Fixed Income Market Commentary

August 2011

Anything but the Dog Days of Summer

The origin of the phrase "dog days of summer" has to do with a celestial event during the period between July 3rd and August 11th when the "Dog Star named Sirius rises with the Sun." Like many of you, I have heard the phrase a number of times used in describing the hot and humid days of summer. The Merriam-Webster dictionary on the other hand, lists one meaning as "a period of stagnation or inactivity." For my purposes, this last definition is the one I am thinking of because it is a complete and total contrast to how the last few weeks have been in the markets. As many of you are aware, they have been anything but stagnant and inactive.

Two events dominated the bond market as we approached the mid-point of the summer and they have left many of our clients asking questions. The events are related to the integrity of the once sacrosanct world of United States Treasury debt obligations. I say sacrosanct because Treasurys are considered a truly riskless asset class. When I say "riskless" I'm talking about free from default due to their explicit backing by the full faith and credit of the United States government. While Treasury investors have always had exposure to market risk as bond prices move both up and down depending on market action, they have never been at risk of not receiving an interest payment, or receiving the full face value of their bond if held to maturity.

The first event began as nothing more than a date on the calendar this summer when our country would reach its constitutionally-dictated debt limit, sparking a political free-for-all over the size and wisdom of increasing the amount of money our nation is allowed to borrow. All fair game in my opinion as any responsible legislator should be aware of how much debt we can take on and the consequences of taking on too much. Unfortunately, with Washington being what it is, the discussion turned into a political showdown where both sides dug in. When the August 2nd deadline approached the financial press had a field day and the non-financial press ran with stories and suggestions of a looming default where Treasury bond investors would not get paid their interest and principal. We discussed how far-fetched this notion was in some of our commentaries over the past few weeks, so I won't repeat them now.

Suffice to say, in the end the debt limit was increased and a viable plan was set forth for ways to begin to address reducing the size of government. With that event behind us it should have led to a period of tranquility in the markets. Alas, that is not what happened at all.

The second event was a credit rating downgrade on U.S. Treasury securities from Standard & Poor's and we are now faced with the fallout from that action. The downgrade was not a surprise to anyone who was paying attention because the rating company had warned the world well in advance of the action. The immediate aftermath of the actual downgrade has been more of an issue for equity markets while the

Treasury bond market rallied to the upside in dramatic fashion. So much for thinking that Treasurys would have given up some ground due to the downgrade.

Below, I've attempted to answer some of the questions I have received in relation to the matters above and hopefully put them into perspective.

Q: What happened?
A: On Friday evening (August 5th) the rating arm of Standard and Poor's downgraded the credit rating of the United States government by one notch to "AA+" from "AAA". In the accompanying statement S&P said the action "reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics. The downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011." While I believe that political issues contributed to the downgrade, I don't believe this is just politics. The growing level of U.S. debt-to-GDP without a clear or large enough deficit reduction plan led to S&P's downgrade. We should all look at Greece as an example of what happens when debt gets out of control. Whether it is tax increases or reduced spending levels or a combination of the two, something has to be done. In the end, the debt ceiling debate in Washington ended with deficit reductions of only $2.4 trillion with $1.5 trillion coming from future political committee recommendations. This was not enough in the eyes of S&P to merit the U.S. holding onto the coveted "AAA" rating.

Q: What does the other big rating company (Moody's) have to say?
A: Moody's left their "Aaa" rating intact for now. They have said that they believe that the unparalleled size and strength of the U.S. economy combined with the global role of the U.S. dollar and dollar denominated assets (meaning Treasurys) will not change. In times of stress, panic and confusion, the Treasury market will be the go-to asset class (as we saw on Monday, Aug.8, the first trading day after the S&P downgrade.). There is no other bond market that combines size, liquidity and availability the way the U.S. Treasury market does.

Q: Are investors fleeing the Treasury market?
A: No. If anything investors are flocking to the safe-haven of Treasurys. Treasury debt at "AA+" is still considered extremely high quality. There is genuine debate over S&P's decision with some observers faulting them for their action. What S&P does is offer an opinion. To the extent that it differs from what others think, that is what makes a market. Investors have bid-up the price of Treasury bonds in the aftermath of the downgrade, following on the trend we saw throughout the final weeks of the debt-ceiling debate. I am not surprised by the bond market's strength. One big reason for the strength in Treasurys is that buyers have very few options for other places to go with their "safe" money.

Q: Which countries remain "AAA" rated and which are rated alongside us at "AA+"?
A: Canada, Australia, France, Germany, Switzerland and the United Kingdom are some of the countries rated "AAA" while New Zealand and Belgium join us in being "AA+" rated. It should be noted that rating changes occur as economies evolve. As our economy stabilizes and grows, I would expect a return to "AAA" status.

Q: Should I be selling my bonds now?
A: My first advice is not to panic. I would not want to be a seller of any security during periods of market turmoil when liquidity evaporates (meaning you won't be able to sell at reasonable prices). In the immediate aftermath of the downgrade Treasury and high quality bonds went up in value as rates continue

to decline. This is not indicative of a bond-market panic. As I stated above, "AA+" is still considered very high quality and I would not recommend selling based on the S&P's downgrade action alone.

My advice is to stay the course. This may sound self-serving but I firmly believe it. Some observers have drawn a parallel between today and 2008 when Lehman defaulted and credit markets froze. The credit markets – the lifeblood of corporate finance, are functioning smoothly. Corporate issuers are able to tap the bond market and borrow at very competitive and low rates. In 2008 this was not the case.

Lastly, if all of the "noise" from the trading day is keeping you up at night then why don't you give us a call? Your relationship manager can walk you through our thinking on the subjects of both the bond and stock markets, and address your areas of concern. If your current portfolio mix is still leaving you uncomfortable then discuss it with us and we can adjust your portfolio so that you can sleep better at night.

As always, at Adviser Investments we pride ourselves on being "An Investment Adviser You Can Talk To."

Barclays Fixed Income Index Returns Through 7/31/11

	Duration	July	YTD '11	Return '10	Return '09	Return '08
US T-Bill Index	0.32	-0.01%	0.10%	0.22%	0.37%	2.44%
US Treasury Index	5.48	1.82	4.09	5.87	-3.57	13.74
US TIPS Index	4.92	3.91	9.95	6.31	11.41	-2.35
US Aggregate Bond Index	5.18	1.59	4.35	6.54	5.93	5.24
US Govt / Credit Index	5.67	1.95	4.61	6.59	4.52	5.70
US Credit Index {A2}	6.54	2.41	5.90	8.47	16.04	-3.08
US High Yield Index {B1}	4.34	1.16	6.19	15.12	58.21	-26.16
Caa component	3.66	0.40	6.15	16.43	90.65	-44.24
Emerging Market ($$) {BA1}	6.46	1.95	7.05	12.84	34.23	-14.75
Municipal Index	8.55	1.02	5.48	2.38	12.91	-2.47
Municipal Index - 5 Year	3.94	0.92	4.31	3.40	7.40	5.78

Source: Barclays Capital

Christopher Keith
Senior Vice President
Fixed Income Manager