

Bond Market Perspectives



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Differentiating the Debt Ceiling and Federal Spending

Anthony Valeri, CFA

Market Strategist
LPL Financial

Highlights

Federal spending and the debt ceiling are separate issues but may get blurred together again this week.

Failure to raise the debt ceiling does not automatically imply a default on U.S. Treasuries.

Although we view debt ceiling-related risks as very low, it is another reason to consider a light allocation to Treasuries.

Debt Ceiling

The Debt Ceiling is the statutory limit on the dollar amount of U.S. federal debt outstanding and currently stands at \$14.3 trillion. U.S. federal debt consists of both marketable debt, such as Treasury bills, notes, and bonds issued to investors, and non-marketable debt, which consists of a variety of instruments including Treasury debt issued to government trust funds such as Social Security. The debt ceiling has been raised 78 times since 1941, most recently in February 2010.

The distinction between federal government spending and the debt ceiling may get confused once again this week as Congress works on another short-term spending resolution. Following a two-week resolution expiring March 18, 2011 that avoided a government shutdown, Congress is expected to agree on a three-week resolution this week. However, the debt ceiling is a separate issue that is not likely to be addressed until a longer-term federal spending solution is negotiated or, more likely, when the debt ceiling limit is reached between mid-May and mid-July. There are many misconceptions about federal spending, the debt ceiling, and the potential impact to U.S. Treasuries, but armed with knowledge we believe investors can make the right investment decisions.

A government shutdown by itself does not impact timely payment of principal and interest on U.S. Treasuries. Payment of Treasury obligations is a top priority and existing revenues are directed to service debt obligations even if it means delaying other Federal spending. State municipal bond obligations provide a precedent. For example, the state of California has failed to pass a budget on time the past two years. However, bond payments were made without incident. In 2009, the state of California went as far as issuing IOUs while still directing available cash to debt service. The U.S. Treasury could take a similar tack and redirect cash as necessary in order to maintain timely debt service.

Failure to raise the debt ceiling does not automatically imply a default on U.S. Treasuries. A default would arise from the inability to repay interest or principal to holders of U.S. Treasuries. However, the Treasury receives income from a variety of sources and interest payments consume only a small portion of Treasury revenues. Therefore, even in the absence of a debt ceiling increase, the Treasury can continue timely payment of bond interest. Payment of maturing bonds is more involved but the Treasury can still issue new debt to pay off maturing debt as long as the dollar amount of new debt does not exceed that of the maturing debt and the overall debt level is not increased. This latter scenario requires that investors maintain confidence in the U.S. government's ability to service its debt and sell new debt, a risk, but a manageable one if investors view the disruption as short-term.

Making Room

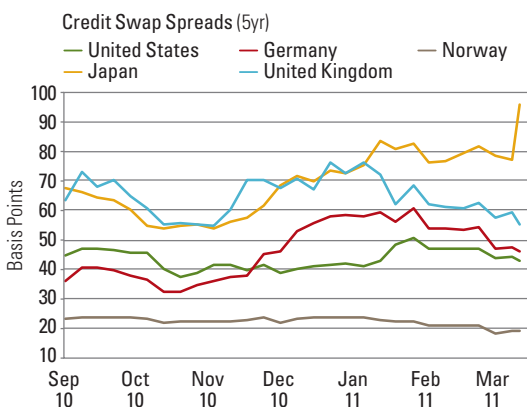
The Treasury department can take proactive steps to delay bumping up against the debt ceiling. The Treasury can defer payments to non-marketable



The Treasury department has several tools at its disposal to buy time and delay hitting the debt ceiling even as politicians squabble.

debt (see sidebar) in order to direct available cash to make interest payments to Treasury bonds held by investors in the marketplace. In 2011, the Treasury has already begun to wind down a special T-bill issuance program, known as the Supplementary Finance Program (SFP), in order to delay hitting the debt ceiling. Issuance of State and Local Government Securities (SLGS) may be suspended and is typically one of the first options employed by the Treasury. SLGS are used by municipalities that have excess proceeds and wish to redeem bond maturities before maturity date. The tactics used can get very detailed but, for bond investors, the main point is that the Treasury department has several tools at its disposal to buy time and delay hitting the debt ceiling even as politicians squabble. We believe the debt ceiling may be reached anywhere from mid-May through mid-July depending on what tactics the Treasury pursues.

1 Market-Based Measures of U.S. Creditworthiness Have Been Stable



Source: CMA, Bloomberg, LPL Financial 03/08/11

Delays over approving the federal budget and over raising the debt ceiling have not impacted the bond market so far in 2011.

History

Under the Clinton administration the government shut down over select days in late 1995 and early 1996 as a Republican-led Congress argued for greater spending cuts before agreeing to approve a new budget, a similar situation to now. Furthermore, like today, the Treasury was simultaneously approaching the debt ceiling. In 1996 Republicans used the debt ceiling limit as a bargaining chip to obtain spending cuts from the President, a situation that may very well repeat itself in coming weeks and months. The delay in raising the debt ceiling back then prompted Moody's to put \$387 billion in Treasury debt on credit watch negative for a possible downgrade. It is important to note that Moody's did not place the AAA rating of all Treasuries on watch for a downgrade but just those that would have been adversely affected over a 90-day period due to the potential inability of Congress to raise the debt ceiling.

In 1996, there was no bond market impact from Moody's threat or delays to either raising the debt ceiling or approving a federal budget. Treasury prices increased and yields declined for much of 1995 and prices held relatively steady from December 1995 through the middle of February 1996. Bond investors saw through the political wrangling and kept calm despite the rhetoric. Ultimately, Moody's warning coupled with President Clinton's threat to delay social security checks (so that available cash was used to maintain timely payment of treasury obligations) sparked negotiation on both the budget and the debt ceiling.

Delays over approving the federal budget and over raising the debt ceiling have not impacted the bond market so far in 2011. Similar to the period in late 1995-early 1996, the bond market correctly, in our opinion, views any disruption to Treasury payments as highly unlikely. Treasury prices have increased over the past month on flight-to-safety related buying despite the possibility of a government shutdown or the inability to increase the debt ceiling. In addition, the cost to insure against a default on Treasuries remains very low [Chart 1] as measured by credit default swap (CDS) spreads. CDS are an excellent gauge of perceived credit quality risks in the marketplace.



The debt ceiling is of greater importance for bond investors. A government shutdown could lead to safe-haven buying as bond investors may view any spending disruptions as anti-growth. Meanwhile, the debt ceiling issue can more directly impact Treasury securities.

Risks

Unlike 1996, the stakes are much higher now: sovereign credit risk is at the forefront of investors' concerns, outstanding Treasury debt is much larger relative to the size of the economy, and foreign investors own a much larger share of the Treasury market. A delay in raising the debt ceiling and forcing the Treasury to undertake tactics such as withholding payments to trust funds or suspending state and local government issuance (SLGS) may undermine investor confidence in U.S. Treasuries. Whether ultimately realized or not, Treasury bond fears could ripple across the high-quality bond market.

Although we view debt ceiling-related risks as very low, it is another reason to consider reduced allocation to high-quality bonds. We believe safe-haven buying resulting from Middle East turmoil and, most recently, from uncertainty over the ramifications of the earthquake in Japan, may wane. A highly charged political debate and long delays are not what a Treasury investor needs.

IMPORTANT DISCLOSURES

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

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