



Debt Ceiling Update  
July 28, 2011

The ugly food fight in Washington continues over raising the debt ceiling with no real signs of progress (at least publicly), and only a few days left until the August 2<sup>nd</sup> deadline. We continue to agree with almost all the commentators on Wall Street and off that believe the debt ceiling will be raised so that the US does not miss any payments on its debt. It may take a 10 day extension for the final details of an agreement to be worked out, but certainly the parties are not stubborn enough to throw the country in default. We hope!

The other issue is a downgrade of the US debt by one or both of the major rating agencies. To avoid this rating agencies are saying there needs to be a sizable and credible deficit reduction plan agreed to by all parties. Based on what I am reading, it looks like a 50/50 bet whether this can be avoided. A downgrade of our debt would certainly be a black eye for America, but having a lasting effect on the bond market is something we don't think is likely. A short term increase in bond rates is to be expected if a downgrade does happen as institutions and other major holders and buyers of our debt adjust to the new reality. Currently the US Treasury 10-year bond trades at a rate of 2.95%. Market commentators I've seen say this rate could kick up to the 3.25%- 3.50% range for a couple days before settling back to its current level. Long term interest rates are determined mostly by what the Federal Reserve is doing to short term interest rates, inflation expectations and economic fundamentals. All of these factors continue to argue for historic low interest rates. Other countries with an "AA" rating include China, Japan and New Zealand, all strong countries with lots of foreign investors. In the case of Japan, their 10-year bond still trades at around 1.10% a decade after their debt was downgraded to "AA".

So what's an investor to do? Stick with the long-term investment game plan laid out with your portfolio manager. Its gut wrenching at the moment to stick to your guns, but it could be worse if you overreact to short term events driven by political games in Washington.

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