

THE OMNIVEST MARKET VIEW



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S&P Cuts US debt Outlook to Negative

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Standard and Poor's Rating Service cut its outlook on the US Government's long-term debt to negative this morning and the implications are quite resounding. First and foremost, the demarcation of "risk-free" is now being challenged. Moreover, where do global investors turn to during periods of great uncertainty which leads to certain flight-to-quality? Historically, the US bond market and the US dollar have benefited from a flight-to-quality. However, this too is now being challenged by the potential downgrade of US Treasury debt.

Over the very near term, the asset class which will benefit most from the risk of a Treasury downgrade will be real assets, such as gold, silver and other metals, as well as land as the perceived safety of physical assets moves ahead of paper assets.

Conversely, long-term Treasury yields are most vulnerable to losing value, as the long-term outlook for credit quality becomes questionable. Hence, risk of a much steeper yield curve, in the near term, has returned until the Federal Reserve begins to normalize interest rates.

Municipal debt may have just been given another negative slap - to the extent that Municipal debt has been pre-refunded with Treasury debt. Any downgrade of US Treasury debt will also cause a downgrade of the collateral used to pre-refund Municipal debt securities.

Corporate debt and equities should benefit from any downgrade of US Treasury debt. Why? The answer is that the transparency of corporate balance sheets and the general tone of improving corporate credit quality runs counter to the ballooning debt of the federal and local government(s). It is important to remember that the \$1.4 trillion US dollar deficit is not the sole byproduct of QE1 and QE2. Quite the contrary; the poor US fiscal condition is also clearly the result of years of abusive over-spending, relative to large entitlement plans, and uncontrolled defense spending.

The US dollar is also at great risk of losing its unambiguous role as the world's global reserve currency. The currencies that benefit will be the Swiss Franc, BRIC currencies and the euro. More broadly, the shift of economic balance between industrialized countries and the growing strength of emerging countries requires investors to carefully review their global asset allocation plans. Clearly, we believe that given this new dynamic, emerging equity markets should be expected to outperform developed equity markets.

In the debt markets, we find that high-yield debt and investment grade corporate debt will continue to outperform both Treasury debt and Municipal bonds. The risk of a downgrade of US Treasury debt will likely delay any Fed action to begin to lift rates. As such, interest rate volatility will be unevenly distributed to the back-end of the Treasury yield curve.