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Dear Client:

In light of the current uncertainty surrounding the U.S. debt ceiling and deficit, we wanted to share with you some brief thoughts from our team of investment professionals. Of course, we always are available to speak with you personally about this or any other topic of financial interest.

Background:

The U.S. Constitution gives Congress the sole power to borrow, which it does by setting the aggregate limit – or ceiling – on the total amount of bonds that can be issued. Presently, approximately 60% of monthly government expenditures are covered by revenue, with the remaining 40% borrowed. The current concern is that Congress will fail to raise the debt ceiling, and the government will be unable to meet its obligations.

Primary Risks:

- *Credit downgrade of U.S. debt:* A downgrade could trigger fund investment guidelines and bank reserve rules, resulting in forced selling and potential investor losses.
- *Default:* The failure to pay interest on Treasury debt or other government obligations could result in higher borrowing costs for the U.S.
- *Government spending:* Because government spending comprises about 10% of GDP, a prolonged slowing of that spending could be a meaningful drag on an already weak recovery.

Expectations:

- *Timing:* A potential default and downgrade is not necessarily tied to the August 2nd date reported by the news media. Standard & Poors, one of the major U.S. rating agencies, has indicated that a failure to make progress on the deficit is the principal trigger for a downgrade, rather than missed payments. In addition, there have been indications from the government that other temporary sources of revenue might extend its ability to make payments for a short period of time after August 2nd and that interest on the debt would likely be the last item cut as spending is prioritized.
- *Equity markets:* It is possible that the current impasse will be resolved before there is meaningful damage to the economy but not necessarily before an equity-market decline. The equity markets are likely to react before the economy responds to slower government spending. Congress has heard dire warnings from various quarters, but despite making little progress on the deficit or the debt ceiling, markets have remained somewhat calm. In turn, the pressure on Congress to act has not yet been sufficiently compelling. A sharp downturn in the equity markets would likely change that perspective.
- *Fund investment guidelines:* These rules are in place to protect fund investors. In our view, it is likely (but not assured) that these rules will be suspended, if only temporarily, to protect investors from the potential loss in value associated with funds having to sell U.S. debt securities.

- *Reserve currency:* Demand for Treasuries is not likely to evaporate just because of a downgrade or default. The dollar is likely to remain the global reserve currency for the foreseeable future, and, as such, should remain in demand. Global trade still will largely be conducted in dollars, and China continues to need a stable liquid asset in which to store reserves. Even if Treasury securities are downgraded, they would seem to be the lowest risk asset available in sufficient supply to handle potential demand.

Conclusions:

We generally recommend that clients maintain diversified portfolios with appropriate cash positions and a longer-term view. The financial markets have remained relatively calm, likely reflecting either (1) the expectation that the risks will not be fully realized, (2) the fact that there are few attractive alternatives to fill the role Treasuries play in portfolios, or (3) the reality that there is little consensus on direction. Therefore, there has been insufficient cause for immediate, dramatic action. That said, should the current impasse continue and our expectations change, we will respond accordingly. In sum:

- It is not clear that the debt ceiling deadline is the critical trigger point for either a downgrade or a default.
- It is also not clear what other assets are sufficiently liquid and risk-free to be considered alternatives to Treasury securities.
- In light of the current circumstances, there is the potential for greater market volatility, underscoring the need for appropriate asset allocation.
- The timing, length, and severity of a potential market decline, if any, are unclear. Any decision to exit the financial markets would necessitate an eventual decision to re-enter the markets. As 2008 and 2009 demonstrated, market-timing can be difficult and result in large opportunity costs.

If you have any questions regarding your personal circumstances, please do not hesitate to contact your financial counselor.

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- Jeffrey Heisler, PhD, CFA, Market Strategist

This letter is not to be construed as investment or legal advice and is not an offer for sale of any security. Individuals should seek advice from their financial counselors before undertaking actions in response to the matters discussed herein. This letter is intended for clients and should not be further disseminated.