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First Trust

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Monday Morning Outlook

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# It's Still AAA

Standard & Poor's fired a shot heard round the world last week. It said it was reviewing the triple-A credit rating of the United Kingdom. This was happening despite planned tax hikes, because the debt burden was to rise to 100% of GDP.

Although S&P said nothing about the US, the financial markets went into panic mode anyway, worrying that big spending fiscal policies could put the US's AAA-rating in jeopardy. The dollar fell sharply and yields on long-term Treasury securities jumped by 30 basis points. At this point, any downgrade of the US debt rating is pure speculation. But it's speculation that cannot be superficially dismissed.

According to the Congressional Budget Office, the US debt would have been 42% of GDP in 2019 (and falling thereafter) if President Obama simply kept fiscal policy on automatic pilot, making zero changes. That level of debt is well within the post-World War II historical norm. But the CBO says the proposed Obama administration budget, combined with new stimulus spending, will double the US debt load to 82% of GDP in 2019 (and heading higher thereafter).

No wonder the president said in an interview on C-Span that "we are out of money."

So the fiscal stability of the US is a legitimate concern. But the issue for owners of US Treasury debt is not whether they will get their cash back. They will. Regardless of the rating, the US would still make all payments of interest and principal.

The US is not some emerging market where the government cannot borrow in its own currency. In those countries, a debt downgrade can cause a vicious cycle as it drives up interest rates and drives down the local currency, making it even tougher for the government to get the dollars or Euros it needs to repay its debt. Think Argentina.

But because the US borrows in dollars, this cannot happen. In a way, if S&P ever reviews the US's credit rating, it is really reviewing the whole world's credit rating. If the US can't be fully trusted to repay, who can be trusted?

Instead, the "real" issue for Treasury investors is the value of the dollars with which the US government makes its future payments. If the Federal Reserve ends up printing extra money just so the government can pay its debts, the value of the repaid dollars is going to be worth substantially less than the dollars that were lent to the government in the first place.

The greatest bulwark against this inflation threat is a return of bond market vigilantism – where any whiff of inflation sends interest rates higher. Policymakers who attempt to monetize the debt (having the Fed provide funding to the government by printing money and buying Treasury bonds) will be quickly and forcefully punished by the financial markets.

All of this is leading to an argument for tax hikes by the current administration so that the US will avoid a downgrade of its debt rating. When "we are out of money," government usually tries to find some more.

This is ironic. Back during the budget showdown of 1995, when President Clinton faced off against the new Republican Congress, then-Treasury Secretary Robert Rubin repeatedly warned that the rating agencies could put the US on review for failing to increase the debt limit. The political angle was that a review would jack up interest rates, leading the Republicans to capitulate on trying to reduce government spending. The markets, however, scoffed at Rubin, and interest rates fell during the budget "crisis."

This time around, we wonder whether in the next couple of years President Obama will declare a fiscal emergency that only a tax hike can solve, using the threat of a rating downgrade as a way to put political pressure on his opponents. If so, we need only look at the UK, where the threat of a downgrade comes despite large tax increases already built into their budget.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 5-26 / 9:00 am | Consumer Confidence - May | 42.6 | **44.3** | 54.9 | 39.2 |
| 5-27 / 9:00 am | Existing Home Sales - Apr | 4.660 Mil | **4.700 Mil** | | 4.570 Mil |
| 5-28 / 7:30 am | Durable Goods - Apr | +0.5% | **+1.0%** | | -0.8% |
| 7:30 am | Durable Goods (Ex-Trans) - Apr | -0.3% | **-1.8%** | | -0.7% |
| 7:30 am | Initial Claims - May 23 | 628K | **626K** | | 631K |
| 9:00 am | New Home Sales - Apr | 0.360 Mil | **0.370 Mil** | | 0.356 Mil |
| 5-29 / 7:30 am | Q1 GDP Preliminary | -5.5% | **-5.1%** | | -6.1% |
| 7:30 am | Q1 GDP Chain Price Index | +2.9% | **+2.9%** | | +2.9% |
| 9:00 am | Chicago PMI - May | 42.0 | **44.2** | | 40.1 |
| 8:45 am | U. Mich. Consumer Sentiment | 68.0 | **68.0** | | 67.9 |