Trustmark Investment Advisors, Inc.

**SPECIAL MARKET COMMENTARY**
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# Debt Ceiling & The Government Shutdown 2013

The situation in Washington surrounding the government shutdown and the debate on the debt ceiling is a fluid situation which changes daily.

### How did we get to this point?

The current impasse dates back to the passage of the Budget Control Act of 2011, which coincidentally was the last time the topic of the debt ceiling made headlines. After much haggling in Washington, the bill ultimately raised the debt ceiling and at the same time established a bipartisan “super committee” which was charged with coming up with deficit reducing measures. In the end, the “super committee” could not come up with a plan and as a result, automatic spending cuts and a tax increase in the form of the expiration of the Bush Tax Cuts went into effect.

The passage of the Budget Control Act kicked the can until the end of the current governmental fiscal year, which ended September 30 and marked the beginning of the current shutdown.

### When will the debt ceiling limit be reached?

On May 19, we technically reached the maximum amount of money the U.S. can borrow back. The Treasury Department has been using "extraordinary measures" since then to keep the government operating. By October 17, the Treasury will have run out of "extraordinary measures." Treasury Secretary Jack Lew said in a September 25 letter to Congress that "at October 17, Treasury would have only approximately $30 billion to meet the country's commitments. This amount would be far short of net expenditures on certain days, which can be as high as $60 billion."

### What happens when October 17 arrives?

On that day, the federal government will only bring in enough tax revenue to pay about 68 percent of its bills for the coming month, according to analysis by the Bipartisan Policy Center. A default wouldn't necessarily happen on October 17, but likely soon thereafter. By most estimates, there would be enough cash available into November to pay for mandatory items such as Social Security payments, disability benefits, Medicare payments, military and retiree pay.

### Does it matter if the government misses a few bills?

Yes. The financial markets could be really unforgiving. A missed payment on U.S. debt could have significant ripple effects, as the global financial markets are structured around the notion that U.S. Treasuries are one of the safest assets in the world. The risk of uncertainty is currently only appearing in the pricing of US Treasuries maturing in October and November, signaling that the market expects the issue to be resolved, but there is near term uncertainty and a risk premium being assigned to it.

The current debate is not one of the U.S.’s ability to pay, but rather its willingness to pay.

### What are the economic consequences of breaching the debt ceiling?

It could result in massive fiscal austerity, putting a big dent in economic growth. A default would almost certainly create big disruptions in the financial markets. If austerity comes into play, Goldman Sachs has estimated the spending cuts would come to about 4.2 percent of GDP, much more economic affect than either the sequestration budget cuts or the furloughs caused by the government shutdown. The Treasury Department issued a statement on what the financial market effects of missing a debt payment saying "Credit markets could freeze, the value of the dollar could plummet, U.S. interest rates could skyrocket, the negative spillovers could reverberate around the world, and there might be a financial crisis and recession that could echo the events of 2008 or worse."

Standard & Poors has estimated that for each week that the Government is shut down, the impact on GDP is approximately .3%, so if the debt ceiling and government funding debate stretches out longer, the possibility increases of having a negative quarterly GDP.

### Has the U.S. ever defaulted on its debt before?

In 1979, there was a similar congressional stalemate on raising the debt ceiling. It was resolved at the last minute but due to unexpectedly high demand on Treasury bills and an error in word-processing equipment, the government missed a timely payment on about $122 million in Treasury bills, which equated to less than 1% of U.S. debt at that time. The error was quickly corrected but the damage was done. A 1989 study in the Financial Review estimated that the incident raised the nations' borrowing costs by about 0.6 percent, or $12 billion. That was after a brief, accidental default that was quickly corrected. A debt-ceiling breach today would almost certainly have more far reaching consequences.

### What about the stock market?

During the 2011 debate, the S&P 500 experienced a peak-to-trough decline of almost 18%. This time, the decline has thus far been about 2%. According to Ned Davis Research, there have been 17 government shutdowns since the mid-1970s. On average stocks experience modest downward pressure in the days before, during, and immediately after a shutdown, but tend to rebound beginning 10 days after the government reopens.

### What is the most likely outcome?

In our opinion, congress will again wait until the $11^{th}$ hour to pass a bill to raise the debt limit, with each side (Democrats and Republicans) trying to use the crisis as an opportunity to score political points and gain an advantage. The longer they wait, the more the potential for market disruption increases.

Sources: Bloomberg, Factset, Standard & Poors, T. Rowe Price: *Price Points,* October 2013

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