"There's no such thing as a free lunch" – Economist Milton Friedman

Is the term "risk-free investment" not an oxymoron? Surely "investment" implies taking at least some "risk"? Yet professional investors always refer to the "risk-free rate of return" as the percentage return that should be expected over a period of time from an investment that demonstrates absolutely no risk of default (non-payment of interest or capital). **For decades US treasury bonds (government debt) have typically been used as that benchmark** and investors have measured the return that they receive from these investments as a relative guidance for what they should expect from other, riskier investments. **However, with the recent US government shutdown threatening (but ultimately avoiding) a technical "default" of US government debt, can these bonds really still be considered "risk-free"?** If not, is there anything else out there that can possibly do the job?

We suggest that the US could consider cancelling a portion of its own debt and assess the implications of this for US treasury bonds. Given that we are also approaching the end of the 30-year bull market in bonds does this mean that government bonds in general will be anything but risk-free over the next 30 years?

Most people believe that the US has never defaulted on its obligations to pay its debts, but this is actually not true. According to Prof. Carmen Reinhardt the first time that the US ever defaulted on both its domestic *and* external obligations (far more critical – see below) was in 1790. Then in 1933 during the Great Depression, the US defaulted again on domestic debt related to the repayment of gold-based obligations. In 1979, the Treasury was late in redeeming T-bills (short-term bonds) which became due on May 3 and May 10, 1979. (Incidentally this latter delay was blamed partly on the failure of Congress to act in a timely fashion on the debt ceiling legislation in April of that year - sound familiar?). This evidence challenges the concept of "risk-free" **because even the "most credit worthy" nation on the planet is still capable of reneging on its obligations to its creditors**, even if that likelihood is fairly small. **However, as above it is important to note that the only time that the US has defaulted on its *external* obligations was over 220 years ago, in 1790**. This is an important point that we will revisit later.

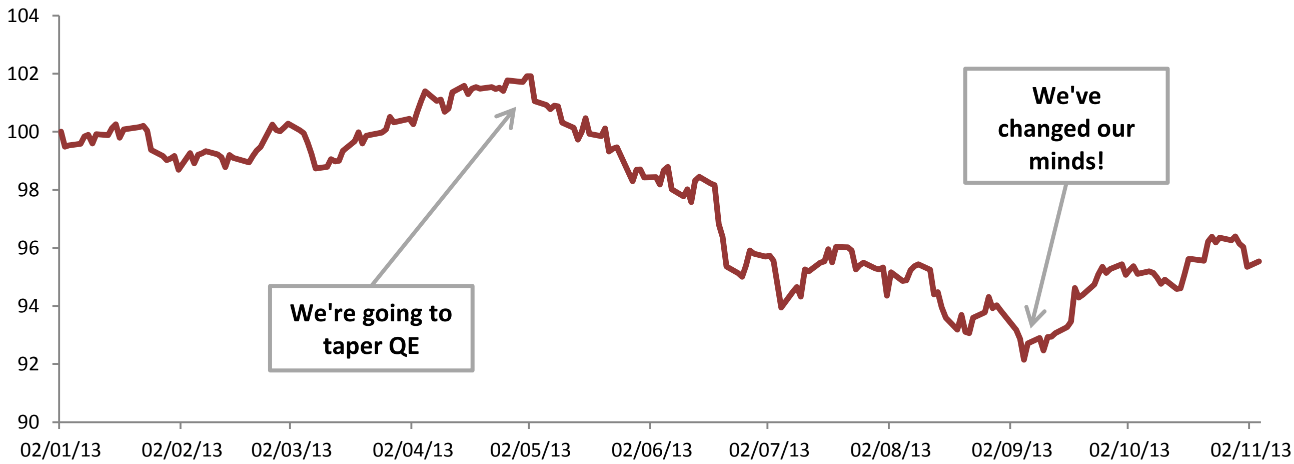
So if US treasuries aren't the safest asset available then what are the alternatives? **For an asset to be truly "risk-free" only investments that have no chance whatsoever of losing their *nominal* value can be considered** and only cash truly meets this condition. However we know from Iceland and Cyprus that banks can fail. Even in the UK, HM Treasury worries enough about a possible default that they make it explicit to consumers that the depositor protection limit in the UK is only £85,000.

Tic Toc. The "US National Debt Clock" pushes over the $16.7tn debt ceiling

In reality any investment that pays investors any kind of return is rewarding that investor for taking some sort of risk. **Seemingly then US Treasury bonds are the best of a bad bunch**, being plentiful (liquid and easy to price), backed by the US (considered by ratings agencies to be one of the safest economies in the world) and denominated in the world's global reserve currency (USD).

With this in mind it's extraordinary to consider that on the 17th October 2013, a US congress stalemate could easily have led to the first US external debt default for over 220 years if a stay of execution had not been agreed at the 11th hour. With the economy surpassing the $16.7tn self-imposed debt-ceiling, if they had taken no action to delay or increase this ceiling then the US would have been forced to stall the interest payments due to owners of US Treasuries. **Are US Treasuries therefore really "risk-free"?**

US Treasuries, the "risk-free" asset of choice, have actually been very volatile in 2013, falling over 9% peak to trough



Shortly after this crisis was averted, US Treasury bond prices quickly recovered and the fact that we did not see huge selling pressure in the run-up to the deadline suggests that **investors believe that there was very little chance that the US would renege on its obligations.** However, early next year the US debt-ceiling issue will have to be addressed once more and policy makers in the US will need to agree to either increase the ceiling again, actually start to cut debt or possibly both.

On October 24, 2013, total US public debt stood at $17.078 trillion and **since the Federal Reserve (Fed) embarked on its massive Quantitative Easing (QE) program, its share of this total US public debt outstanding has increased to 12.0% or just over $2 trillion**. **As this debt is originally issued by the US Treasury, the Treasury has to pay interest on this debt to the Fed.** Farcically the Fed then pays all of this interest back to the Treasury (after all – it's just an accounting trick between government departments), thereby ensuring that the loan remains interest free and that the loan can then be used to inject back into the US economy.

Confused?

Imagine planting a money tree in your garden. You *lend* 100% of this newly "grown" cash to your spouse to spend, on the condition that they pay you interest, which you immediately then give back to them in full. But why not just *give* them the money? Or in QE terms, **why doesn't the Fed (the government) just tell the US Treasury (the government) to not bother paying them back**, **thereby "defaulting" and wiping out the "debt" entirely?** A number of economists and politicians have forcefully argued for this option. Republican Congressman Alan Greyson wrote "The debt held on the balance sheet of the Federal Reserve can be cancelled without any significant consequence, because it is a bookkeeping artefact corresponding to the money supply. In essence, the government owes this money to itself. If I owe money to myself, I can cancel that debt at will and without consequence, essentially taking it out of my left pocket and putting it in my right pocket."

Doing so would reduce the US debt burden from $17 trillion to $15 trillion in an instant, thus creating significant debt-ceiling headroom and taking some of the pressure off next January's review meeting. This seems to be a rational, if controversial approach **but such action is untested and undoubtedly it would make a large number of foreign owners of US debt very nervous in the short-term**. Consider that the Chinese own over $1.2 trillion of US Treasuries and in total, foreign investors own over 33% of all US debt. Whilst no-one would seriously believe that the US would ever default on $5.44 trillion worth of externally owned debt, **cancelling the domestic debt burden would inevitably lead to some panic selling that might hurt the US dollar and cause US treasury yields to spike upwards** in the short-term.

Ironically the US would then face higher interest rates when they issue new debt as investors would require a higher return to compensate for the perceived higher risk of "default".

However **we believe that this panic sell-off would only serve to create a good buying opportunity for US Treasuries**, because the US would quickly move to demonstrate that they have absolutely no intention of defaulting on the money owed to their foreign creditors and business partners (see Argentina 1998 as an example of how government bond defaults make your future bond issues unpopular).

Would the Fed make such a bold, unprecedented move? In reality **we believe not**, particularly since Janet Yellen (the Fed Chairman elect) is one of Bernanke's disciples and he has not even mentioned the possibility of such action on his watch.

In any case **we believe that external buyers of new issues of US treasuries should be confident that their nominal value will be protected** (i.e. they won't default) and **therefore their status as the risk-free asset of choice will remain intact**. **However in our opinion it makes no sense to buy and hold US treasuries at present** because you are at best guaranteed to make a real capital loss (after taking inflation into account) and at worst you will suffer materially higher losses if interest rates rise. This is therefore a great dilemma for us because **we certainly wish to ensure that our clients have exposure to some low risk assets but at the same time almost by default (pardon the pun) we have very little exposure to "risk-free" treasuries** due to the risk of capital loss as interest rates rise. Our fixed interest exposure is specifically tilted towards other types of bond that can instead profit from rising interest rates. Also we have reduced our clients' exposure to bonds in general and currently continue to hold an overweight position in equities reflecting a shift in our general "market stance" from neutral to positive.

What if the US government were to cancel the debt owed by the US Treasury to the Federal Reserve? In essence, the government owes this money to itself.