

# Vanguard leaders on the possibility of a U.S. debt default

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**Greg Davis:** I'm Greg Davis, chief investment officer at Vanguard. With me today is Sara Devereux, the global head of our fixed income group. Well, Sara, June is just around the corner, so guess what we'll be discussing today—the U.S. debt limit.

**Sara Devereux:** Yes, it's top of mind for many investors and certainly all professional money managers, particularly those of us in fixed income. Treasury Secretary Janet Yellen said that it's possible the U.S. government may default on its debt as early as June 1. But really, we've been working on this for a while. Since January, we've been taking precautionary steps in our portfolios in case that actually did happen.

**Greg Davis:** So, before we go there, it might benefit some of our listeners for us just to take a step back and talk broadly about the debt ceiling and the possibility and potential ramifications of a debt default. As we're talking now, we know that Congress and the White House are still debating the policy changes that would accompany a debt ceiling increase and ultimately how long that increase could last.

Normally, we know that this is a routine affair with Congress raising the debt limit to pay off obligations that were previously approved by Congress. It's really not an authorization for future spending. We know that Congress has raised the debt limit multiple times, dozens of times, over the past century under both Democratic and Republican administrations. The closest thing that we've come to a debt default was back in 2011, when they raised the debt limit just days before exhausting all of the Treasury's cash reserves.

**Sara Devereux:** Oh, yes. And that incident resulted in Standard and Poor's downgrading the federal government's credit rating. That was inconceivable until then.

**Greg Davis:** So, Sara, what's your assessment of a possible debt default now?

**Sara Devereux:** Well, collectively, we still believe that a debt default is unlikely. It would be truly unprecedented with far-reaching ramifications.

**Greg Davis:** And what are those ramifications for our fixed income investors?

**Sara Devereux:** Well, first, a caveat. Since a default would be unprecedented, no one really knows for sure exactly what all of the consequences would be. Obviously, there will be volatility in the markets even before the default itself, as the markets price in for an anticipated future.

Treasuries and government agency bonds are by far the largest share of the U.S. taxable bond market. But you don't have to be invested in Treasuries to feel the impact, because the impact of a default would be felt across the entire global economy. Treasuries are widely held by foreign governments and parties, so it has implications on currencies, trade balances, and prices of goods and services. Also, borrowing costs are pegged to Treasuries, so it has an impact not just for the government, but also for businesses, homeowners, and consumers.

I should add that even if there is a default, we expect Congress will eventually raise the debt limit and the U.S. will resume paying its obligations. The real question is whether there is long-term damage. Will the phrase "the full faith and credit of the United States" still hold as much weight in the future? Or will higher rates be a permanent fixture from now on?

**Greg Davis:** So, you have risk at the macroeconomic level, as well as within fixed income. What have we been doing to reduce the risk within our portfolios?

**Sara Devereux:** Well, we've been taking a number of steps within our bond and money market funds, such as not investing in Treasuries where the maturity dates fall in the potential default window whenever we can avoid it.

Since the government will ultimately make good on its debt, managing the risk of default is largely an operational exercise in timing cash flows. We at Vanguard are mitigating that risk for investors so they can tune out the noise and stay focused on the long term.

That said, there will be volatility, and no one can totally escape that, which is true for all asset managers, not just Vanguard.

Now, Greg, let me turn the table on you. What are the ramifications for the equity markets?

**Greg Davis:** It's a great question, Sara. I mean, some of the same macro factors that you mentioned earlier would clearly have an impact on the equity markets as well. When you think about a slowing economy, lower consumer and business spending, you couple that with greater uncertainty in general may cause investors to ultimately pull back from stocks just like they did back in 2011. And again, that was a period where we were very close to a debt default as well. So, unless there's really a quick resolution, we'll likely see volatility on the equity side as well.

**Sara Devereux:** You've been at Vanguard for almost 24 years now, so you are no stranger to periods of volatility.

**Greg Davis:** Yeah, unfortunately, we've seen volatility many times before. Although an actual debt default would be very unique and, hopefully, we don't go there.

The message we're giving to our investors has been consistent because it stands the test of time: If you're already well diversified in an allocation that suits your goals, your time horizon, and your risk tolerance, then of course, stay the course.

That includes maintaining the appropriate level of cash reserves, which will help prevent needing to sell securities in a potential down market. But the other thing we want people to remember is that volatility goes both ways—up and down. Time in the markets is better than trying to time the markets. So that's our thoughts.

**Sara Devereux:** That's so true. Thanks, Greg.

**Greg Davis:** Thank you, Sara. And for our listeners, as the situation in D.C. continues to develop, please stay tuned to our digital channels for updates and thoughts from other Vanguard leaders. Until then, take care.

**END OF AUDIOCAST**

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