

GREYCOURT

Implications of a US Debt Downgrade

July 25, 2011

If Congress fails to raise the debt ceiling by August 2, there is widespread fear that the United States could default on its debt and/or lose its Triple A rating. We think the likelihood of default is remote, as there are many other obligations that could be delayed before an interest payment or principal maturity would be missed. (Consider the recent example of Minnesota, where many state functions shut down but no debt payments were missed.)

However, even if our view is right and the fear of default abates, US government bonds (Treasuries) could still lose their AAA status if the US doesn't seriously address its debt position. US creditworthiness is now inextricably tied to credible action by our political leaders to resolve structural debt and deficit issues.

This brief outlines the investment implications of a credit-induced disruption – just in case.

There is huge uncertainty about the outcomes of a ratings downgrade because such an event is unprecedented in the US. Major macro investors have left the markets, convinced that it is impossible to anticipate outcomes with enough clarity to justify making investment bets. That said, here are some thoughts on what might happen in the event of a downgrade.

Precious metals such as gold, silver and platinum would likely surge well above current prices as investors (notably foreigners) would accelerate their diversification away from US Treasury holdings. It is unlikely that the surge in precious metals would carry over to the broader commodity complex, since fears of decelerating global growth – leading to a possible double dip recession – would be expected to hurt industrial metals, energy and the agriculture commodities over the short run. Since Greycourt's longer-term outlook is for rising commodity prices driven by emerging markets consumer demand, any material pull back in prices would represent a buying opportunity.

It seems likely that investors would rapidly move into a "risk off" mind set, leading to declines in global equity prices. In particular, higher beta and more cyclical markets such as US small caps and emerging markets equities would be expected to suffer. We would also expect EAFE to fall more than US large caps over fears that a US default would lead to European sovereign defaults which, in turn, would lead to another round of financial crisis for Europe's banks. That said, we would expect equities (with the exception of the banks) to recoup initial losses reasonably quickly. First, investors may be drawn to the more attractive yields offered by stocks. Currently, US large caps offer a 2% yield while EAFE offers a 3.4% yield. Following a market decline, equity yields may actually exceed Treasury yields. Second, equity valuations are already slightly below normal (US large caps are around 15X while EAFE is around 13X). Unless corporate earnings were to plunge in response to a US default (although we don't expect it, corporations could pull back on capital expenditures, M&A and share repurchase plans), and as consumers retrench, even lower valuations would likely attract

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equity buyers. Again, we would view any sharp sell off in US large caps and global multinationals as a buying opportunity.

Interest rates are a tougher call. Rationally, one would expect that Treasury rates should rise against fears of default and downgrade. In the short run, rates will rise and might stay elevated until there is resolution to the crisis. However, if a US downgrade leads to equity and commodity price corrections (as outlined above) and if fears of a double dip recession accelerate, we expect to see the Federal Reserve enter the markets leading to rallies in the short-to-intermediate ends of the curve as investors flock to the perceived safety of Treasuries. Yes, we said the “safety of Treasuries,” even after a default or downgrade. The question, after all, is “What is the alternative?” Few markets in the world other than US Treasuries possess sufficient liquidity to absorb massive world capital flows as a flight-to-safety accelerates.

Municipals would look even more attractive on a relative basis than they do today. Most states are required to balance their budgets and have already imposed (or soon will be imposing) austerity measures needed to close their deficits. Some weaker credits may be forced into default as “risk off” investors avoid their bonds, but we do not expect any kind of broadly-based systemic risk. We should note, however, that if US sovereign debt is downgraded, it is highly likely that a number of municipal GOs would also lose their Triple A status. (The same fate would likely befall bonds issued by Ginnie Mae, Fannie Mae and Freddie Mac.)

There could be disruptions in associated markets. For example, insurance companies, pension funds and even some mutual funds may have to dump Treasuries and buy – what exactly? The perception of a US default could raise the cost of doing business for US-based companies. Credit default swaps (CDS) that pay off in the event of a Treasury default have unknown implications, although the CDS market operated smoothly during the Lehman collapse. Although we noted above that flight-to-safety investors might flock to Treasuries even in the face of a default, if they don't the dollar could weaken substantially. Banks hold billions of dollars worth of US Treasuries as security for various pending transactions (securities lending, short sales), and those banks could demand substantial additional security if Treasury prices decline.

Corporate credit will likely represent a mixed bag depending on underlying issuer credit quality. We would expect high yield bonds to react a bit like equities – initially sell off then rebound fairly quickly. It's important to note, however, that unlike equities, where valuations are currently trading below normal levels, high yield and distressed credit spreads are very tight – nearly back to pre-crisis levels. As a result, we would avoid adding much high yield exposure prior to a satisfactory resolution of the debt ceiling. Investment-grade credit, on the other hand, may perform quite well in the face of a US default. As was the case with gold and silver, fixed income investors may seek to diversify away from US Treasury holdings in favor of corporate bonds. Spreads may narrow as a result. Beware,

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though: even with narrowing spreads, absolute yield levels on high-grade bonds are nothing to write home about.

So how should investor portfolios be positioned today? As we stated at the very beginning of this letter, the likelihood of a US default is low and the market's reaction to such a situation is very difficult to predict. Our general advice is simple: stay very broadly diversified. As Peter Bernstein said, "If you don't know what's going to happen, don't structure your portfolio as though you do." This means, among other things, to stay globally invested: in a world where the US can default, you don't want to be a US-centric investor. More specifically, we would advise clients to maintain the tactical positioning that we have promulgated for some time. Namely, maintain tactical overweights to high quality US large cap and, to a lesser extent, non-US domiciled global multinational firms. In addition, underweight high beta and/or cyclical securities (such as small caps, high yield and emerging markets). And, finally, despite low current yields, clients may wish to maintain an overweight to high quality fixed income so that they will have the "dry powder" needed to capitalize on temporary stock, bond and commodity price declines.

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