaders in Washington to do the correct thing – to compromise on a solution to this sticky problem. As was said before – we, and much of the rest of the Western world, are defining the role of government. If nothing else, the dialogue is intriguing.



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