

## Weekly Investment Commentary

### US Fiscal Policy a Risk, But an Actual Default Is Unthinkable

July 25, 2011

Thanks to a new agreement to at least temporarily resolve the Greek debt crisis, some intermittent progress on the debate over raising the US debt ceiling, and strong corporate earnings results, stocks posted solid gains last week. For the week, the Dow Jones Industrial Average climbed 1.6% to 12,681, the S&P 500 Index rose 2.2% to 1,345 and the Nasdaq Composite advanced 2.5% to 2,859.

The decisions made by European policymakers last week will put Greek government debt into a technical default, but importantly, it will be an orderly default with a voluntary rollover in privately held bonds. The fear had been that a default could lead to broader contagion and a dramatic sell off of European bonds, banks and the euro itself. Those risks drove area leaders to find a solution that would allow Greece to default and yet reassure markets that risks would be contained. There is still work to be done in terms of solving some of Europe's longer-term credit problems, but at least for now the debt crisis has been put on the back burner.

In contrast, the issues of US fiscal policy, the debt ceiling, default risks and credit downgrades remain front-and-center in investors' minds. The worsening political gridlock and polarization around these issues has drawn the debt-ceiling-related deadline of August 2 into sharp focus. Virtually every major party in the debates agree that a US debt default is unthinkable since no one wants to take the political hit for the financial chaos a default would cause. In our view, the possibility of an outright default is extremely low and we are expecting to see some sort of short-term debt ceiling extension.

The wild card in all of this is the ratings agencies. A potential downgrade of US Treasuries from AAA to AA has emerged as the greatest threat to the markets over the last several weeks. Although we are discounting any substantive possibility of a debt default or a federal government shutdown, the same cannot be said about a ratings downgrade, since there appears to be a real chance that one or more ratings agencies could downgrade US debt if substantive progress is not made in terms of deficit reduction. Any downgrade of US debt would have serious negative implications since investors who are required to hold AAA debt would be forced to divest from Treasuries.

There is a great deal of brinkmanship as the White House and Congress argue over a number of possible plans to deal with all of these concerns. To us, it looks like some sort of longer-term deficit reduction plan will come into formation since it seems that the austerity theme is still in place. We believe that deep spending cuts are coming — it's just a matter of Washington coming to an agreement over which cuts, how much and when.

Despite all of these debt-related risks, global indicators are not signaling a recession. One area of significant strength remains the corporate earnings landscape. We are early in the second-quarter earnings season with roughly 25% of companies having posted



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results. Of those that have reported, 75% have exceeded earnings-per-share estimates and revenue growth levels have been strong. Outside of earnings, we have also been seeing a rebound in industrial production and consumption. There are certainly areas of economic weakness (notably, the last two months have seen slower levels of jobs growth) and uncertainty remains high, but we are continuing to expect to see stronger growth levels in the second half of 2011.

From an investment perspective, we are aware that near-term risks appear elevated, but our cautiously optimistic outlook remains intact. Fundamentals are solid and there is still a great deal of cash on the sidelines that could move into the markets to fuel further gains. Over the coming months and years, we still expect risk assets including stocks to outperform cash and government bonds.

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