Perspective on U.S. Fiscal Situation

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Political brinkmanship is expected but U.S. default is unlikely.

In case anyone thought America's massive deficit did not have implications for investors, the stock market drop in the wake of Standard & Poor's decision on April 18 to reduce its outlook on the credit quality of the United States might give them pause. The unexpected move by Standard & Poor's this week overshadowed the 2011 fiscal budget deal recently passed by Congress. However, the fiscal-budget actions to address the deficit so far have not been meaningful: the recent budget deal between Congress and President Obama cut nearly $40 billion in spending, but reduced the burgeoning federal deficit by only a small fraction.

The political debate in the public arena now appears to have shifted toward not only whether to raise the Treasury's statutory borrowing limit, but perhaps more importantly, how to solve the unsustainable trajectory of the U.S. deficit. During the next few months, market participants can expect much political wrangling and brinkmanship over the U.S. fiscal situation. While a U.S. default is unlikely, the heightened attention to fiscal matters could ultimately lead to some much-needed long-term reforms.

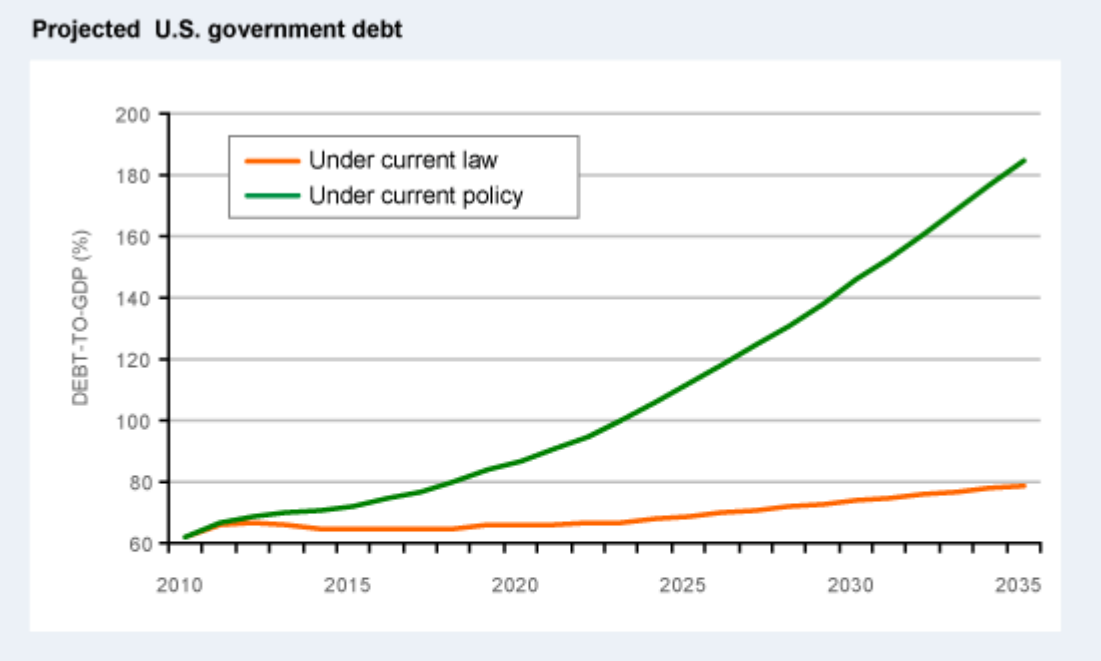
Key Takeaways

- If the current political debate over whether to raise the U.S. government's outstanding debt limit forces officials to address much-needed structural reforms that help rein-in the burgeoning U.S. fiscal deficit, it could be a positive development for financial markets.
- The recent move by Standard & Poor's to revise the long-term credit outlook of the United States to "negative" raises the level of urgency in addressing the nation's fiscal situation.
- At the current pace of federal spending, the U.S. Treasury could reach its statutory debt ceiling within a few months.
- Congress must vote to raise the debt limit to avoid a potential U.S. sovereign default, but a default is very unlikely, in large part because politicians recognize that it could trigger a major global financial market crisis.
- The ongoing political debate and uncertainty over the U.S. debt ceiling could provoke greater near-term volatility in Treasury bonds and other financial markets.

Unsustainable fiscal path

The federal government has been running a fiscal deficit since 2001, the last time the nation's fiscal budget was balanced. Since then, federal debt has risen to 62% of gross domestic product (the value of all goods and services produced in the economy) from 33%. In short, the government has been spending more than it has been receiving in revenues, forcing it to borrow large amounts each year to make up for the deficits.

Under current policy, federal spending is projected to continue increasing faster than revenues throughout the next decade, causing deficits and outstanding debt levels to soar (see chart below). More specifically, the nation's debt is expected to rise to about 90% of GDP in 2020. Longer term, the situation could get even worse. In 2025, the government's total revenue would only cover Medicare, Medicaid, Social Security, and the cost of interest payments on its debt, leaving every other government expense–such as military spending, transportation and homeland security–to be paid for with borrowed funds if new policy measures aren't enacted.[1]



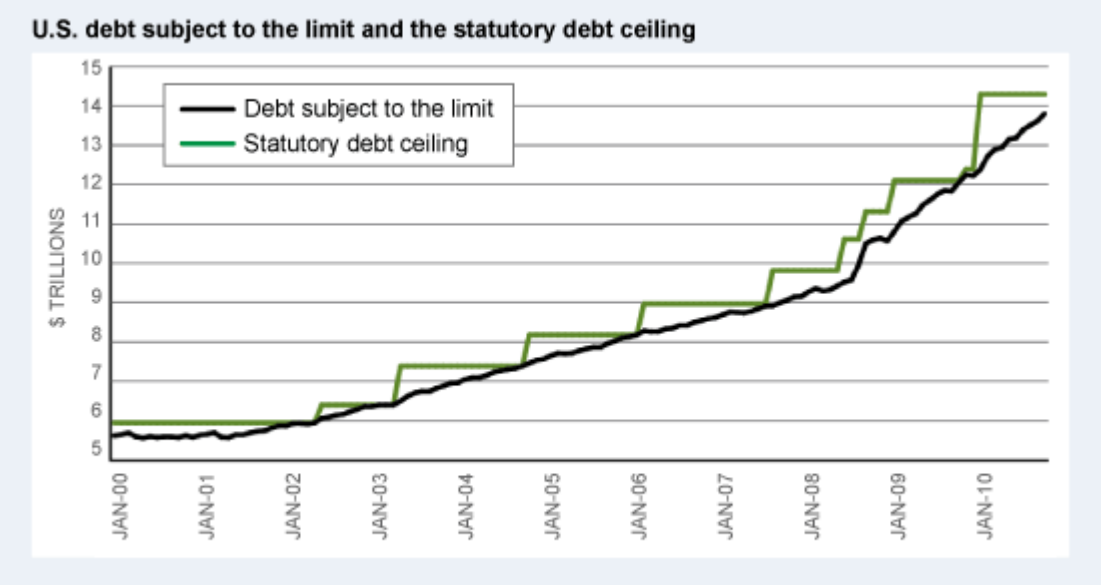
The under current law scenario adheres most closely to current law. It follows the CBO's March 2010 baseline budget projections (adjusted for the effects of recently enacted health care legislation) for the next decade and then extends the baseline concept beyond that 10-year window. The under current policy scenario embodies several possible changes to current law that are likely to happen, continuing certain tax and spending policies that people have grown accustomed to (because the policies are in place now or have been in place recently). For example, some of the changes assumed in the scenario—such as the renewal of the 2001/2003 tax cuts on income or those related to the Alternative Minimum Tax, and Medicare's payments to physicians—have regularly been enacted in the past.

Source: Congressional Budget Office (CBO), FMRC0. (MARE) as of 8/31/10.

In the April 18 report that reduced its outlook on the long-term credit quality of the United States to "negative," S&P noted, "There is a material risk that U.S. policymakers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013...which would...render the U.S. fiscal profile meaningfully weaker."

Short-term options to increase the Treasury's borrowing capacity

In recent weeks, some politicians have focused on whether to raise the federal debt limit. The U.S. Treasury projects it will reach its maximum debt ceiling of $14.3 trillion on May 16 unless Congress votes to raise it before then (see chart below). The U.S. government's debt limit is the total amount of outstanding debt obligations, and any change in the limit requires a vote by Congress. The debt limit was last increased by $1.9 trillion to $14.3 trillion in February 2010.



Source: U.S. Department of Treasury

If Congress fails to vote to raise the debt ceiling by May 16, the U.S. Treasury has some short-term options at its disposal to temporarily increase its borrowing capacity, thereby postponing the date at which the debt ceiling would be reached. Short-term measures that are permitted by statute would involve accessing inter-governmental sources of liquidity and asset dispositions. For example, the government could choose to cease the issuance of short-term (i.e., daily maturity) Treasury securities provided to federal employees in a government fund (G-Fund) as part of its retirement plan (Thrift Savings Plan), thereby freeing up roughly $125 billion in borrowing capacity. Similarly, the federal government has the ability to cease issuing debt of other non-marketable, short-term securities in other funds, such as the Exchange Stabilization Fund and the Civil Service Retirement and Disability Fund, to boost its borrowing capacity.[2]

In total, these “extraordinary” tools could provide the Treasury with $165 billion to $195 billion in additional borrowing capacity (See chart below). Given the availability of these measures, a more important date for investors to focus on is July 8, 2011. Secretary of the Treasury Timothy Geithner has stated that all of the tools at the Treasury’s disposal will be exhausted and the U.S. government will no longer be able to borrow beyond this date, but even this date is only an estimate and could be off by more than a week depending on many factors, including higher-than-expected tax collections or lower-than-expected expenditures in the interim period.[3]

Extraordinary Treasury tools to increase borrowing capacity

TOOL	POTENTIAL BORROWING
Thrift Saving Plan G-Fund	$125 billion
Civil Service Retirement and Disability Fund	$20–$50 billion
Exchange Stabilization Fund	$20 billion
Potential additional borrowing capacity	**$165–$195 billion**

Source: Pyramis Global Advisors

What if the U.S. debt ceiling is not raised?

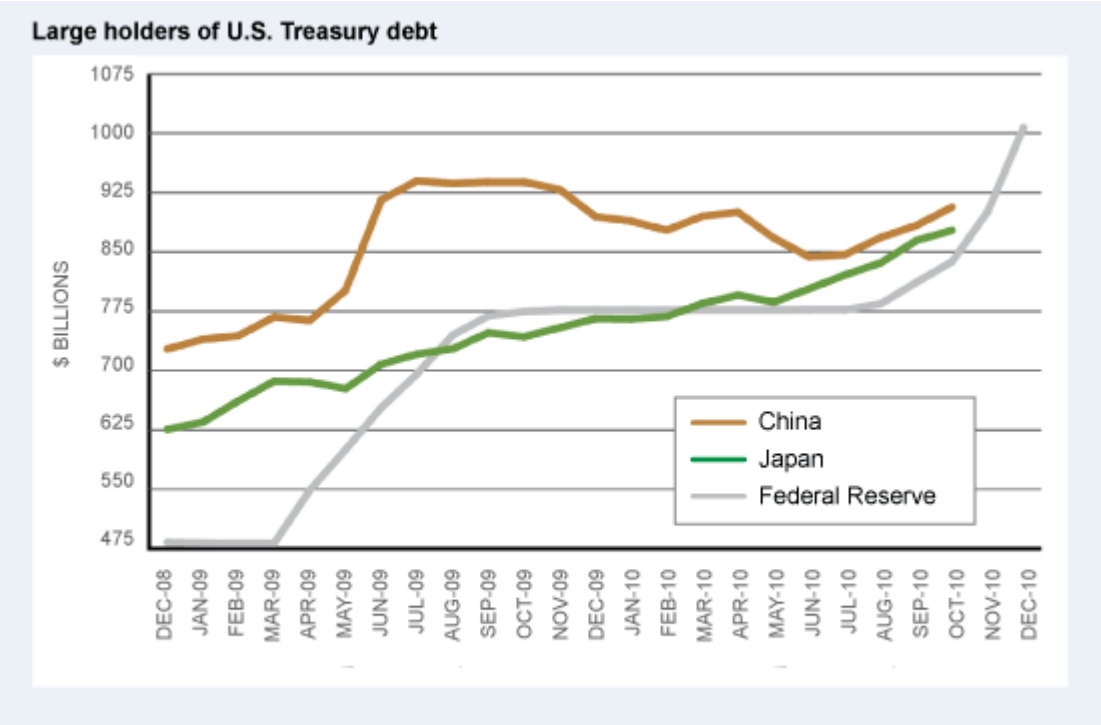
If all of Treasury's cash balances are drawn and all the extraordinary measures have been exhausted, the Treasury would be at the limit of the debt ceiling. Such an outcome has not occurred in the modern era and it remains uncertain as to exactly what developments would transpire next. However, if Congress still had not raised the debt ceiling, the U.S. government would have to operate on a cash-flow basis, meaning that outflows (including interest payments on existing Treasury debt) would have to be funded by inflows (i.e., tax receipts and fees). Operating in this manner would require prioritization of payments, which could have several negative implications. For one, this prioritization would place some counterparties in a subordinate position, which could spook the markets. Also, the rating agencies would most likely place the sovereign rating of the United States under review and would potentially lower the ratings, if a debt ceiling increase was not enacted. Furthermore, critical functions to operate the government, including spending

for military, Social Security and other programs, would likely be interrupted, pressuring economic activity. Finally, the timing of tax collections is always uncertain, creating the potential for an inadvertent missed interest payment.

Avoiding financial market turmoil

As the political debate in Washington persists over raising the debt ceiling, the level of uncertainty in various financial markets is likely to build. Administration officials often work behind the scenes to stress the importance of raising the limit relatively quickly and without fanfare. This approach helps to limit financial market uncertainty surrounding the debt ceiling extension, minimizing the potential for government borrowing costs to increase amid a debt-ceiling debate, and limiting the fears of investors. However, it is not uncommon for this issue to turn into a prolonged political debate.

Based on historical observations of the behavior of foreign investors, the longer Congress takes to come to a vote regarding the debt ceiling, the more nervous foreign creditors are likely to become regarding the Treasury's ability to service its debt. Foreign governments are large holders of U.S. debt. At the end of 2010, China held $906 billion and Japan held $877 billion in U.S. Treasuries, the two largest owners of U.S. debt behind the Federal Reserve ($1,007 billion)[4]–see chart below. Some foreign investors may stop participating in Treasury auctions or begin selling existing Treasury securities. Interest rates in the United States could gradually begin to rise, and the U.S. dollar may fall in value vs. other currencies if market participants increasingly incorporate the potential for default in their forecasts. These outcomes would significantly pressure economic activity.



Source: U.S. Department of Treasury

Former leaders from the Treasury of both major political parties have made it abundantly clear that dealing with the debt ceiling in a political manner could have an adverse impact on financial markets. For example, in September 1995, former Secretary Robert Rubin urged Congress to extend the debt limit because even the perception that the government would default on its debts “would roil the financial markets and cause severe economic problems.”[5] Amid debate about raising the debt limit in 2002,Treasury Secretary Paul O’Neill said, “If we run into the ceiling that’s a really bad thing...it casts a shadow on the good faith and credit of the United States.” More recently, on April 11 former Obama Administration chief economic advisor Larry Summers said that he found it “close to inconceivable that elected (U.S.) policymakers would allow the risk of default.”[6]

Possible implications of a default

In the event of an actual default, the U.S. dollar could lose significant value relative to other major currencies, and it is very likely that interest rates in the United States would rise sharply. Credit markets globally would face severe repercussions given that the "riskfree" benchmark would no longer be "risk free." Losing the risk-free asset would complicate security valuation more broadly because the risk-free asset establishes a baseline for evaluating other securities that are not risk free. Equity markets would likely experience significant declines as investor confidence

would be severely shaken. It also would not be surprising to see gold and commodities have significant rallies as investors hoarded "real" assets. In short, the financial markets might never look the same again. So far, the impact of the delay and uncertainty in raising the federal debt limit on the financial markets has been limited, though money markets have seen reduced supply of short-term debt and falling yields in an already low-yield climate.

While investors may be rightfully concerned about the implications of an actual default, it is worth noting that there have been periods in recent history when the issue of raising the debt ceiling has come to the forefront of political debate and resulted in maneuvering by the Treasury to stay within its statutory borrowing limit, yet the financial markets have remained stable. Focusing solely on whether to raise the debt ceiling may allow the U.S. government to meet its debt obligations and avoid the disastrous implications that a sovereign default would have on financial markets, but it also ignores the ongoing issue of running sizable budget deficits.

Outlook for financial markets

Political brinkmanship may delay the vote to increase the debt ceiling and provoke higher near-term volatility in the financial markets over the next few months. However, given the potentially disastrous implications for global financial markets, we think it is highly unlikely that Congress will allow the U.S. government to fall into default. Just as an agreement for the 2011 fiscal year budget occurred in the final hours to avoid a government shutdown, we think a bipartisan group in Congress will likely come to the conclusion that it is in their best interest to raise the Treasury's debt ceiling.

In the medium-term, a renewed focus on deficit-reduction efforts—even if they are accompanied by noisy and sometimes acrimonious political debate–may ultimately be perceived by financial markets as an increasingly serious determination to deal with the U.S. fiscal budget problems. Without question, meaningful policy changes are needed to ensure a stable fiscal future for the United States. An effort by politicians to focus on and implement structural reforms that provide a long–term solution to reducing the U.S. deficit–rather than solely on whether or not to raise the debt ceiling–may have a positive impact on financial markets over time, and could ultimately alleviate growing concerns about the sustainability of the U.S. fiscal position.

(This analysis contains insight from the following members of Fidelity Management & Research Co.: Christine Thompson, Chief Investment Officer, Fixed Income.; Bill Irving, Portfolio Manager, Fixed Income; Bob Litterst, Portfolio Manager, Money Markets; Lisa Emsbo-Mattingly, Director of Research, Global Asset Allocation.)

Asset allocation does not ensure a profit or guarantee against loss.

1. Congressional Budget Office report, 8/31/10.

2. Monthly Statement of the Public Debt of the United States, Table III – Detail of Treasury Securities Outstanding, Thrift Savings Fund, Federal Retirement Thrift Investment Board, p.8, Department of the Treasury, November 30, 2010.

3. Source: The Washington Times, April 4, 2011.

4. Rubin Urges Congress to Raise Debt Ceiling Budget: Default Is 'Unthinkable,' Jack Nelson, Los Angeles Times, September 08, 1995.

5. Source of Larry Summers quote: Financial Times, New Economic Thinking, Bretton Woods Conference, April 8, 2011. Source of Paul O'Neill quote: Capital Hill Club, Reuters, May 8, 2002.

6. Source of Larry Summers quote: Financial Times, New Economic Thinking, Bretton Woods Conference, April 8, 2011. Source of Paul O'Neill quote: Capital Hill Club, Reuters, May 8, 2002.

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