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A Special Note on Potential Government Debt Default

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We find it incredible that the government is, once again, on the verge of a default on US debt. Although we doubt that the US will actually default, it is unfathomable that elected officials would even consider such an event. Worse yet, some officials apparently believe that a default might benefit the US.

The federal budget should always be scrutinized and pruned outside of a recessionary period, in our opinion. Future budget discussions remain important to the financial markets, and to the path of the US economy's growth. Despite our concerns about future spending patterns, we do find it curious that few elected officials have mentioned that the budget deficit has cyclically shrunk from over 10% of GDP to roughly 4.3% of GDP. However, budget issues and future spending are different issues from defaulting on the debt that pays for past outlays incurred by administrations from both parties.

Although political rhetoric might suggest otherwise, one must recognize that no country or company has ever received a cheaper cost of capital after a debt default. The notion that a default might be good is in no way based on empirical evidence, and it seems quite misleading to imply otherwise.

Auto insurance seems to provide an appropriate analogy to the situation now faced in Washington. Suppose one has an impeccable driving record, but unfortunately one day gets into an auto accident. Will the auto insurance company raise or lower one's insurance rates? Of course, the insurance company will raise the premium. One doesn't know how much the insurance premium will go up, but one can be fully certain that it will not go down.

Defaulting on the debt provides a similar range of outcomes. If the US defaults on our debt, one really doesn't know how much the US will be penalized in the financial markets, but one can be quite certain that the US will not be rewarded. One doesn't know how large the penalty will be, but our cost of capital will undoubtedly increase.



We are not sure that the apocalyptic forecasts need come true. That seems as extreme to us as do the forecasts that there will be a beneficial outcome. However, just as in the auto insurance example, all outcomes are negatively skewed.

Elected officials often talk about placing unfair burdens on future generations. Defaulting on the debt has the potential to significantly burden future generations with a structurally higher cost of capital. Despite that we don't know how large the burden would be, one has to recognize that default will necessarily result in a burden on future generations.

Although one can't assess how negative a default would be, it is critically important to realize that, just as in our insurance example, there is no possible positive outcome associated with default.

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