Association for
Financial Professionals

AFP SURVEY:
THE FEDERAL BUDGET
AND
DEBT LIMIT

Key Results

October 2013

<u>AFP Survey: The Federal Budget and Debt Limit</u>

On October 1, 2013, the Federal government partially shut down due to a lack of agreement between Congress and the White House on the Federal budget. Complicating the situation even more, the Federal Government's debt limit will be reached on October 17 unless there is agreement to raise that limit. The effects of the partial government shutdown and fears that the U.S. could default on its financial obligations if the debt limit is not raised are already being felt by American businesses. But the impact of their decisions will likely reverberate beyond Wall Street, Capitol Hill and Pennsylvania Avenue and onto Main Streets across the country.

On October 3rd and 4th, the Association for Financial Professionals® (AFP) conducted a survey of U.S. corporate finance professionals to assess the current and anticipated effects on their organizations of the Federal government shutdown and lack of agreement on the Federal budget and debt limit. These corporate finance professionals are critical decision makers who determine whether and how America's largest companies invest their cash, both in long-term, growth-oriented investments as well as short-term financial instruments to generate surplus operating cash. The survey generated 964 responses, which are the basis of this report. The survey, produced by AFP's Research Department, focused *solely* on the possible impacts on organizations' investment strategies, access to capital and operations—<u>not</u> on the debate surrounding specific federal budget issues or the Patient Protection and Affordable Care Act.

The survey findings reveal that over the short-run, the partial government shutdown and political wrangling over the debt ceiling is expected to result in reduced demand for goods and services. In addition, the inability to reach a long-term deal to resolve the budget deficit and debt ceiling issues has already caused organizations to be more hesitant in making investments in the U.S. tied to growth (e.g., capital investment, hiring) because of the unpredictable nature of Washington and the resulting challenge in evaluating investments.

Should there be no agreement to raise the debt ceiling, companies expect to reduce capital expenditures, reduce hiring, shorten their investment durations or even consider layoffs. Failure to raise the debt ceiling and the possible subsequent default by the U.S. government would also have direct impacts on short-term investment strategies and access to capital for a number of U.S.-based organizations.

<u>Summary of Findings</u>

Sixty-one percent of survey respondents report that their organizations currently hold (or had recently held) U.S. Treasury securities in their short-term investment portfolios. The *2013 AFP Liquidity Survey* (www.AFPonline.org/liquidity), released in June of this year, found organizations invested an average 7.7 percent of their short-term investment portfolios in U.S. Treasury securities with another 5.9 percent held in money market mutual funds invested solely in Treasury securities.

Even during the recent federal government shutdown and the political posturing surrounding the pending deadline on raising the debt limit, relatively few corporate investors in Treasury securities have liquidated such holdings. Ten percent of organizations that currently hold (or had recently held) U.S. Treasury securities as a part of their investment portfolios have shed some of these holdings. Conversely, nearly nine out of ten organizations that currently hold U.S. Treasury securities have *not* changed their holdings recently, even with the possibility that the U.S. government could default on its obligations in the coming weeks.

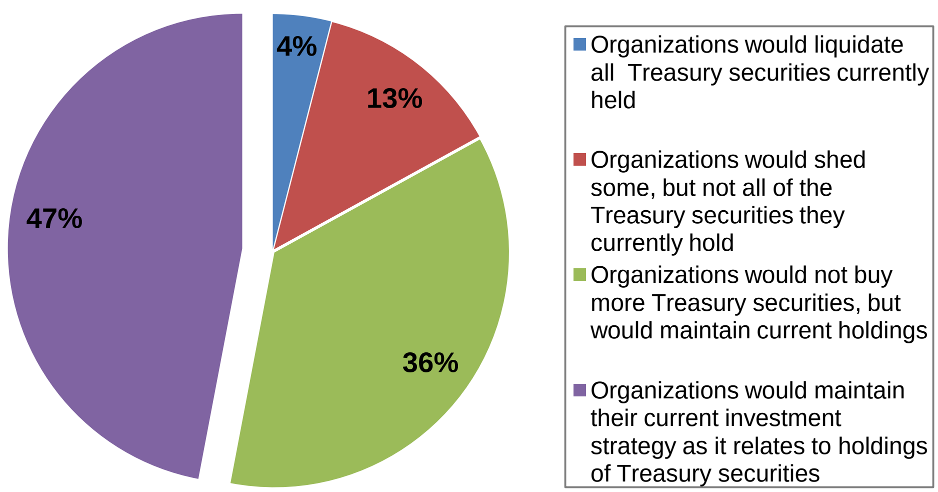
Impact on Organizations' Holdings of U.S. Treasury Securities from the Government Shutdown and the Possibility the U.S. Government Could Default on its Obligations
(Percentage Distribution of Organizations that Hold or Recently Had Held U.S. Treasury Securities)

Decreased holdings	10%
No material impact	89
Increased holdings	1

While some organizations have not yet changed their holdings of Treasury securities, more than half of organizations are likely to alter their strategies *vis-a-vis* investing in Treasury securities should Congress and the White House fail to agree on raising the federal debt limit before the U.S. government is unable to meet all of its financial obligations. If such an agreement is not reached, one-sixth of U.S. organizations that currently hold U.S. Treasury securities would liquidate at least some of these securities. Four percent of survey respondents from organizations that currently hold U.S. securities indicate that their organizations would liquidate *all* of such holdings should an agreement to raise the debt limit not be reached by October 17; another 13 percent of survey respondents indicate that their organizations would shed some—but not all—of their U.S. Treasury securities holdings.

In addition, 36 percent of organizations would not divest their current holdings of U.S. Treasury securities should the debt limit not be raised by October 17, but they also would not purchase any additional securities to augment their current holdings. Just under half of survey respondents do not anticipate their organizations altering investment strategies related to U.S. Treasury securities holdings should the Congress and the White House fail to reach a timely agreement on the debt ceiling.

Impact on Organizations' Current Holdings of U.S. Securities Should the Debt Limit Not Be Raised In a Timely Fashion
(Percentage Distribution of Organizations that Hold or Recently Had Held U.S. Treasury Securities)



The pricing of U.S. Treasury securities has a direct impact on both the supply and cost of capital available to businesses. Yields on Treasury securities impact the risk-free rate-of-return in the pricing of bank credit and other forms of capital. They also serves as the risk-free rate-of-return that is used in evaluating capital investments, as demonstrated in the AFP report, "*Current Trends in Estimating and Applying the Cost of Capital,*" report (www.AFPonline.org/FPA). Should the risk-free rate increase as a result of the failure to raise the debt limit in timely fashion, the cost of capital for many businesses could rise sharply with market disruption a possibility.

Half of survey respondents anticipate that should the Congress and the White House fail to reach an agreement to raise the debt limit by October 17 and the U.S. government defaults on its obligations, it would have a detrimental impact on their organizations' access to capital. Over a quarter of survey respondents each expect any such failure to raise the debt limit would result in increased costs for both debt financing and bank credit. Smaller percentages of survey respondents anticipate a reduction in the availability in debt financing and credit availability (16 percent and 15 percent, respectively).

Potential Impact of a Failure to Raise the Debt Limit on Organizations' Access to (Cost of) Capital
(Percent of Respondents)

No impact is anticipated	49%
Increased cost of bank credit	27
Increased cost of debt financing	27
Reduced access to debt financing	16
Reduced bank credit availability	15
Increased cost of raising equity capital	8
Reduced ability to raise equity capital	8
Other	3

Two out of five organizations are likely to take at least one defensive action should the Congress and the White House fail to agree on raising the federal debt limit and thus the U.S. government defaults on its obligations. A number of such defensive actions cited by respondents are similar to steps organizations took when the credit markets froze during height of the credit crisis in the fall of 2008.

Many of these actions would have a detrimental effect on the U.S. economy and its ongoing but fragile recovery. These actions include: reducing capital spending (cited by 21 percent of survey respondents), freezing/reducing hiring (16 percent), shortening the duration of short-term investment portfolio (13 percent), considering staff reductions/layoffs (ten percent) and tightening credit standards for trading partners (ten percent).

Likely Actions by Organizations Should the Congress and White House Fail to Reach an Agreement to Raise the Debt Limit in a Timely Fashion
(Percent of Respondents)

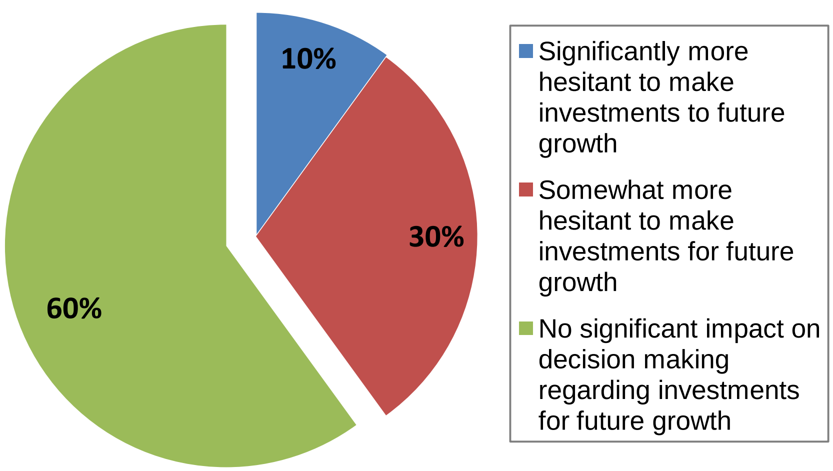
No actions are expected to be taken	60%
Reduce capital spending	21
Freeze or reduce hiring	16
Shorten the duration of short-term investment portfolio	13
Consider staff reductions/layoffs	10
Tighten credit standards for trading partners	10
Delay payments to vendors	7
Draw on credit facilities that are still available to build cash	6
Reduce current or planned inventory levels	5
Delay/discontinue share repurchases	4
Reduce/eliminate shareholder dividend payments	3
Consider closing locations (e.g., stores, factories, offices)	3

The current standoff surrounding the debate on the federal budget and the debt limit is just the latest of a string of events demonstrating the inability of policymakers in Washington to pass legislation and budgets that are critical to a functioning government and economy. Budgeting, tax policy and debt ceiling decisions seem to be made "on the fly" as Washington seemingly moves from crisis to crisis with no unified long-term vision for the nation. The result has been costly: the summer 2011 budget stalemate led one major credit rating agency to lower its sovereign debt rating for the U.S.

One result of the current political environment in Washington is the cautious behavior among business leaders. Not knowing which direction the economy may go, when another dramatic battle over the federal budget may occur, and the fact that some policymakers appear willing to allow the U.S. to default on its financial obligations, make it difficult for organizations to plan for the future. Two out of five financial professionals indicate that their organizations are now hesitant to make investments geared toward future growth (e.g., capital spending, hiring more workers) because of the recurring uncertainty surrounding the federal budget and the debt ceiling.

Impact of Continued Uncertainty Surrounding the Federal Budget and Debt Ceiling on the Willingness to Invest for Future Growth

(Percentage Distribution)



The partial government shutdown and economic uncertainty resulting from the stalemate over budgetary issues and the debt ceiling has also impacted demand for goods and services. Forty-one percent of organizations anticipate lower demand for their goods and services, while 35 percent of organizations expect to slow their own purchasing of goods/services because of the uncertain economic and political environment and disruption caused by the partial government shutdown.

Anticipated Impact of Federal Budget Clash and Debt Ceiling Debates on the Demand for Products and Services

(Percentage Distribution)

	Positive Impact	No Impact at All	Negative Impact
Demand for organization's products/ services	9%	50%	41%
Organization's demand for others' products/services	5%	60	35

Conclusions

Fights over the Federal Government budget may make for good political theatre, but they do little to promote economic growth and prosperity or foment business confidence. A number of financial professionals anticipate significant and detrimental impacts on their organizations' short-term investment strategies and their access to (cost of) capital should the Congress and White House fail to reach an agreement to raise the debt limit by October 17. A failure to raise the debt limit in a timely fashion would lead to lower capital investment and job losses, slowing business activity and harming the economic recovery.

Beyond the current crisis, recurring budget and debt limit battles are leading sources of uncertainty, which has made many organizations hesitant to make critical long-term capital investments in the U.S. and stifled demand for many organizations' goods and services. Only a long-term agreement on fiscal spending, taxation and the debt ceiling will lift the cloud of uncertainty and lead to long-term economic prosperity.

ABOUT AFP ®

Headquartered outside Washington, D.C., the Association for Financial Professionals (AFP) is the professional society that represents finance executives globally. AFP established and administers the Certified Treasury Professional and Certified Corporate FP&A Professional credentials, which set standards of excellence in finance. The quarterly AFP Corporate Cash Indicators serve as a bellwether of economic growth. The AFP Annual Conference is the largest networking event for corporate finance professionals in the world.