



PERSPECTIVES

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Is the Debt Ceiling Made of Glass?

by Gene Dongjieux, Chief Investment Officer

At the eleventh hour, partisan posturing was set aside and compromise was allowed to finally prevail. The debt ceiling will be raised, enabling the U.S. to borrow the funds necessary to maintain its debt payment obligations. And concurrently, deficit-reducing measures — in the form of spending cuts rather than tax increases (for now) — will be enacted over the next decade.

As with all compromise, this outcome resulted in a compilation of benefits and challenges for all involved over both the short-term and the long-term.

What Happened?

In the short-term, a potential self-inflicted financial crisis was averted — America will not default on its sovereign debt. This is good news in that our AAA credit rating will most likely prevail, preventing any immediate interest rate hikes in our credit market. Congress ultimately made the only decision possible for the short-term greater good. *The present-day worst-case scenario has been avoided.*

However, the longer-term downstream effect of this solution is that it sets us up to be between the identical fiscal rock and a hard place in 2013. The bigger picture reveals a net sum of zero progress with regard to minimizing the U.S. deficit — in essence, the proverbial "can" we have heard so much about lately has in fact been kicked down the road to be addressed later. Following are the known specifics of the deal:

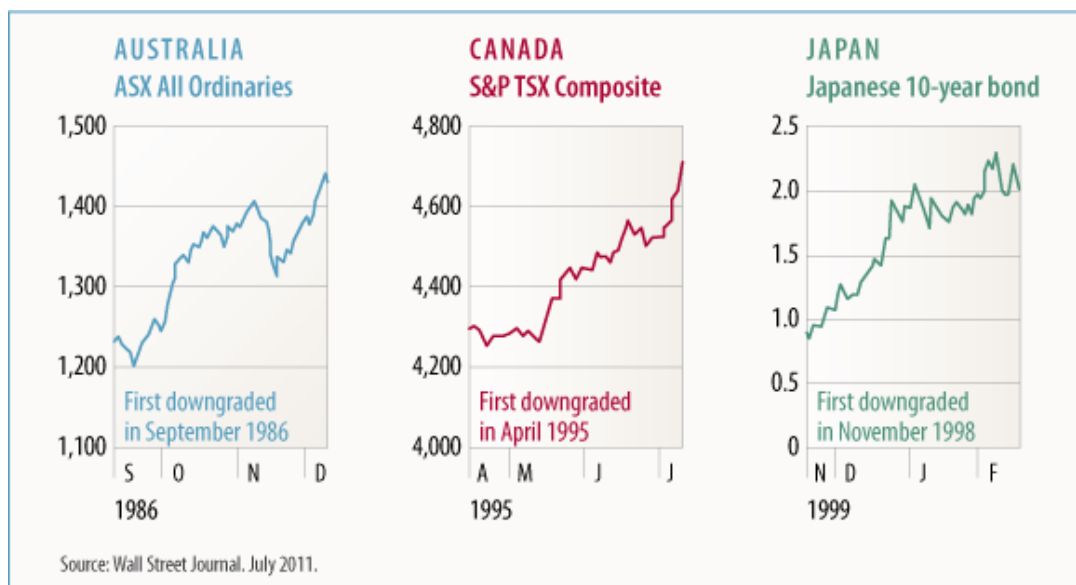
- America's borrowing authority will be raised, in conditional increments, by up to \$2.4 trillion if:
 - At least \$2.1 trillion in spending cuts are produced over the next decade

- A bipartisan debt reduction committee will be inaugurated and tasked with identifying at least \$1.2 trillion in deficit-reducing spending cuts
- Mandatory universal spending cuts will be triggered if the debt reduction committee is unable to pigeon-hole the requisite \$1.2 trillion in cuts. These mandatory across-the-board cuts would be evenly distributed between defense and non-defense (Medicaid, Social Security, Unemployment benefits, etc.) categories
- A required vote on a balanced budget amendment — passed by both chambers of Congress and sent to the States — must occur before 2011 year-end

The broader impact of their decision will depend on the details and execution of the bipartisan solution. *The bulk of austerity has yet to be defined.*

What Are the Ramifications of a Downgrade from AAA to AA+ Rating?

A diminished U.S. sovereign rating remains a distinct possibility for the foreseeable future. Looking to history for context, we recall that Australia, Canada and Japan have experienced a AAA credit rating downgrade in the past. What is interesting to note is that while there was certainly economic, financial and interest rate fallout following each occurrence, the ramifications were neither long-lasting nor catastrophic. In fact, as exhibited below, **each country's stock market rallied significantly shortly after the downgrade was implemented**. As the public market contracted from raising capital (fewer bonds were issued given the increase in their corresponding interest rates and costs), the private sector was able to step in and responded to the demand for debt-investment opportunities. Corporations were able to refinance their debt in opportunistic fashion.



Similar corporate refinancing is occurring now in the U.S. — further benefitting Corporate America and consequently, the stock market. Once again, we are reminded of the importance of keeping separate the significant woes of the federal government from the positive growth and solvency occurring throughout Corporate America today. Don't turn the government's fiscal and economic difficulties into an investment problem — that would only turn the realities of an unfortunate federal situation into a personal investment mistake.

Finally, speculation about a ratings downgrade has been media fodder for months; it will not be a blindsiding reality if it comes to pass — markets and corporations have been gradually adjusting for this possibility for some time.

How Did the Market React and Why?

Last week, the majority of investors continued to trade on their conviction that Congress would resolve the debt ceiling issue before the August 2 deadline. This week however, market activity reflected investor concern over the probability of future debt ceiling issues as well as reaction to media 'noise' regarding a lack of growth prospects evident in the U.S. economy. It is imperative now to remind ourselves that corporations continued to stockpile cash and secure additional financing sources as they prepared for the possibility of a U.S. debt default and/or an interest rate spike.

Yes, the market drifted and fluctuated as the debt ceiling stalemate ran its full hyperbolic course in Washington. Now that the government has shifted its partisan focus toward the issues of economic growth, unemployment, spending cuts and campaigns, we will continue to witness both the peaks and valleys of market volatility — the by-product of emotional and impulsive investor reaction to the latest iteration of media "noise" and speculation. The strong second-quarter corporate performance results will continue to remain largely invisible for a while longer.

Corporate America is currently strong in its recovery and growing — most importantly, it is better positioned to be prepared for the future than it has been for nearly a decade. Many healthy companies have been anticipating and planning for tougher economic times ahead — increasing their reserves of on-hand cash, limiting the hiring of new employees, minimizing inventories and capital expenditures as well as postponing expansion strategies

What Should Investors Do?

It is paramount for investors to keep their emotional responses in check — to the unemployment, foreclosures, economic instability, scarcity and an ongoing threat of a diminished credit quality that will continue to dominate the headlines — independent from an objective understanding of and belief in how efficient markets operate over the long-term.

Corporate profitability remains strong. Corporations are reporting strong and healthy second-quarter earnings. Corporate America has conscientiously and creatively carved out cost savings and has been able to leverage the growth occurring in other parts of the world. Let's use Coca Cola as an example. In 2010, over 65% of Coca Cola's operating revenues were generated from outside their North American operation.

Stocks and bonds continue to be the best long-term investment vehicles. Stocks have continued to generate greater returns than bonds.

The market has performed efficiently through two World Wars, countless other wars, multiple recessions, terrorist attacks and speculative bubbles of every permutation. When measured against other significant domestic and world events, the current U.S. sovereign debt/deficit troubles diminish with both perspective and context. Capital markets have performed through times of adversity and will continue to perform.

Adam Smith, the world's first academic economist, identified in his *Wealth of Nations* — centuries ago — the stock market as being the world's greatest voting machine. Each day, millions of investors cast votes of confidence or strategy with each buy, sell and trade transaction. There are so many factors at play — beyond the actions and inactions of Congress — that contribute to the health and stability of the U.S. economy. Political or governmental impact represents a mere fraction of influence. Some would argue that corporate earnings, unemployment figures or even Toyota's ability to remain solvent post-earthquake/tsunami factor more prominently in market performance than any of the dysfunctional happenings on Capitol Hill.

Final Thoughts

Have confidence in the market. Don't react to the continuing barrage of doomsday media. Remember that much of the media noise has already been accounted for in the daily performance of the market. Continue to be acquainted with your investment policy — remember your stated objectives (or review them with your Strategic Advisor), your risk tolerance and your time horizon. Remind yourself of your long-term financial objectives; use these as your touchstone, rather than the negative 'what-if' scenarios being played out in the media.

Mercer Advisors portfolios are designed for the long-term to withstand the market fluctuations that will occur over time for myriad reasons. They are a compilation of sophisticated, comprehensive and highly diversified strategies, customized to meet each client's unique parameters for success during both the accumulation and distribution phases of the portfolio's lifecycle.

Reference: CNN.com, *Debt ceiling: What the deal will do*, Jeanne Sahadi, August 2, 2011.

Disclosures:

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