

**The Capitol Grill.** We have arrived at the sad precipice of the Treasury's stated deadline of August 2<sup>nd</sup>, when available sources of funding are reportedly exhausted, other than from raising the debt ceiling. Both parties continue to propose deficit reduction plans that are unlikely to be agreed to by the other (or even their own). The Treasury has ~\$1 trillion in assets that it *could* sell (including \$420 bn in gold, \$370 bn in student loans and \$85 bn in mortgage backed securities) to delay a default. The Treasury could also prioritize payments to bondholders, social security recipients, etc. However, there are market-impact, liquidity and feasibility issues that have to be overcome first (see page 3 for details on payment prioritization and the Treasury's view of asset sale risks). **More importantly, asset sales and prioritization are a temporary fix; some combination of markets, rating agencies and unpaid entitlement recipients/vendors will likely force both parties back to the Capitol Grill shown below, where some tough choices will have to be made.** In the near term, a small, less ambitious deficit reduction / debt ceiling increase is all Congress may have time for (let's at least hope for that). But even if a smaller deal is passed, there will be a lot



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# THE CAPITOL GRILL

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## Revenue Raisers, billions of dollars over 10 years

Raise tax rates on ordinary income by 1%	480
Raise the top 2 ordinary tax rates by 1% (joint filers starting at \$212k)	115
Raise tax rates on capital gains by 2%	49
Raise dividend tax rates on HNWtaxpayers* to 20%	24
Increase corporate income tax rates by 1%	101
Allow all Bush tax cuts to sunset as planned	2,502
Allow Bush tax cuts on HNWtaxpayers to sunset	709
Estate/gift tax rates/exemptions to '09 levels	98
Tax carried interest as ordinary income	21
Impose a financial crisis responsibility fee	30
Phase out mortgage interest deduction	215
End deduction for state and local taxes	862
Curtail deduction for charitable giving	219
Limit tax benefit of itemized deductions to 28%	293
Eliminate oil and gas preferences	44
End LIFO accounting	98
Reduce write-off benefits of corporate jets	3
Extend depreciation time for certain equipment	241
End AMT indexation, middle class tax cuts remain (as per OMB)	1,550
End AMT indexation, middle class tax cuts sunset (as per CBO)	661
Change tax bracket inflation indexation	87
5% Value added tax(low estimate)	1,390

\* High net worth taxpayers defined as those with adjusted gross income per year more than \$250k.

## Prime Spending Cuts, billions of dollars over 10 years

Freeze discretionary spending at 2011 levels	1,395
Reduce growth in non-defense discretionary (discr.) spending by 1% a year	327
Freeze non-defense discr. spending at 2011 levels	642
Reduce non-defense discr. spending by 1% a year	932
Freeze non-defense discr. spending until 2015	406
Reduce growth in defense spending by 1% a year	286
Freeze defense spending at 2011 level	611
Reduce defense spending by 1% a year	862
Change inflation indexation for Social Security	112
Change Medicare eligibility age to 67	125
Allow Medicare doctor reimbursement cuts	249
Change Medicaid grants to states	287
Change Medicaid formulas for reimbursements	181
Eliminate extension of unemployment benefits	57

## Spending cuts already assumed to take place by CBO

Reduce troops in Iraq/Afgh by 45k by 2015	1,134
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**No credit cards accepted** without deficit reduction plan sufficient to stabilize debt ratios at ~70% of GDP by 2021 (see next page). The CBO Baseline stabilizes the debt ratio, but requires \$5 trillion less in deficits over 10 years compared to the CBO Alternative Case, which assumes a continuation of most current policies.

Congress must wash hands before returning to work

Sources: Office of Management and Budget, Congressional Budget Office, Committee for a Responsible Federal Budget, Joint Committee on Taxation, J.P. Morgan Private Bank.

more work to do. As proposed by both Boehner and Reid plans, after agreement on \$1-\$1.5 trillion in spending cuts, 12-member bipartisan committees would be formed to make additional deficit reduction recommendations (joint committee reports due by Thanksgiving, with deliberations under special expedited rules by Christmas). To get a sense for **why both revenue raisers and spending cuts are needed**, we created two deficit reduction plans<sup>1</sup> representing ideological extremes. The first is a Huey Long “Share the Wealth” (STW) program relying exclusively on the wealthy and the corporate sector to close the deficit, without any spending cuts. Here’s the STW program:

- Raise top two ordinary income tax brackets (>\$212.3 k in annual adjusted gross income) by 5%; limit benefit of itemized deductions to 28% on top 2 brackets; raise capital gains tax rates on top 2 brackets back to 2001 levels; return estate & gift tax rates to 2009 levels; tax dividends for high income taxpayers at 20%; end oil and gas tax preferences; tax carried interest at ordinary rates; eliminate tax preferences for corporate jets
- Total deficit reduction of \$1.4 trillion, including interest

The other case is the Herbert Hoover Austerity plan (HHA), which achieves deficit reduction solely through discretionary spending and entitlement cuts, with no revenues raised:

- Freeze non-defense discretionary spending at 2011 levels; reduce defense spending by 1% a year; change inflation indexation for social security (lowering payments); change Medicare eligibility age to 67; allow Medicare doctor reimbursement cuts to proceed as previously agreed
- Total deficit reduction of \$2.4 trillion, including interest

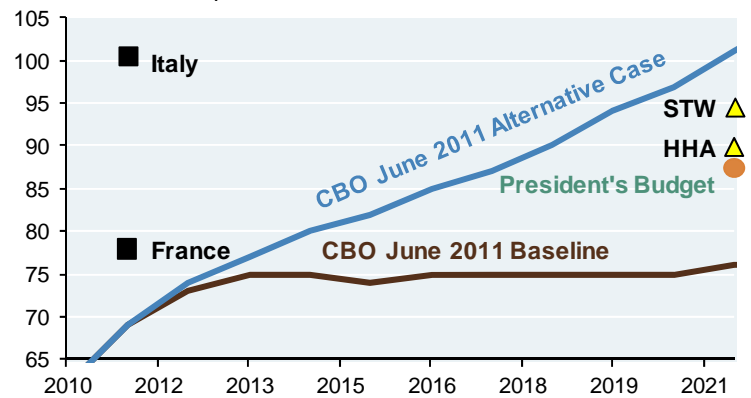
We plot the STW and HHA plans on our CBO wedge, in between the CBO Baseline (all tax cuts return to 2001 levels and other contractionary measures), and the Alternative case (continuation of most current tax policies). **As shown, neither plan arrests the rise in Federal debt; nor does the President’s budget, nor the initial phases of the Reid or Boehner plans.** You can use the Capitol Grill menu to construct deficit reductions of your own.

**Even if a smaller deal is all that is agreed to, perhaps S&P<sup>2</sup> will wait to see what happens with the bipartisan deficit reduction committees before deciding what to do about the rating. In case there is a downgrade, we do not foresee a meaningful selloff in the Treasury markets; it could be a bigger problem for equity markets, at least in the short term:**

- Most collateral agreements appears to have leeway to avoid immediate liquidation of the collateral in case of a downgrade
- Money market funds that are subject to 2a7 legislation even have the ability to hold *defaulted* collateral if selling would be disruptive and not in the fund’s shareholder interest, so a downgrade should not force any specific action
- There is nothing in ERISA language governing pension funds that would trigger a sale in case of a downgrade; it would be up to individual account guidelines as to whether there was flexibility on collateral rules.
- We do not foresee any changes to bank or insurance company regulations regarding the zero risk-weighting applied to Treasuries, nor its eligibility as general collateral in repo transactions<sup>3</sup>.
- A downgrade by S&P would probably trigger a matching downgrade of Agency paper (Fannie Mae and Freddie Mac), GNMA, municipal bonds backed by Treasury bonds, the Federal Home Loan Bank and the Federal Farm Credit Bank. There could be eventual downgrades of insurance companies, bank subsidiaries and bank holding companies due to “sovereign ceiling” issues, but S&P softened their language on this topic on this week’s conference call. Other potential downgrade candidates: states with high levels of government dependency (e.g., South Carolina, Tennessee, Maryland, Virginia, New Mexico), defined by their exposure to Federal employment, procurement contracts and Medicaid transfers.
- Finally, we do not expect material change in demand for Treasuries and quasi-sovereign paper by central banks reinvesting their current account or petrodollar surpluses. Well more than half of all AAA securities in the world are US Treasuries, Agencies and Agency-backed securities, leaving few and highly fragmented immediate options for central banks, insurance companies and other AAA buyers (soon to be AA buyers?). An end to central bank reserve *accumulation* (perhaps out of concerns for inflation) appears a bigger risk for Treasuries than central bank reserve *diversification*.

US long-term debt scenarios

Net debt to GDP, percent



Source: CBO, IMF, OMB, J.P. Morgan Private Bank.

<sup>1</sup> While we use OMB and CBO estimates of each budget item, there are cross-coefficients that take place when budget items are combined that we are not accounting for. There is no way to determine if they would have a systematically positive or negative bias.

<sup>2</sup> At the current time, Moody’s does not appear inclined to downgrade the US, as long as the debt ceiling is raised.

<sup>3</sup> Haircuts applied to Treasury collateral are typically 2%; a downgrade could increase this by 1% or so, but there is no reason to think this will happen automatically. It will depend on the volatility of the Treasury markets in the interim.

Of course, we can't account for the "unknown unknowns" we might be missing; it wouldn't be a surprise if some market participants reacted negatively or unpredictably if the debt ceiling is not raised. There are already some signs of funding tightness in short term credit markets; unwinding decades of market precedent is generally a bad thing. The US first received a AAA rating almost 100 years ago, when the US began to take over as the world's reserve currency from the United Kingdom. It would be a lamentable thing to lose. In not being able to agree on how to prevent escalation of the Federal debt, the country's elected representatives (and citizens they represent) may abrogate one of the most important parts of Washington's Farewell Address, which was to avoid "**ungenerously throwing upon posterity the burden which we ourselves ought to bear**". As time grows short, we are left hoping for divine inspiration to drive a sound compromise, perhaps driven by Senators Reid and McConnell; maybe we'll have one next week. Bottom line: don't sell your gold.

Michael Cembalest  
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### On asset sales to fund government operations

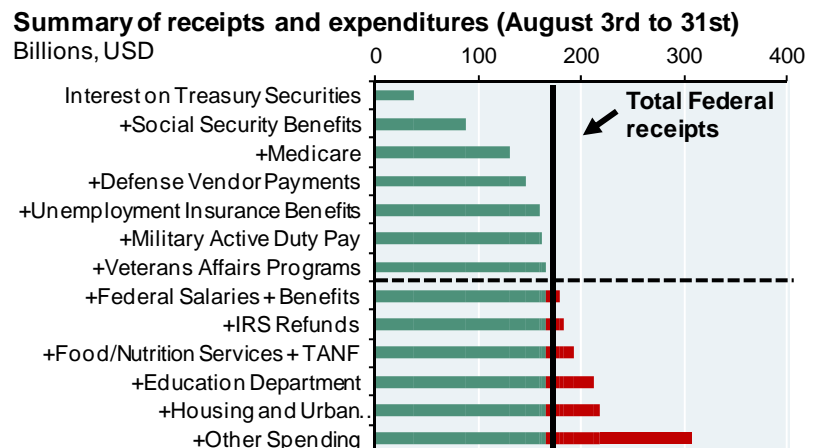
If the debt ceiling is not raised, asset sales may be a better option in the short term than prioritization or default. However, asset sales would be a very tough pill for the Treasury to swallow. As recently as May 2011, Assistant Secretary of the Treasury for Financial Markets Mary Miller wrote a note entitled "*Federal Asset Sales Cannot Avoid Need for Increase in Debt Limit*". Miller states that "*a fire sale of financial assets would be damaging to the economy, taxpayers, and financial markets. It would harm the interests of taxpayers, and would undermine confidence in the United States. Nor would such sales postpone reaching the debt limit for a meaningful amount of time. Congress would still need to raise the debt limit.*" Interestingly, Miller quotes Treasury Secretary James Baker as saying that the "*gold reserve is the foundation of our financial system*", a comment which was made *after* the move away from the gold standard in the early 1970's. Perhaps the Treasury would enter into a gold-for-cash swap with the Federal Reserve? Stranger things have happened.

### On our understanding of payment prioritization

See chart for a theoretical modeling of what the Federal government might pay (and perhaps not pay) if it had to live only on the \$170 billion in government receipts expected for August. The items above the dotted line are assumed to be paid. We have no idea if this can be done; it could be administratively impossible.

### On the Manchurian Candidate proposal of the week

In the *Manchurian Candidate*, the far right and far left of the political spectrum converge together for a brief moment. This happened recently when Congressman Ron Paul and Economist Dean Baker of the Center for Economic Policy Research agreed (as per the July 26 WSJ) on how to give the Treasury room to issue more debt under the existing ceiling. Their idea: the **Fed should rip up the \$1.6 trillion of Treasuries it owns**. Aside from its questionable legal issues and the hole it would blow in the Fed's balance sheet, it would compromise the Fed's ability to drain liquidity when the time comes (since it would do so by selling securities). It could also conjure up fears of debt monetization (and Zimbabwe). Consider this: people are worried about ECB holdings of Greek debt, which are much smaller.



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