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Uncertainty Surrounding the Current Debt Ceiling And Budget Deficit Debates: Possible Outcomes and Implications

In light of the recent debt ceiling and budget deficit debates intensifying over the past few days, Highland wanted to share our thoughts on the current situation. While a default on the U.S.'s current debt appears unlikely, many believe that a downgrade from AAA to AA by one of the rating agencies is possible. In April, Standard and Poor's cut the outlook for the United States from stable to negative citing that a downgrade is possible if Congress and the President cannot enact a credible reduction plan. In the report S&P said the outlook change was based on the sizable growth of U.S. deficits over the last few years as a percentage of gross domestic product. Furthermore, they stated that unlike its European counterparts the U.S. has done little to work on or enact any type of austerity plan. Unless the debt ceiling is raised in coordination with a $4 trillion deficit reduction plan by the August 2nd deadline, S&P will likely move towards a downgrade.

As for the consequences of a downgrade, some economists believe a rate cut will negatively impact an already anemic consumer confidence level. The economy has already shown signs of stress over the past few months as industrial production has slowed, unemployment has ticked up and the housing market continues to languish. A possible downgrade could put further stress on an already fragile economy.

Others have said that a backlash from a ratings downgrade is perhaps a little overblown. Presently there are 10 major countries with an AAA rating, Australia, Austria, Canada, Finland, France, Germany, Luxembourg, the Netherlands, New Zealand and Singapore. In aggregate, they add up to about $8.5 trillion of debt outstanding vs. $13.5 trillion for the U.S. AAA bond market. Rick Reider, Managing Director and CIO of Fundamental Fixed Income at Blackrock, wrote that "we do not believe the potential selling of Treasuries out of portfolios would be that sizable if a downgrade is announced." Even with a downgrade, investors of high grade debt will have few places to go and will continue to hold Treasuries. With a AA rating, the U.S. Treasury market would still remain a high quality liquid market and many investors will continue to hold their positions. However the implications for other risk assets, as Rick Reider further commented becomes significantly more difficult, and financial markets become much more inefficient for virtually all issuing entities.

As the political debates continue and become more acrimonious, many such as Mohamed A. El-Erian, CEO and Co-CIO of PIMCO, believe the damage has been done. As he stated in a recent op-ed piece for *The Washington Post*, "Already weak business and consumer confidence is being dealt a further blow. Companies with massive cash holdings now have yet another excuse to stay on the sidelines." He further states that when the debt ceiling debate is finally settled, our political leaders should begin to address the necessary steps to improve the functioning of the housing and labor markets and other programs in order to reverse the weakening of the U.S. economy.

Regardless of whether or not the immediate debt ceiling issue is resolved, we believe that the economy is positioned for slow growth going forward. As we have discussed in recent client meetings, the current employment situation will continue to be a big drag on growth for the foreseeable future and the choppy economic numbers continue to point to an overall economy that has bottomed out but certainly not on an upward trajectory. While corporate earnings and balance sheets appear to be in good shape, capital expenditures and hiring continue to be low. We believe that corporate profits will continue to grow as companies focus on growth via M&A activity and demand for their products and services overseas. However, until we see corporations begin to significantly invest in capital domestically, growth in the U.S. economy will continue to be muted.

Over the past year, our client portfolio recommendations have been defensive in nature. Exposures across all asset classes continue to be broad in hopes of diversifying portfolio risks in light of the uncertainty and expected volatility. While most of our client's portfolios still have a sizable allocation to fixed income, where appropriate, we have recommended an underweight to the class in light of a potential rise in rates. While we think equities are slightly undervalued, we tend to favor managers who are global in nature with a value bias and who have historically performed well in difficult environments. We also have advocated an allocation to inflation sensitive assets as a hedge to inflation down the road. And finally, a hedged equity position (via a core fund of funds approach) can help provide absolute returns in a very volatile environment.

Highland will continue to monitor these events as they unfold. We look forward to discussing our thoughts on the debt ceiling and budget deficit debates at your upcoming quarterly meetings.

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