

# UNITED STATES ECONOMICS UPDATE

31<sup>st</sup> Jul. 2011



## Default seemingly averted, but downgrade almost certain

- **The latest noises from Washington suggest that politicians are close to reaching a compromise on a deal that will raise the debt ceiling ahead of Tuesday night, thereby preventing a debt default and a government shutdown.** This might prompt a short-lived relief rally in risk assets. **However, the reported size of the deficit reduction package is very unlikely to prevent America from losing its AAA credit rating.** The only question is therefore whether S&P and the other rating agencies pull the trigger this week or wait a little longer. Either way, though, we stand by our long-held view that 10-year Treasury yields will fall to 2.5% by the end of the year and stay there for some time.
- The compromise deal being discussed in Washington on Sunday afternoon reportedly contains two parts. The first involves an increase in the debt ceiling by enough to cover American's borrowing requirements until the end of this year accompanied by measures resulting in "roughly" \$1trn of deficit reduction over the next 10 years. The second part contains a further increase in the debt ceiling at the start of next year, but only if a bipartisan commission implements measures leading to a further \$2trn in deficit reduction over the next ten years.
- **While such a deal will avert a government shutdown and debt default (at least for this year), it will almost certainly not prevent the US from losing its AAA credit rating.** The combination of only \$1trn in deficit reduction being "in the bag", the remainder \$2trn not being guaranteed and the danger that we will have to go through this all again at the end of the year, all falls short of the "credible solution" involving "a medium-term fiscal consolidation plan of \$4trn" that S&P has implied would be necessary to prevent a rating downgrade. It is possible that S&P will wait and see what kind of deficit reduction the bipartisan commission comes up with later this year. **But we would not be at all surprised to see a rating downgrade come as soon as this week.**
- **As we have pointed out many times over the last few weeks, while we believe that a rating downgrade is justified, we don't think it will be a disaster for the Treasury market or the dollar.** (See, for example, our *Global Markets Update* "What if the US loses its AAA rating?", published on 22<sup>nd</sup> July.)
- **Indeed, the fact that 10-year Treasury yields fell below 2.80% on Friday after the disappointing US GDP report and despite the ongoing wrangling in Washington (leaving yields at their lowest level this year) rams home the point that it is the economic fundamentals that really matter.** For some time we have been expecting a combination of weak economic growth and fading inflation fears to drive the 10-year yield to 2.5%. **A rating downgrade, either this week or later in the year, won't change that.**
- **It is possible that there will be a few more twists and turns in this saga yet.** Remember, any compromise agreed late Sunday or very early Monday will need to be passed by both the House of Representatives (which has a Republican majority) and Senate (which has a Democrat majority) before being signed into law by President Obama. Those are some high hurdles that still need to be cleared by the end of Tuesday.
- **Finally, even if a deal is done, it is important not to lose sight of why this issue has arisen in the first place. The bigger picture is that the long-term fiscal position of the US remains perilous.** A raising of the debt ceiling and a package to reduce the deficit by between \$1trn and \$3trn over ten years will do little to reduce net debt.
- Much more fiscal consolidation will be needed, which is likely to act as a brake on economic growth for some years to come. **GDP growth is already on course to disappoint this year and the next few years may be no better. In such a climate, equities will struggle and Treasury yields will remain low.** (For more, see our quarterly *Capital Markets Analyst*, to be sent to clients of our global service on Monday.)

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