THIRD SIGMA
INVESTMENT ADVISORS LLC

How a US Government Default Hurts All Americans

As the deadline for the default approached in October, prices and yields for certain segments of the bond market swung wildly, due to uncertainties created by the congressional gridlock – a preview of what an actual US Government default might look like. The bond and stock markets seem to have stabilized since that brush with default, and we had hoped that we finally had a temporary reprieve from the gridlock in Washington; but there are some in Congress that are talking up a potential default again.

Most business and economic leaders have warned of the dire consequences of default, regardless of their political stripe. Other pundits and politicians have been saying that default would have no real effect on the country or the economy; we ask these folks to reassess their position based on what's best for our country. It is clear that, even though default has been temporarily averted, just the threat of default has already cost the country and the US economy plenty. Besides the effects of default on the borrowing costs for the government, there would almost certainly be a trickle-down effect on the US and global economies and markets. It is worthwhile to show why default *is* an economic threat, and how almost everyone could be adversely affected.

The US Treasury issues Treasury bonds, Treasury notes, and Treasury bills to raise money to pay for the projects and programs that Congress *has already authorized*. The debt ceiling, which allows the issuance of US Treasuries, has been raised on a perfunctory basis for the last 6 decades. These bonds are bought by investors across the country and across the world. Default would likely create havoc with investors; but we are not just talking about missed payments to investors, we are also talking about Mom's social security check, and Uncle Dave's Medicare Insurance, farm subsidies, and military readiness, for example. Some politicians have suggested prioritizing US Government payments, making sure that bondholders (such as China) get paid before Mom and Uncle Dave's doctor, as a way to preserve the US's credit rating. Besides being impractical from a system's standpoint (as far as we know, there is no system in the Treasury Department for prioritizing payments), implementing any such priorities should be subject to vigorous debate and public scrutiny.

It is important to realize that the US's ability to borrow money is based on investors' willingness to lend it. Everyone wants to get the best interest rate on their credit card, auto loan, or home mortgage. Any homeowner knows that a 1% difference in interest rates can mean tens of thousands of dollars over the term of the loan. So of course, it is best that the US Government (and its citizens) is able to borrow money at the lowest interest rates possible. A default could hurt the USA's credit rating, thus raising rates for the government and everyone else.

How are interest rates for treasuries set? Many think that the Federal Reserve (the *Fed*) sets interest rates. While the Fed Open Markets Committee does set the target rate at which banks lend money to each other (the *Fed Funds Rate),* US Treasury Securities are issued by the Treasury Department and sold at *auction* to the highest bidder. Existing (previously issued) Treasury securities are bought and sold on the secondary market by bond traders. Buyers and sellers of US Treasuries include individual investors, institutional investors (i.e. pension funds, 401(k) plans, insurance companies, money market funds, and mutual funds), and countries (such as China). As any creditor would do, these buyers of US Treasuries look at the credit-worthiness of the borrower (in this case the US Government) to evaluate the credit risk and decide what interest rate to charge. Even a minor change in the perception of US credit-worthiness can cost the US Government many billions of dollars in interest payments. And as mentioned earlier, the damage from these increased borrowing costs are not limited to the US Government.

Individual investors, retirement plans, and most borrowers (including homebuyers, credit card holders, and car buyers) could be adversely effected by a US Government credit downgrade brought about by default. Just how would a US Government credit downgrade hurt investors and US borrowers? Higher interest rates can impact investors holding US Treasuries by reducing the market value of their portfolios. Most Americans hold Treasuries directly or indirectly, in some form or another, usually in their pension funds, 401(k) plans, or mutual funds.

Any rise in US Government borrowing costs could mean billions more paid in interest payments. Other borrowers are effected as well, since many interest rates are linked to the cost of US Treasuries. Not only would the US Government have to pay more interest, but so would a home or car buyer, or a company. Higher borrowing costs mean less cars sold, fewer homes sold, less money for business expansion - and so on.

For a period of time, we (the US Government) were able to borrow money at close to 2.5%-3.00% for 30 year Treasury bonds, because we were perceived to be the most stable economy in the mist of the recent economic crisis. Since inflation has averaged 3% since the mid 1920's, we were borrowing money at what may very likely be negative or almost 0% *real* interest rates over the longer term. When the US borrowing cost are at such lows, lenders like China could be *paying* to help finance the US economy.

At the risk of confusing the reader, we must mention the Fed's "Quantitative Easing" *(QE)* program. The Fed has been buying Treasury and mortgage securities with the hope of keeping bond *prices* high and bond *yields* (interest rates) low; there is a negative correlation between bond prices and bond yields. We had expected that as the economy began improving, the Fed would reduce the QE program. The Fed's reduction of QE would signal that the economy is making progress in terms of both productivity and employment. There had been a rise in interest rates due to the expectation of reduced QE at mid-year, as the economy improved. A growing economy and threat of inflation would be a valid reason for higher interest rates, but a default could raise rates and lower the US's credibility for no good reason. Small wonder that the political wrangling and threat of default in October raised rates. As background, the rise in interest rates due to the expectation at mid-year makes it difficult to sort out the effect of the default on interest rates as compared to the interest rise created by the anticipated tapering by the Fed.

We should spend time examining our priorities and if necessary, decide whose fatted calf should be sacrificed in the future; but regardless of what we do in the future, the current debt is the *financial obligation* of the US Government. Failure to pay our debts would reflect badly on US stability and creditworthiness, and could cost all of us dearly.

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