Debt Ceiling Scenario Analysis

July 21, 2011

Principal Global Investors Economic Committee is providing three scenarios relating to the current Debt Ceiling debate. The scenarios include a baseline forecast, upside risk and downside risk. For each scenario, the Committee outlines some key implications.

Baseline: 40% "Just Enough to Get By"

As pressure grows on both Congress and the Administration, a last-minute deal is struck which goes a bit beyond Sen. McConnell's original proposal of non-binding, recommended spending cuts to include a watered down deficit reduction package. Although the package comes in at the lower end of the ~$1.7 to $4 trillion range, the agreement offers hope for more meaningful actions in the future (perhaps including a spending cap or balanced budget amendment) and so is just enough to avoid downgrades by the rating agencies.

Implications:

- This scenario, given it still involves significant spending cuts, would likely be seen positively by markets, especially since it would be facilitated by continuation of the AAA rating.
- Even if the markets and rating agencies conclude that this outcome essentially represents another episode of "kicking the can down the road", with any real structural changes deferred until after the 2012 elections, immediate volatility is likely to be muted despite continued policy risk. The economy is likely to stay in a 2-3% real growth trajectory throughout 2011 and 2012.
- All eyes will then be on how the 2012 elections are shaping up and how the budget debt and deficit issues are addressed by political candidates.

Downside risk: 30% "No Turning Back"

There are two variations of the downside scenario.
a) In the first downside scenario (20% probability), even with passage of a watered down deficit package as described above there is little confidence that the government has the willingness to address longer term debt and deficit reduction issues and as a result one or more rating agencies lower the federal government credit rating. Indeed, this scenario would actually be consistent with recent statements by the rating agencies.
b) In this second downside scenario (10% probability), despite enormous pressure as the August 2 deadline approaches the partisan divide proves just too deep. No agreement is reached and the debt ceiling is hit. Congress and the Administration are then faced with servicing the debt by prioritizing other obligations to avoid missing coupon payments. There are dramatic short and long-term negative impacts on the economy,

including increased risk of another recession and possibly even freezing markets again, with the Government in a much weaker position to provide additional stimulus.

Implications:

- Implications of scenario a) are likely not too severe. In a sense AA becomes the new AAA, and most credit ratings of US-domiciled entities become de facto capped at AA as a consequence. This would raise the cost of capital and weaken the dollar, since those investors wanting AAA would switch to German, Swiss and British paper. Markets would be unsettled, but unlikely to suffer major disruption.
- In terms of what that "unsettling" might involve, there would likely be an initial market kneejerk reaction reflecting concerns about elevated systemic risk of the US losing its AAA rating that increase market volatility and causes asset prices to fall broadly (ex-gold or other precious metals), including Treasury bonds and stocks. However once that initial reaction has passed, it is likely that systemic risks would fade and the market would return to a focus on idiosyncratic risks.
- Implications of scenario b) would likely be much more severe, especially over the near to intermediate term. In the event that the debt ceiling is not raised, the government will need to make a decision as to which current liabilities to prioritize. It is likely those priorities would include interest payments on Treasury bonds, Medicare, Social Security, and essential defense services. Adequate tax revenues exist to fully cover these areas. For other spending sectors that are not covered by tax receipts (representing about 40 – 45% of total spending), the government would either issue IOU's or be forced to curtail spending, essentially a form of forced austerity. While government austerity would likely be well perceived by the markets over the longer term, this form of immediate forced austerity probably would not be. Instead, such a sudden and disorganized form of austerity would not only create a direct and immediate drag on GDP growth, it would also likely create market confusion and additional volatility, because it would further reinforce the issue of policy uncertainty and policy error as a heightened risk issue.
- As such, an economy that is already struggling to move beyond its soft patch would be burdened with an immediate additional drag on growth, possibly leading to a double dip recession. In addition, the global media coverage in the aftermath of the failure to raise the debt ceiling would, along with likely falls in asset prices that significantly disaffect the wealth effect, badly rattle the consumer market and could lead to a decline in consumer spending. Further, businesses would likely become even more reluctant to engage in meaningful expansion and hiring initiatives, leading to an entrenched soft patch or possibly even an actual economic contraction.
- The degree and duration of immediate downward pressure on asset prices and increases in volatility (especially if the level of severity relative to the VIX index were to match the spikes during late 2008 and mid 2010) might then force the government to respond with a more definitive deficit reduction plan more to the liking of the market and the rating agencies.
- Ironically, scenario b) could cause Treasury rates to move lower because of heightened fear of a recession and a sharp move toward risk aversion (especially since Treasury bonds would still be kept current, given their prioritization by the government). However, it is also likely that credit spreads would widen.

Upside risk: 30% "Enter the Gang of Six"

Using the proposal advanced by the Gang of Six as a framework, Congress and the Administration are able to reach agreement on a significant deficit reduction package. The package balances near-term economic

considerations with long-term entitlement cuts/tax increases. While there is not time to actually finalize and pass the package before August 2, the fact there is agreement in principle generates sufficient bi-partisan support to get a debt ceiling increase through both houses. The rating agencies also defer any downgrade actions on that basis.

Implications:

- This would be very positive for markets. Depending upon whether the framework is considered by the private sector (both businesses and households) to permanently remove a considerable amount of current policy uncertainty and does not involve material tax hikes, it could serve as a reasonably strong boost to the economic outlook for 2012. That would come primarily from businesses that increasingly may be willing to deploy large cash reserves into expansion initiatives, if they conclude that the debt and deficit reduction proposal is a serious and workable solution.
- Treasury rates move 25bp higher with the risk-on trade coming back in vogue.

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