

MARKET COMMENTARY

June 30, 2011

Thoughts on the Debt Ceiling

The debt ceiling refers to the legal maximum amount of money the federal government can borrow to pay for its commitments – including items such as Social Security, Medicare and military operations. If the government does not have enough money to cover its commitments, then it borrows money by selling U.S. Treasury bonds, notes and T-bills. The U.S. government actually hit its current \$14.3 trillion debt limit on May 16th. However, by suspending payments to federal retirement funds, the Treasury estimates that the government can continue borrowing until August 2nd without hitting the ceiling.

While the debt ceiling has been routinely raised, Congress is currently engaged in a prolonged battle regarding the circumstances under which it would agree to do so again. Republicans in the House of Representatives, bolstered by the Tea Party movement which has fought for reduced government spending, are now insisting that they will not agree to another debt limit increase unless the government makes massive spending cuts. Democrats argue that the consequences of not raising the debt limit are so grave that the ceiling needs to be raised even before large spending cuts are agreed to. Democrats say that a failure to raise the debt limit would result in the U.S. defaulting on its debts as it would not be able to raise the necessary money to pay its bills, which they say would harm the U.S. credit rating and possibly lead to higher interest rates for the government and for U.S. consumers. Democrats also say that such a default could adversely impact the dollar, as the currency might no longer be seen as a safe haven for global investors.

Republicans counter that any damage done by failing to raise the ceiling would be offset by gains that would come from a smaller federal debt load. They argue that default, if it were for a brief period of time, would not necessarily harm the U.S. credit rating. Republicans further contend that the Treasury Department could still have enough funding to pay debts by choosing to temporarily underpay certain government contractors as well as people receiving unemployment or Social Security benefits.

Roosevelt Investments believes that the consequences of not raising the debt ceiling would be catastrophic. One of our concerns is the structure of the final negotiation, as we are worried about near term cost cutting which might reduce economic activity in an already weak economy. Although it might go down to the wire, and there is likely to be a lot of political wrangling between now and the

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August 2nd deadline, we think that the debt ceiling will be raised. Treasury bonds and the dollar's level relative to other currencies currently indicate that the market is not expecting the debt limit to be a persistent or a serious problem.

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