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WORRIES OVER “THREAT” OF DEFAULT UNNECESSARY; SOLUTION IS CLEAR

It appears that everyone in Washington – President Obama, Republicans, Democrats – is trying to exploit the threat of a government default to their advantage.

The madness has to stop – our “leaders” in Washington need to step up and find a solution to this debt ceiling issue. The political posturing has become appalling, and it appears that all parties involved – Republicans, Democrats, Congress, Senate, President Obama – are trying to exploit the threat of a bond default to their advantage. With 2012 elections approaching, it seems like some politicians would rather have someone to blame for a calamitous default (“It’s the President’s fault!” “The Republicans wouldn’t budge!” “Tax hikes from the Democrats killed the deal!”) than work cooperatively to solve the issues at hand.

All that said, at this point the probability of an actual default is extremely low. While the exact impact of a default is unknown, it does not take long to come up with some dire prognostications. First, a default would ruin the assumption that the US will always pay its debts, causing interest rates to rise. Our debt would no longer be viewed as THE “risk-free asset” and investors would sell holdings accordingly. Ratings agencies would likely knock the US credit rating down several notches from the current triple-A rating. Government agencies would, in turn, be downgraded as well, causing their costs of borrowing to rise. Since mortgage rates are derived from US Treasury and government agency (e.g. Fannie Mae) interest rates, buying a house would become more expensive and push any housing recovery even further into the future. The list goes on and on; we’ll stop here before it gets any more depressing than it already is.

What is important is that Washington is aware of the potentially disastrous effects of a default, and deep-down our lawmakers know that they cannot afford to let that happen. Reports have surfaced that government officials have assured investors and business leaders that a default will not happen. If that’s the case, then why is everyone still goofing around?

While the impact of a US default could be equal to (or potentially greater than) the damage wrought during the financial crisis of 2008, the prevention of another crisis is much simpler. During late 2007 and into 2008, the size and scope of the mortgage mess and credit default losses were unknown and nearly impossible to quantify. Hardly anyone predicted the extent of the

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damage to come, and nobody knew how to prevent the onslaught of financial pain. It wasn't until the Troubled Asset Relief Program (TARP) was announced that markets calmed down and the financial system stabilized. Financial leaders had to come up with creative solutions to an unprecedented problem.

Unlike the financial crisis, the solution to the current situation is clear – agree to a budget deal and raise the debt ceiling.

With the debt ceiling / budget talks, the solution is clear. Congress, Senate and the President need to quit playing games and strike a compromise on a budget deal and raise the debt ceiling. At this point, everyone on Capitol Hill has to realize that this is what's needed. The only questions remaining are: a) when will they stop posturing and get a deal done, and b) will the size of the final budget deal be sufficient enough to placate the ratings agencies and allow the US to keep its triple-A rating?

In our view, the biggest risk at this point is that a deal is reached but US debt gets downgraded to double-A from triple-A. In this scenario, yields on US government bonds would rise, but not tremendously (the yield on a 10-year may rise from 3.0% to 3.5%). The "full faith and credit of the United States government" wouldn't mean quite what it used to, but would still carry a lot of weight, and US government securities would still be viewed as a risk-free asset. Mortgage and consumer financing would become more expensive, creating a slight drag on economic growth.

At RiverPoint, we have been contemplating for some time the possibility that unsustainable debt levels may push interest rates higher and lead to more tepid economic growth. This is reflected in our preference for corporate bonds and high quality stocks. To be sure, all asset classes would likely experience heightened volatility in the wake of a US debt downgrade; however, high-quality corporate bonds would be relatively unaffected. Company operations would continue apace, with no change in underlying credit quality. We have avoided US Treasury bonds and government agency bonds (especially mortgage bonds), the areas of the market with the most direct exposure to an adverse rating change.

The stock side of our client portfolios consists of financially strong, multi-national companies, many of which pay handsome and growing dividends. These stocks are advantaged in a period of slower US economic growth. Companies with strong balance sheets and international operations are better positioned to capitalize on the faster growing areas of the global economy and can even benefit from a weaker dollar. A consistent stream of dividend payments also becomes an increasingly significant component of total return in periods when earnings growth is more moderate.

As always, feel free to contact a RiverPoint professional if you have any questions.