

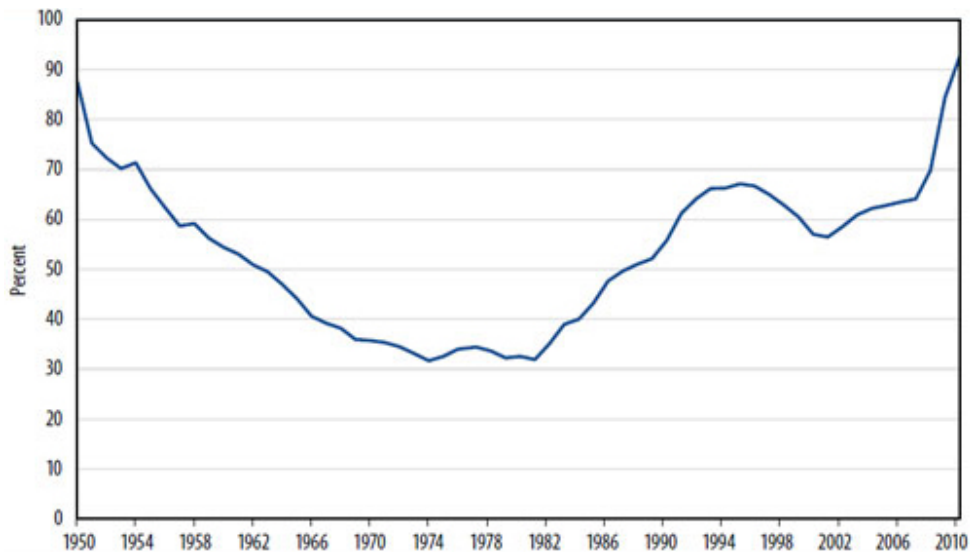
Will the US government default on its debt?

Western Asset Management, Legg Mason's largest fixed income specialist, highlights the risks involved in the current political discussions surrounding the raising of the US government debt limit.

There has been substantial coverage of the need for US politicians to raise the limit on issuance of US federal debt and the possible default of US Treasuries. The US Treasury Department originally forecast that the government would reach the debt limit on May 16, 2011. Because Congress did not act, the Treasury Department is employing extraordinary measures to create additional headroom under the debt limit. Those measures are limited and are projected to be exhausted by August 2, 2011, a date that is subject to change based on government receipts. However, unless Congress ultimately acts to increase the debt limit, the government will begin to default on its legal obligations on or near August 2.

It is important to note the difference between the current debt limit situation and previous US government shutdowns that have occurred a number of times over the last 30 years. While unpleasant, a shutdown does not have a long-term negative impact on the creditworthiness of the US. In contrast, if Congress fails to increase the debt limit, the government would have to stop, limit or delay payments on a broad range of legal obligations, including Social Security and Medicare benefits, military salaries, interest on the national debt, tax refunds and many other commitments. Such an event may negatively affect the long-term creditworthiness of the US.

US Government Debt-to-GDP Ratio



Source: Bureau of Public Debit. As of 30 Sep 10

The Credit Rating Agencies May Downgrade US Government Debt

The credit rating agencies are concerned about the deterioration in the financial position of the US government and have noted that the level of US debt is already beyond what they would ordinarily allow for a AAA rated sovereign. With respect to the current debt limit debate, Moody's has explicitly stated that if Congress does not increase the Treasury's borrowing authority in the coming weeks, the nation's credit rating may be lowered "due to the very small but rising risk of a short-lived default." Fitch said it would put US debt on watch for downgrade in early August in the event that Congress fails to lift the debt ceiling before other measures aimed at avoiding default are exhausted.

There are a number of creative legal solutions being proposed that are designed to circumvent the August 2 deadline. However, it is unclear whether such a legal solution could actually be implemented. Recently, some politicians have suggested that the US delay interest payments on its debt. Although this is the view of a small minority, it has nevertheless caused concern among investors in the bond market.

There may be substantial negative repercussions of a default on US Treasuries, such as an increase in the cost of financing the budget deficit and the potential loss of the US dollar's status as the world's reserve currency. We believe it very unlikely that this will actually occur; however, any political process has a risk of mistakes due to political brinksmanship. We believe the most likely outcome is the "kick the can down the road" scenario in which the debt limit is raised just enough that it will not be reached until at least 2013, when a new Congress will get to deal with the problem.

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