Fiscal Crisis *Barometer*

Watch the spreads between corporate and Treasury bond yields.

BY DAVID AHN AND ROBERT DUGGER

Given America's current and projected deficits, some Treasury officials wonder why Treasury bond yields are so low. We believe they are focusing on the wrong indicator. The first sign of fiscal crisis will be a widening of corporate-Treasury yield spreads in a process we call fiscal adjustment cost (FAC) discounting. Because of the United States' longstanding reserve currency position, the relationship between corporate and Treasury assets is crucial.

It is wrong though to think that government debt is just debt of a government. Government debt is debt of the government's constituent people and businesses. Government debt is a liability, and regardless of whether businesses think of it this way or not, some portion of it is an implicit liability on their balance sheets.

For markets, it is the unsustainable portion of the debt that matters. This is the portion that is going to be forcibly eliminated in a U.S. fiscal crisis by massive spending cuts and tax increases. Spending cuts and tax increases to achieve fiscal sustainability will echo through the U.S. economy in millions of ways. Done within a planned long-term framework, the results will be beneficial. If the needed fiscal adjustment is as large as the Congressional Budget Office and Government Accountability Office say it is, and if done suddenly and aggressively, every U.S. household and business will be hit, and the ones most dependent on unsustainable spending and tax policies will suffer most.

FAC discounting describes how investors move the unsustainable portion of a company's implicit government debt liability onto the company's balance sheet as probabilities of crisis-driven spending cuts and tax increases rise.

FAC liabilities are off-balance-sheet in stable times, but as the odds of a fiscal crisis rise, investors move these liabilities onto company balance sheets and reduce investments in those with the highest FAC liabilities. As crisis risks rise, investors sell corporate bonds and stocks, and force the yield spread between corporate and Treasury assets to widen. Some investors will move out of U.S. dollar assets altogether, pushing the dollar down. However, many

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need to keep portions of their assets in dollars because of currency allocation decisions. These investors will sell corporate securities and buy Treasury debt, pushing down Treasury rates relative to corporate rates.

A widening of the spread between corporate and Treasury yields will be the best indicator of imminent U.S. fiscal crisis, not rising Treasury rates. Marketable corporate bonds and stocks amount to about $29 trillion, far more than the $9 trillion of Treasury debt in public hands. Even a small flow from private into government assets would push down Treasury rates. A U.S. fiscal crisis could actually be accompanied by falling Treasury rates.

What does this mean for Congress? Very simply, as quickly as possible, Congress must put in place a long-term fiscal stabilization plan and do nothing to aggravate FAC discounting.

Take, for example, an investment manager with a one-to-five-year time horizon. The sharp upturn in U.S. political polarization and recent budget brinksmanship are making him worry that big U.S. fiscal changes could occur during his planning horizon. He is certain that eliminating government fiscal shortfalls is good for companies in the long-term, but he is worried about how the balance sheets of companies he is invested in could be hurt if the adjustments occur quickly. He wants to know how dependent each company is on unsustainable spending and tax levels. Does a company depend on large government contracts? Are its customers dependent on low-income tax rates, tax loopholes, or government subsidies? Answers to these questions will lead him to estimates of FAC liabilities—the present-value cost to a company of suddenly eliminating unsustainable fiscal policies.

A shorthand way of calculating a company's FAC liability is to assume that it pretty much gets what it pays for from the government. That is, its tax payments equal its benefits. The amount of those benefits that are fiscally unsustainable is what a fiscal crisis is going to eliminate. How do we know what is unsustainable? The CBO and GAO's projections of the U.S. "fiscal shortfall" provide the answer.

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Consider Exxon. If we assume Exxon's U.S. federal income tax payments equal the benefits it gets from the U.S. government, we can derive an estimate of its FAC liability. The most recent available shortfall projection is from the GAO. The present value of the twenty-year shortfall is $21.7 trillion. Exxon's 2004–09 taxes accounted for 0.12 percent of all federal taxes. Applying 0.12 percent to the $21.7 trillion gives an estimate of Exxon's FAC liability of $25.4 billion.

Exxon's year-end 2009 book net worth was $110.5 billion. If investors believe with certainty that the U.S. twenty-year fiscal gap will be closed quickly by crisis-driven spending cuts and tax increases, they could be expected to discount Exxon's book value from $110.5 billion to $85.2 billion—a 23 percent decrease.

A long-term stabilization plan will minimize FAC discounting and help job creation. Think of it this way. If you are a manufacturing executive with a design-to-delivery time horizon of ten years or so, you can be quite sure that whatever the United States needs to do to achieve fiscal sustainability will probably be enacted within your planning horizon. Your company has known for many years that big fiscal changes are inevitable. For over a decade, it has been adjusting operations to make sure it can weather the fiscal storm and have the resources needed to invest strategically after the storm passes.

For the sake of your stockholders, your company has had little choice but to invest more outside the United States, where fiscal adjustment risks are lower, and increase cash holdings. These choices maximize long-term shareholder value, but they detract from near-term U.S. growth and job creation. If you could see a solid long-term path to sustainability, your incentives to invest in the United States and create jobs would increase.

Many companies have already prepared for the fiscal storm. Markets may not be far behind, but we need to understand what they are telling us. ◆

Cost of a Fiscal Crisis

Probability of Fiscal Crisis	Book Value of Equity	FAC Liability	FAC Liability Percent of Equity	Adjusted Book Value of Equity
10 percent	$110.57 billion	$2.54 billion	2.30 percent	$108.03 billion
50 percent	$110.57 billion	$12.69 billion	11.48 percent	$97.87 billion
100 percent	$110.57 billion	$25.39 billion	22.96 percent	$85.18 billion