

# US Treasury's threatened with a down grade to B+

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U.S. - Ratings Agency, Fitch, says it will downgrade the U.S. from AAA to B+ if it does not increase the maximum amount it can borrow by 2<sup>nd</sup> August 2011 or fails to make its first debt repayment after that date.

The U.S. hit its debt ceiling yet again earlier this year, but this time without raising it as would be their normal policy. The serious clashes between Democrats and Republicans have hindered agreement on the country's massive deficit.

Fitch expects the country's politicians to come to an agreement and enable the U.S. to meet its obligations. The Ratings Agency has published a note to warn of a sharp downgrade if the agreement does not materialise.

**We warn that a financial crisis could ensue if no resolution is found swiftly. There is an increasing threat of a U.S. debt default these days, as recognised in the corridors of power.**

The U.S. Republican lawmakers are certainly playing with fire by contemplating even a brief debt default as a means to force deeper government spending cuts! Recently Li Daokui, an adviser to China's central bank, commented that a default could undermine the U.S. dollar, and Beijing needed to dissuade Washington from pursuing this course of action. Li told reporters at a forum in Beijing "I think there is a risk that the U.S. debt default may happen and, if they were to default, the result will be very serious".

**Members should know that China is the largest foreign creditor to the U.S., holding more than \$1 Trillion USD in treasury debt as of March 2011, as U.S. data shows. Its concerns therefore carry very considerable weight in Washington.**

Far from it not being possible, it is also a fact that the idea of a technical default (essentially delaying interest payments for a few days) has gained backing from a growing number of

mainstream Republicans, who see it as a price worth paying if it forces the White House to slash spending, as Reuters recently reported.

However, I believe that any form of default could destabilize the global economy and sour already tense relations with big U.S. creditors, such as China.

The U.S. Congress has balked at increasing a statutory limit on government spending as lawmakers continue to present strong arguments on how to curb the US deficit, which is projected to reach an enormous USD1.4 Trillion this fiscal year. The U.S. Treasury Department has announced that it will run out of borrowing room by Aug. 2<sup>nd</sup> 2011.

**If the U.S. cannot make interest payments on its debt, the Obama administration has warned of "catastrophic" consequences that could push the still-fragile economy back into recession.**

Ben Westmore, a commodities economist at National Australia Bank, went on record, saying "It would have dire implications for the economy at a time when the macro data is softening; it's just a horrible idea."

The Republicans' theory is that bondholders (investors) would simply accept a brief delay in interest payments if it meant that Washington finally addressed its long-term fiscal problems, putting the USA in a stronger position to meet its debt obligations later on. My research indicates that most investors would definitely consider such a default as unacceptable, and thus only a remote possibility. Many have commented that the very possibility must be surely impossible to imagine? Really?

One such investor, an official at India's central bank, spoke out recently, saying "How can the U.S. be allowed to default?" He further commented "We don't think this is a possibility because this would then create huge panic globally." Indian officials say they have little choice but to buy U.S. Treasury debt because it is still among the world's safest and most liquid investments, or at least they have been seen as such historically! I would bring the reader's attention to the fact that India holds USD39.8bn in U.S. Treasuries as of March 2011, according to U.S. data.

Barry Evans, who oversees USD83bn in fixed income assets at Manulife Asset Management, has also commented on this topic, stating "It just wouldn't happen, they would pay their Treasury bills first instead of other bills. It's as simple as that." But is it?

Marc Ostwald, a strategist with Monument Securities in London, noted that the default scenario is "extremely frightening". In voicing this opinion, he commented that bondholder's patience would more than wear thin should US lawmakers persist in following the current strategy in the coming weeks.

**More good news for RIO:**

**RIO Professional Investors Fund gained another +1.6% during May, its seventh consecutive gaining month. The Fund remains positioned to benefit from any further bad news from the US, Europe or the Middle East. I would comment that the Fund looks likely to add to its positive performance due partly to its ability to benefit from the continued economic and political uncertainty!**

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**The RIO Club**