MARKET COMMENTARY

UPDATE ON THE U.S. DEBT CEILING SITUATION

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In the past week, since we issued our first commentary on the debate over raising the U.S. debt ceiling, we have seen the legislative outlook deteriorate. The opportunity for a "grand bargain" that could cut nearly $4 trillion from the deficit over the next 10 years appears to be lost, and Republicans and Democrats each are now working on their own packages. Overnight scorings from the Congressional Budget Office have downgraded the potential savings from both potential solutions, sending them back for rework.

WHAT IS HAPPENING?

- The lack of progress in breaking the political deadlock has begun to have repercussions in the markets, causing some flight from risk in the equity markets.
- The U.S. Treasury market remains well-behaved, with the yield on the 10-year Treasuries staying under 3.00%.
- Standard & Poor's (S&P) has warned that if the legislative solution doesn't sufficiently address the long-term deficit, the United States faces a potential downgrade of its current AAA rating to AA.

OUR EXPECTATIONS FOR THE OUTCOME

- We continue to expect an increase in the debt ceiling that would avoid a sustained default that would disrupt financial markets. A sustained default, which we view as a small (but non-zero) probability, would be damaging to risk assets such as equities, and likely also the U.S. dollar.
- The odds have increased that the cost savings eventually agreed on will be insufficient to stave off a downgrade of U.S. debt to AA by S&P.
- If U.S. debt is downgraded, we would expect some steepening of the yield curve. Money market funds would not be required to sell the resulting AA-rated debt, supporting short-term yields, while an increased risk premium on longer-term U.S. debt would lead to rising long-term rates.
- While the financial impact of a ratings downgrade is likely much smaller than a default, it would be a psychological blow to corporate and consumer confidence at a time when they could really use some positive news. Economic growth is

dependent on financial market stability, and continued uncertainty in this area is highly undesirable.

HOW IS THIS AFFECTING OUR CURRENT RISK OUTLOOK?

- Over the next 12 to 18 months, the pace of global growth and inflation will be the primary drivers of the financial markets. Failing to resolve the current debt-ceiling situation in the United States could materially suppress growth. For this reason, the U.S. debt-ceiling situation is one of the key risks holding us back from increasing exposure to equities (along with the European sovereign debt situation and the post-QE2 outlook for credit creation). While we don't anticipate the big issues of entitlements and taxes being resolved until after the 2012 election because they are too central to each party's re-election strategies, we are clearly disappointed in the devolution of the current legislative process.
- Our favored portfolio hedge against these risks remains gold, which benefits from both the policy-induced low interest rate levels and investor uncertainty over the value of fiat currencies.

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