

Commentary

U.S. Debt Ceiling: The Clock is Ticking

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Discussions between members of the U.S. Congress have intensified in recent weeks, as the Republican and Democratic parties continue attempting to forge an agreement that will raise the U.S. debt ceiling. If legislators cannot reach an agreement, there is potential for significant disruption of the financial markets and the global economy.

What is the Debt Ceiling and Why is it Important?

Simply put, the debt ceiling is the maximum amount of money the federal government is authorized to borrow. Once the debt limit is reached, there will not be enough money available to pay the nation's bills. If payments are missed, the United States will default on its debt obligations.

The Current Ceiling: \$14,300,000,000,000.00.

Can the U.S. government default on its debt? The knee-jerk response is, "no." The logic is that, at present, the United States is the world's only superpower. The dollar is the global reserve currency. U.S. government debt is bought and sold globally, and has the confidence of investors because it is backed by the full faith and credit of the United States.

The more realistic response is, "maybe." The possibility of a default is certainly real. After all, we've been there before—the United States has defaulted in the past. The default, which occurred in the spring of 1979, was in the form of missed Treasury bill payments. Since the dollar amount of the missed payments was relatively small and corrected swiftly, not everyone may view this as having been a default. However, a missed payment is a missed payment. The scenario in 1979 is similar to what is happening today with Treasury bills set to mature on August 4. Adding to the uncertainty, the Bipartisan Policy Center reports that the government will not be able to honor all of its monthly payments (which equates to roughly 80 million bills) scheduled to be paid on August 3. This includes Social Security payments, pension obligations and military pay. Although the missed payments in 1979 were looked at as only minor disruptions, the takeaway is that a delay of payment is possible.

AAA-Rating in Jeopardy

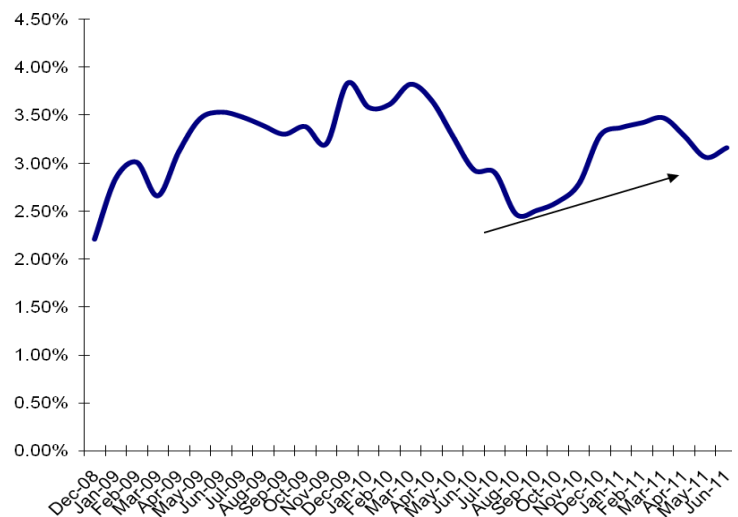
There are downstream ramifications beyond the possibility of missed payments. Earlier this summer, Standard and Poors' (credit rating agency) downgraded its credit outlook on the United States to "negative." S&P also stated that

missed payments on August 4 would cause a rating change to "selective default" with a "D" rating on maturing Treasury bills. Any type of default or missed payment would likely increase U.S. borrowing costs significantly. It would also pose challenges for investors seeking the relative security of AAA-rated government bonds and for the reputation of the United States. The other major rating agencies, including Moody's Investors Service and Fitch, commented that they would likely take action on U.S. debt if the government is unable to raise the debt ceiling in time to avoid missed payments.

Market Expectation

To date, markets expect the government will come to an agreement to raise the debt ceiling prior to August 2 – the targeted date at which the nation will reach the \$14.3 trillion debt limit. At the time of this writing, investors' demand for U.S. Treasuries remains strong and trading continues without significant disruption, as shown in Exhibit 1, while the U.S. economy works its way through the current economic soft patch and increased concern over the default of certain European countries sovereign debt. There is no question that the treasury market may sell off if payments are missed, pushing borrowing costs higher. We also expect to see a re-pricing of riskier assets that may direct money into the treasury market, helping to offset the negative pressures.

Exhibit 1: Yields Remain Range



Source: Bloomberg data, SEI

Conclusion

SEI's Investment Strategies Group and SEI Fixed Income Portfolio Management¹ share the opinion that failure to raise the debt ceiling prior to the deadline would likely have a significant, negative impact on the global economy, raising the potential of sliding back into recession.

Due to the severe consequences of late or no action by Congress, we believe an agreement will be reached by the prescribed deadline. While it would not be prudent to discount the possibility of default, we view the potential for such a scenario as being low. It is clearly in the best interests of the U.S. government to take all necessary measures to avoid missed payments or default due to the inability to raise the debt ceiling. Based on our current outlook, SEI's portfolio managers do not view the debt ceiling debate as a reason to alter our portfolio positioning. We, along with the rest of the world, will watch and wait for Congress to do the right thing.

¹ SEI's Investment Strategies Group is the umbrella group representing SEI's equity, fixed-income and alternative investment mutual funds. SEI Fixed Income Portfolio Management, under the direction of Portfolio Manager Sean Simko, manages fixed income portfolios in SEI's Managed Account Program.

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