Update on S&P Downgrade

August 8, 2011

Standard & Poor's downgrade of the US amid an already uncertain US economic environment, limited progress in reducing the US deficit, and a worsening European sovereign debt crisis has worsened market sentiment. Given the recency of the 2008 market decline, market volatility will be high as investors re-assess their objectives and risk tolerance.

The US remains unlikely to default on any interest or principal payments on its outstanding debt obligations. We note that the US' AAA rating was reaffirmed by two of the three major rating agencies. Unlike situations in Europe where there was not enough money in the respective treasuries to make the required interest payments, that is not an issue for the US. As a last resort, the US can print money to cover debt payments, if needed.

Additional ramifications of the US downgrade include the potential downgrade by S&P of entities that rely on US Federal funding or credit support. Fannie Mae and Freddie Mac are backed by the US Treasury, and consequently their debt was downgraded today. Similarly, municipalities that rely heavily on Federal funding are likely to see similar action. However, we again note that two of the three major rating agencies view the US as a AAA entity, a fact we believe will mute the immediate effects of the S&P downgrades.

Although the downgrade is historic, European debt problems remain a more pressing issue. Italy's current fiscal situation has worsened and its government yields have risen in reaction. The European Central Bank is currently considering buying sovereign bonds, like the Federal Reserve did in the US, in order to stabilize the rise in interest rates. Countries considered safer, such as Switzerland and Japan, have recently intervened in the currency markets to temper the rise in their currencies. Investors have flocked to safe havens to avoid investments with elevated default risk or other effects of economic weakness. Europe is in a situation mirroring the US when the asset-backed security turmoil was taking hold in 2008. The European Union has created funds to provide immediate financial assistance to members, and they have been utilized by Greece, Portugal, and Ireland. The funds are currently not large enough to provide a backstop if Italy should default, and that is driving unease in Europe.

We note that fundamentals for US companies remain strong. US companies are generating above average earnings and have significant cash on their balance sheets. Worsening consumer and business confidence could cause a pull back in spending, hurting earnings. Further deterioration in the dollar's value could have inflationary implications, resulting in a contraction of price/earnings ratios. At today's level, the S&P 500 appears fairly priced trading at 14.5x trailing earnings and 12.0x forward earnings. But, falling earnings or signs of inflation could result in the market trading down. The European markets appear cheaply priced, but are most vulnerable to further decline given their current economic and fiscal problems. Emerging markets remain healthy, but amid a global slowdown, earnings growth may slow.

US Treasury yields remain at historically low levels, as Treasuries continue to be viewed as a safe haven investment, despite the decline in the US dollar. We believe the most significant implication of the US downgrade initially could be a widening in credit spreads.

Overall, we do not believe that Standard & Poor's downgrade should be cause for a change in investment objectives. However, given more volatile markets, we recommend raising cash for any near term spending needs at this time. In addition, we will be evaluating your investment policy statements to assure that the US downgrade does not require any changes.