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Rethinking Sovereign Risk

Is it possible the risk free rate is not risk free? Financial markets have operated for years under the assumption that U.S. government debt is the most creditworthy in the world. Backed by the ability to tax in the world's largest economy, government bonds have enjoyed little scrutiny. However, after years of unfettered government expenditures and the deepest recession in 80 years, the U.S. government's finances look decidedly weak.

In 2009 the government's deficit increased by about $1 trillion, taking the cumulative red ink to nearly 12% of GDP.[1] The government's debt stands at 84% of GDP a ratio typically associated with troubled emerging economies rather than the largest country in the world. Given the unusual aspects of the recession, many claim the deficit and elevated debt levels are temporary and will be repaired with an improving economy. Perhaps, but the challenges confronting the authorities are daunting, especially when considering the current administration's policy priorities.

In 2000 government debt stood at $5.7 trillion (58% of GDP). As of September 30, 2009 debt had risen to $11.9 trillion (84% of GDP).[1] The only way to reduce the debt is for the government to operate a budgetary surplus. However, even if expenditures do not increase and the economy grows at 4.0% per year, it will take over 5 years for revenues to catch up. In the mean time, a 1.0% increase in interest rates adds $120 billion to the government's expenditures, approximately the same amount the government receives in additional revenue from a 4.0% increase in GDP! Should the economy fail to grow or the government's initiatives become more costly than expected, the negative spiral for the government's obligations could get out of control.

Does the government's creditworthiness matter? Setting aside the philosophical debate on whether the government is AAA rated, there are some very important implications to the current predicament. The most important issue relates to interest rates. If financial markets lose faith, interest rates could rise sharply with a damaging effect on the economy. The cost of financing would increase for everybody, even though it is conceivable that some highly rated credits could trade through the government (this, in fact, has occurred for some bonds of highly rated industrial firms). Perhaps the most damaging effect would come from a significant increase in mortgage rates, which would stall any recovery in the housing market.

Furthermore, many investment strategies, including those of sovereign wealth funds, have a permanent allocation to government bonds based on the absence of repayment risk. As any emerging market debt investor knows, sovereign risk is real and potentially very expensive. Should all investors who follow government bond or core bond benchmarks be forced to rethink their allocation assumptions, there could be a huge repudiation of US government debt. This possibility is not yet being considered by the markets, but if 2008 taught us anything, it is that no assumptions are safe.

Recently, global markets learned of financial difficulties in Dubai and Greece. Many countries were forced to incur large deficits to battle the effects of the recession. Cumulatively, governments went from relatively healthy fiscal positions to the opposite. While U.S. investors can easily choose to avoid the obligations of any other government, it may be a lot harder for the world to avoid the debt of the US government.

1. Sources: US Treasury, Bureau of Economic Analysis

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