



## Client Newsletter

### *Market Implications of Debt Ceiling Negotiations*

July 28, 2011

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#### **Introduction**

We have received a number of calls over the past week regarding the debt ceiling negotiations and their investment implications. We remain confident that a resolution will be reached (if not by August 2nd, very shortly thereafter) and do not see any scenario under which the United States defaults on its debt. We and many of those we trust continue to believe this is a game of political brinksmanship and the investment markets have recognized this.

Recently, we came across the following article written by Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, that touches on a number of angles with an even and measured tone. Sonders discusses the risk of default, the potential of a ratings downgrade, portfolio positioning and other economic and market-related events currently unfolding. Though published a week ago, we feel it remains relevant.

In following the principles of our *Adaptive Risk Management* investment process, we do not believe that the short term uncertainties presented by this issue offers a compelling reason to make any tactical changes to client portfolios in advance of the August 2nd “deadline”. Instead, we believe the wiser course is to stay invested based on a longer perspective, allowing our investment managers to navigate through the market noise caused by the debate.

As always, please feel free to pass this *Client Newsletter* along to your friends and family members who may be concerned about the debt ceiling negotiations and their investment implications.

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## **Staring at the Ceiling**

*Liz Ann Sonders, Senior Vice President, Chief Investment Strategist, Charles Schwab & Co., Inc.  
July 18, 2011*

### **Key points**

- Everyone's focused on the debt-ceiling negotiations, impacting everything from market action to consumer confidence.
- Default remains unlikely, but investors are wondering about portfolio positioning in the event the unthinkable occurs.
- Behind the scenes, the news isn't all bad, as some economic readings and most corporate earnings releases have been pleasant surprises.

The debt ceiling negotiations have taken center stage and it seems they're all anyone cares about at the moment. Bank Credit Analyst (BCA) wrote in a recent report, "...it seems that short-term, vicious circles of debt crisis, policy paralysis and a sickening banking system are intertwining with the bleak, secular trend of debt, deficit and growth stagnation, to create a weird miasma of both complacency and despair."

Interestingly, BCA was writing about the eurozone debt crisis (which has now troublingly spread to Italy), but it also characterizes our own problems here in the United States. Two major ratings agencies, Moody's and Standard & Poor's, are certainly weighing in with their consternation by threatening to lower the US Treasury's AAA rating.

Having gotten the subprime crisis so very wrong, the agencies have stepped up to try and redeem themselves by getting ahead of the curve on US and other sovereign debt ratings via downgrade threats. S&P went as far as specifying that it's looking for a very large deal of around \$4 trillion over 10 years to accompany the raising of the ceiling.

### **Market reactions?**

Today, I want to lay out in a little more detail possible market reactions as we head toward the deadline of August 2 (which in reality is July 22, since time is needed to pen a bill's language).

Assuming the United States did indeed default on its debt (which we believe is still extremely unlikely), most investors and certainly the media believe it would be calamitous for both the stock and bond markets. A worst-case scenario would have Treasury yields rising significantly, bringing other yields up alongside, representing a material tightening of financial conditions in less-than-perfect economic times. The dollar would likely drop, as would stocks—perhaps meaningfully so.

I don't disagree with that pessimistic assessment, but I still wouldn't attempt to handicap or forecast moves by any asset class. There's a more-benign, albeit non-consensus view that markets may not move as dramatically as many are assuming. In fact, it's supported by the so-far benign moves by both stocks and Treasury bonds as we've approached the deadline.

Demand for Treasury securities has remained strong throughout the debt-ceiling debate and stocks have been volatile, but not starkly weak. This suggests investors don't believe there will be a default and/or that Treasury prices are reflecting the global soft patch.

A default (particularly if it was short-lived) could cause the stock market to fall to the lower end of the trading range it's been in for more than a year, but may also provide some support for stocks if it triggers more meaningful negotiations and ultimately a bigger deal on debt/deficit reduction. Bonds might also rally under a more-benign scenario due to the reduction in government spending, suggesting a lessened need for Treasury financing going forward. A smaller supply of Treasury notes and bonds via issuance could lead to higher prices. This is not my base case, but I think it's always important to review every possible reaction by markets.

### **History as a guide?**

We don't really have much history to go on to gauge market reaction except for other countries that have lost AAA ratings. S&P downgraded several European countries (Belgium, Ireland, Italy, Portugal and Spain) from AAA in May 1998—a week later, 10-year bond yields for those countries were only slightly higher; a month later they were actually slightly lower; and a year later they were nearly 1% lower.

Japan lost its AAA rating in February 2001. A week later its 10-year bond yield was flat; more than 0.3% lower a month later and only slightly higher after a year. As noted by ISI, both the European and Japanese experiences suggest that other factors, such as the market's own opinion of a country's creditworthiness and broad macro and policy trends, may be more important than official credit ratings in determining a country's borrowing costs.

We can look at past government shutdowns as a pseudo-proxy for what we might expect. The most recent US government shutdown was from December 13, 1995 to January 6, 1996. The Dow Jones Industrial Average actually rose about 2% during that period.

### **What to do?**

We've heard a lot of questions about what investors should do in their portfolios to account for the risk of a default. We continue to preach the benefits of diversification among and within asset classes, both domestic and international.

There are indications that many investors have moved money into other currencies and gold, and are buying insurance against the possibility of a US default. Supporting those moves: the dollar has taken a fresh turn down, sharply relative to the Japanese yen; gold has hit record highs over the past two weeks; and the price of US Treasury credit-default swaps have risen by about 20% since early April.

Why not just recommend investors flee to cash? Even if you did put all your money under your mattress (if only figuratively), you'd have problems if inflation accelerated, not to mention the opportunity cost in the event of a substantial relief rally in stocks and/or bonds.

### **Any progress over the weekend?**

There doesn't appear to have been much forward movement over the weekend. This week Republicans will hold a House vote on a balanced-budget amendment that limits government

spending and makes it difficult to increase taxes. Although success in the House is expected, passage in the Senate is unlikely.

As noted by ISI, unless a deal is reached between President Barack Obama and House Speaker John Boehner (R –Ohio), the Senate seems poised to vote on some version of the proposal from Sen. Mitch McConnell (R –Kentucky), which would raise the debt ceiling and cut \$1.5 to \$1.8 trillion in spending. It would create the possibility of another major round of deficit reduction for later this year or early next year. But the McConnell approach has not been well received by either political party in the House, so passage is far from certain.

In the meantime, a lot has happened over the past couple of weeks. The Federal Reserve's second round of quantitative easing (QE2) came to an end and a rash of economic reports have been released, including the second consecutive weak jobs report.

Unemployment claims are just coming down from a troubling spike, but are not yet back into the sub-400,000 comfort zone. The Empire Index for July was weaker than expected and the University of Michigan consumer sentiment report was a real dud, although I think the debt ceiling debate was a major contributor to that weakness versus elevated concerns about the health of the economy. Home prices may be stabilizing, with the Case-Shiller index down only 0.1% in April.

As hard as it can be in a volatile period, I remain optimistic that we'll see a deal struck before August 2 and that the second half of the year will see a pick-up in growth. I'm often asked about "favorite" indicators and I want to highlight one below. Thanks to the Fed keeping short rates on the floor and longer-term yields remaining near 3%, the spread between the 10-year Treasury yield and the fed funds rate is near an all-time high. For those fretting a double-dip recession, note in the chart below that spreads this steep in the past have occurred **well before** recessions have begun.

### Yield Curve Says Recession is Far Off



Source: FactSet, Federal Reserve, ISI Group, Ned Davis Research, Inc., as of July 15, 2011. (Further distribution prohibited without prior permission. Copyright 2011 Ned Davis Research, Inc. All rights reserved.) Dotted line represents most recent peak.

On top of that, the global central bank tightening phase may be over as China's Premier Wen Jiabao has publicly said China's inflation problems are waning. And even though the European Central Bank's latest tightening was roundly criticized for its improper timing, the futures market is showing the next move by the ECB to be a rate cut.

### Fed and QE3

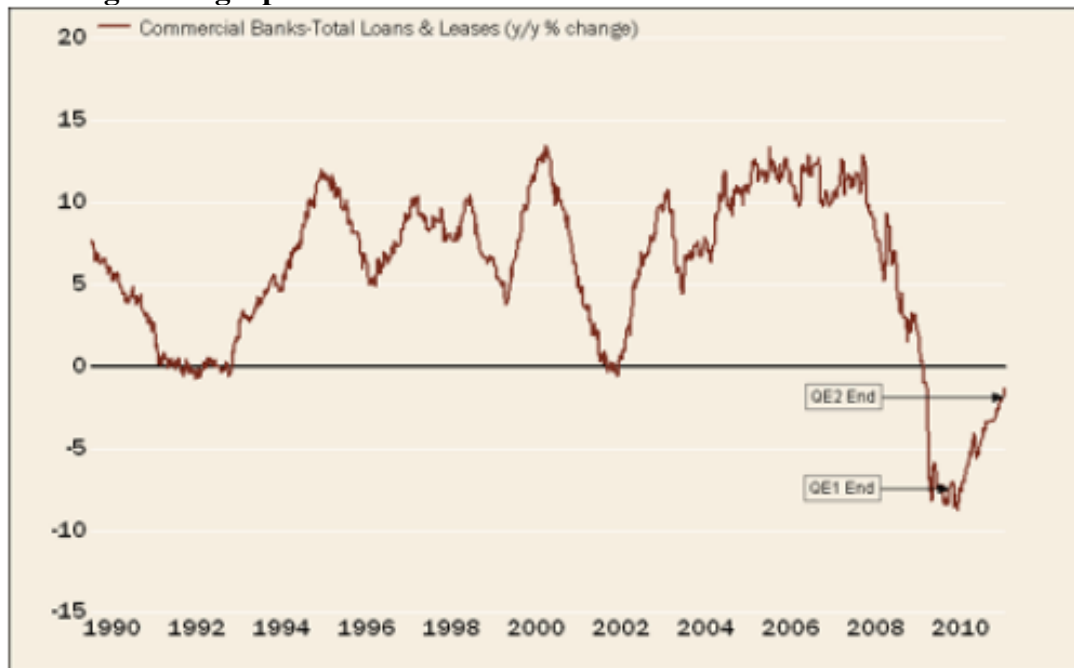
Another reason for hope can be seen when looking at the lending environment, particularly post-QE2. Although Fed Chair Ben Bernanke troubled markets on Wednesday and Thursday last week when it was perceived he was hinting at QE3 during testimony before Congress on Wednesday before seeming to back-track the following day.

Bernanke is keen to avoid two major mistakes made by the United States and Japan in the past. In 1937, the Fed halted a recovery by tightening policy too soon. In the 1990s, Japan failed to convince markets that they could fight systemic deflation.

Regardless of the market misreads of Bernanke's position, we believe his view is simply that all options remain on the table—that QE3 would only be announced if **both** of the Fed's mandates, stable prices and maximum employment, are breached. In other words, the Fed would need to see a significant deflation risk emerge anew **and** significant further deterioration in employment.

After all, the United States is no longer facing a liquidity crisis, as it was back in 2008 and 2009. As you can see below, borrowing has picked up (albeit from a very depressed level).

### Lending Picking Up



Source: FactSet, Ned Davis Research, Inc., as of July 8, 2011. (Further distribution prohibited without prior permission. Copyright 2011 Ned Davis Research, Inc. All rights reserved.) Data prior to March 31, 2010, adjusted by Ned Davis Research, Inc. to reflect FAS166 and FAS167 changes.

**Earnings looking good**

Finally, another reason for hope beyond the debt-ceiling debate comes courtesy of corporate earnings. We're still early in the reporting season for second-quarter earnings, but so far about 75% of companies have beaten expectations, which is historically high. Beats have been across a broad range of industries and sectors and earnings are on track to surpass their 2007 peak.

In sum, however, the debt ceiling is still a big cloud overhead. It has likely driven confidence way down, but other downside risks remain. Washington must act soon to restore confidence by getting a deal done.

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