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UBS first take

Debt ceiling crisis: flirting with a downgrade

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- We continue to expect a budget agreement and an increase in the debt ceiling, although it is increasingly likely this will occur after the current deadline of 2 August. We are heading into uncharted territory, so predicting political and market outcomes is difficult.
- We see a material chance that the US will be downgraded to AA this week, and if the budget that Congress ultimately passes does not include sufficient cuts, the chances are high that at least S&P will move the US to AA in the next several months.
- While initial reaction to a downgrade may be dramatic, we do not expect it will be as much of a watershed moment as many have predicted. We address potential market reactions for Treasuries, munis, equities, the dollar and gold.

Our original assessment published on 13 July was that the outcome of the debt ceiling debate will be a package of approximately USD 2.5 trillion of deficit reduction over the next 10 years. This remains our base case. However, the possibility of a larger package (USD 4 trillion) and the inclusion of any revenue component has faded. While the US may escape the worst-case default outcome, the risk of a near-term downgrade has increased significantly in the past week.

To date, the White House and Congressional leaders have yet to identify a path forward on a measure that could gain sufficient support to pass both the House and Senate and be signed by the President. It is unclear whether the short-term debt extension plan unveiled by Speaker of the House John Boehner earlier this week has sufficient Republican support to gain passage, and it already has been rejected by Senate Majority Leader Reid and the White House in any event. It will only come to a vote on Thursday, meaning that little will likely happen before then. A competing USD 2.5 trillion "cuts-only" measure sponsored by Reid also has uncertain prospects, but may emerge as "the last idea standing," especially if the Boehner bill cannot pass the House. Negotiations continue behind the scenes among many parties, so a third proposal may be added to the mix, but we do not view that as likely over the next few days.

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Although the outlines of a potential deal may take form by week's end, the likelihood that the timelines slip past the 2 August deadline are increasing, pushing us further into uncharted territory in terms of potential prioritization of payments and other emergency measures to avoid a default. Because of this uncertain path, we continue to assess the risk of default at 10%, consistent with the 13 July scenario.

Downgrade to AA likely, but timing uncertain

We are now close enough to Treasury's deadline of 2 August that there is insufficient time to craft comprehensive legislation for an aggressive budget-cutting deal. As the political quagmire continues, we perceive that S&P's suggestion of a downgrade this week could materialize.

Even if the debt ceiling negotiations conclude successfully and the ceiling is raised, if the planned cuts are not large enough for the rating agencies, we anticipate that they would lower the credit rating into the AA range. We expect that anything less than USD 4 trillion in cuts is likely to worry these agencies. S&P has taken a somewhat more aggressive approach than Moody's, stating that there is at least a 50% probability of a downgrade within the next 90 days.

Manageable bond market impact

Because a downgrade is not priced in, we believe Treasury yields could rise by approximately 25bps on the news, with shorter-maturity bonds widening less but longer-maturity bonds widening more. We do not anticipate a sharp sell-off for several reasons, but we emphasize that this is uncharted territory. While other countries have lost their AAA rating in the past, they have not played the same international role as the US does with the dollar and Treasuries, nor have they generally depended as much on foreign financing. However, the implications are likely contained as a AA rating, while not "risk free," still denotes a high-quality asset. Second, no other bond market in the world has the size and liquidity of the Treasury market. Because the US would remain the largest and most liquid bond market in the world, and in the upper tier of the credit spectrum, we believe most investors who own Treasuries will maintain positions because there are no similar investment substitutes. Finally, we believe a sell-off would be tempered as buyers step in to pick up Treasury securities at cheaper levels, putting a floor under Treasury prices.

The ramifications of a downgrade to the AA category would not be limited to the Treasury market. The credit rating of agency securities would move in lock-step with Treasuries. As a result, Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the Federal Farm Credit Banks would likely carry a

AA rating as well. Within the agency market, we could see a differentiation in yields between Fannie Mae and Freddie Mac, which are reliant on cash infusions from Treasury, compared with the Federal Home Loan Banks and the Federal Farm Credit Banks, which are in better shape from a credit perspective. The ratings of certain large US banks and insurance companies could potentially be affected. However, S&P has stated that any ratings downgrades to US banks and broker dealers would not be a direct result of a lower US sovereign rating, but would rather come from any indirect impact on the company's liquidity or funding profile. Finally, we expect spreads in the corporate bond market would tighten versus Treasuries because of the compression in credit quality between the two sectors.

Implications for municipal bonds

Although the debate in Washington has overshadowed other credit developments in the state and local government sector, munis thus far have not demonstrated an unusual amount of volatility. Rating agency warnings regarding the knock-on effects of a sovereign rating revision have been greeted with some anxiety but pricing has not yet changed materially. That said, the protracted political stalemate has focused more attention among credit analysts on the repercussions on municipals should a sovereign rating downgrade occur.

We believe the implications will vary depending upon the individual credit's degree of reliance on federal payments. Credits that currently enjoy a AAA rating but which are dependent upon the cash flow generated by Treasury securities would be subject to an immediate downgrade. Prerefunded bonds are the most prominent example of bonds that are directly linked to the US sovereign rating. These bonds are secured by escrow accounts funded with State and Local Government Series securities (SLGs), direct obligations, or agency bonds.

Credits with a high degree of reliance on federal aid or reimbursement payments fall into a second category. These municipal bonds are not tied directly to sovereign obligations but are indirectly linked. Highly rated general purpose state and local governments who rely on federal aid for a relatively large percentage of their budget will be subject to great scrutiny by the rating agencies. The third category encompasses muni credits that are less susceptible to a rating revision based on the US sovereign rating. Essential purpose public utilities with segregated revenues generated by retail customers provide a good example. In these instances, the utilities are more or less self-sustaining and provide public services to a customer base without much reliance on federal funding.

Limited equity market impact

Here again it is difficult to measure the impact a downgrade would have, given that there are few relevant historical precedents. Keep in mind that a downgrade does not necessarily give markets new information about the underlying condition of the sovereign, but rather underscores widely recognized problems. However, we expect global stock markets would experience a modest near-term sell-off in the event of an S&P downgrade of the US credit rating to AA led by cyclical sectors, financials, and domestically oriented stocks. Rising uncertainty over the potential economic spillover from higher borrowing costs would likely lead to a short-lived, near-term decline in the most economically sensitive stocks. Financials would also likely be negatively impacted in the short-term given the potential decline in value of Treasuries and government-backed MBSs held on their balance sheet. The combination of elevated domestic economic uncertainty coupled with the likely short-term weakening of the dollar would most negatively impact S&P 500 companies without a global footprint.

However, in our view, the initial negative impact to equities should ultimately be mitigated by three factors:

- Equities already appear to be discounting a significant amount of potential risk. The current equity risk premium is roughly two standard deviations above its average over the past 25 years;

- For the same reason that corporate bond spreads may compress, high-quality equities with dividend yields competitive with government bond yields would become more attractive and could attract fund flows out of fixed income. In contrast to government finances, corporate balance sheets are very healthy. S&P 500 leverage ratios are at multi-cycle lows and cash as a percentage of assets has more than doubled over the past two decades. Twenty-six S&P 500 companies representing 23% of the market value of the index have credit ratings of AA or higher;

- History suggests that there is mixed stock market impact when a nation's sovereign credit rating is downgraded from AAA. Japanese equities fell 7% over six months following S&P's downgrade of its sovereign credit rating in 2001, while the domestic equity markets in Australia (1987), Spain (2009), and Ireland (2009) all delivered positive six-month returns after losing their AAA status.

USD not alone
We think that the shock of a downgrade could trigger a short-term dollar sell-off, but we do not expect that this will fundamentally change the role or trajectory of the US dollar. We do, however, believe that without a more fundamental and aggressive way to correct US imbalances, the dollar will face drops in purchasing power over time, not just against the major currencies but also versus small advanced economies and emerging markets. All this suggests that a diversified currency exposure makes sense for most investors and that some hedging away from the dollar is prudent, even though we find a dollar collapse unlikely.

The US dollar has seen sharp declines over the past week against many currencies as the debt ceiling debate intensifies and discussion of a possible downgrade becomes more serious. Importantly, however, the surge of EURUSD above 1.45 is also a result of markets' current confidence in the most recent attempts by European heads of state to contain the sovereign debt situation in Greece. While a US downgrade would probably produce a sharp sell-off of the greenback, Europe faces many similar problems. Ironically, if markets were to aggressively shed risk, the USD could actually be in demand.

As outlined in the discussion about Treasuries, there are few alternatives to the dollar of sufficient scale, and the other major currencies – from Europe (euro), the UK (GBP) and Japan (JPY) – face similar fiscal challenges. Small currencies from fundamentally sound economies are likely to do well over the long term, but currencies from Canada (CAD), Australia (AUD), Norway (NOK) and Sweden (SEK) could see a typical sell-off in severely risk-averse markets. The Swiss frank (CHF) is at record highs against the dollar, and the euro as a beneficiary of risk-averse flows; while the Swiss economy is strong, the currency's valuation is severely stretched and it is therefore likely to drop when markets regain calm.

We see further upside for gold
Our price target for gold is for $1,800/oz, up from $1,650/oz, largely reflecting our expectations for continued uncertainty about global debt markets. A US downgrade in the face of continued uncertainty about the debt ceiling could provide a meaningful uptick in gold prices. However, the price of gold could see a short-term setback if and when the debt ceiling is lifted, as it has drifted up in response to the uncertainty around the US fiscal situation.

Appendix

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