

Playing with Fire: The Threat of a Default

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The most serious economic event that investors face in the next two weeks is the possibility that the US government may default on its Treasury bonds. If Congress does not approve an increase in the debt ceiling by August 2, the federal government may not be able to pay the interest and principal due on Treasury bonds. If this were to occur, US Treasuries would lose their AAA credit rating, and their reputation as the “safest investment” on the planet would no longer be. The impact would be higher interest rates, devaluation of the dollar, declines in bond and stock prices, and an immeasurable loss of confidence on the “full faith and credit” of the US government all over the world.

It is probable that a deal will be reached in Washington in time to avoid a default, but with only 10 days remaining, both sides of the negotiating table still have not come to an agreement. The fact that lawmakers are even considering defaulting on behalf of the American public is tantamount to playing with fire—and surely someone will get burned. As a result, investors must quantify the risks and act accordingly.

The greatest risk of permanent capital loss lies in bonds. If the US defaults, interest rates will go up and drive down the prices of bonds. Recovering from this devaluation in bond prices will be difficult since the future value of those bonds and their interest payments will lag those of new bonds issued after the default occurs. As a result, investors should allocate their assets accordingly to minimize this risk either with bond funds that do not own any Treasury securities or bonds that are issued in non-dollar denominations.

Another asset class that will be directly affected is cash. Most people perceive cash instruments as a safe asset class. However, most money market mutual funds own US Treasuries and may have difficulty protecting the principal in the event of a default. For example, in September 2008 the Primary Reserve Fund, a money market mutual fund, “broke the buck” as a result of owning bonds of Lehman Brothers before it went bankrupt. The fund’s value lost 3% and its investors were repaid only \$0.97 to the dollar. A hedge to this is the use of FDIC-insured cash, although this is limited to \$250,000 per investor.

Stocks will also experience a drop in value. This will not be permanent so long as a company’s fundamentals are strong enough to weather the short term disruption. In which case, investors should look to identify buying opportunities and take advantage of them as prices go down. Specifically, companies whose businesses are not dependent on borrowing money and whose cash holdings and sales are not solely held in US dollars.

If a default does come to pass, then once the smoke has cleared, a new investment landscape will likely emerge in which the US dollar will no longer be the de facto currency of the global economy. This is already happening as we speak—slowly, but it certainly doesn’t have to be surely so long as our elected officials stop tempting fate (knock on wood).