

MOVING PAST THE DEBT DEAL

*The Budget Control Act of 2011***Gary E. Pzegeo, CFA**

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Gary Pzegeo joined Atlantic Trust in 2007 as head of fixed income, focusing on portfolio management, trading, policy formulation and client service. Gary has 22 years of industry experience and began his career at Evergreen Investments in 1990. Subsequently, he was with Gannett, Welsh & Kotler as a vice president, portfolio manager and head of taxable bonds. He joined Atlantic Trust from recurrent employment at Evergreen Investments, where he functioned as senior portfolio specialist and senior portfolio manager for high yield bonds. Gary earned a Bachelors in Business Administration from the University of Massachusetts, holds the Chartered Financial Analyst designation and is a member of the CFA Institute.

The U.S. Congress avoided a potentially messy prioritization of payments by passing the Budget Control Act of 2011 on August 2, only several hours before a Treasury imposed deadline.

The act, signed by President Obama shortly after passage in the Senate, is expected to produce deficit reduction of at least \$2.1 trillion over the next 10 years through a combination of \$900 billion in caps on discretionary spending and a minimum of \$1.2 trillion in savings to be proposed by a newly created bipartisan congressional committee. Both Congress and the committee have a variety of incentives to act in a timely matter. In exchange for spending cuts, the debt ceiling initially will be increased by \$900 billion with conditional increases extending beyond the 2012 election cycle.

The completion of a deal effectively eliminates the odds of a worst-case scenario for global capital markets by preserving the full faith and credit of the U.S. Treasury for the moment and avoiding a potential near-term liquidity problem. Yields for Treasury bonds are lower since late last week, when an agreement seemed less likely, but the change in market yields seems to be influenced more by lingering concerns over the state of European debt markets and deteriorating domestic economic conditions than by the passage of the act.

While the deal averts an immediate crisis, the question over the longer term credit quality of U.S. Treasuries remains unclear. For several months the U.S. has been under review for downgrade by at least one of the three major rating agencies due to a combination of deteriorating leverage metrics and growing political risk. Pushing the next debt ceiling debate beyond the presidential election diminishes political risk at the margin, but the total amount of expected deficit reduction falls short of some of the raters' thresholds for a sustainable level of debt as a percentage of GDP. Moody's Investor Service and Fitch Ratings have both indicated that the U.S. has done enough to maintain the top rating for the near term, but more needs to be done to secure a AAA rating beyond the scheduled amount of

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deficit reduction. The rating agencies may find that the act meets some of their conditions for holding the U.S. at the highest grade, but that enough risk remains to leave Treasuries on review for eventual downgrade.

The rating of U.S. federal debt has implications for a wide range of debt securities beyond U.S. Treasuries. Rating agencies have identified hundreds of highly rated unique issuers whose ratings would be at risk of falling in the event of a downgrade of the U.S. sovereign debt. Fannie Mae and Freddie Mac are included in this category, as are state and local governments with high levels of dependence on federal employment and revenues. Municipalities have faced a number of challenges over the past several years, and a further reduction in federal funding would have to be addressed by matching cuts in spending, thanks to balanced budget requirements.

Atlantic Trust Outlook

We believe passage of the act reduces some uncertainty for investors, but leaves the questions of credit ratings and the economic impact of spending cuts unanswered. The rating agencies may provide some clarity on the issue of U.S. ratings in the coming days and weeks. Meanwhile, we will learn more about the composition of the deficit reduction committee and will be subjected to further political jockeying as cuts are proposed prior to the November 23 deadline, as established by the act. Economic conditions clearly worsened in the U.S. in the first half of the year and some of the recent wrangling in Washington may be to blame for further declines in business and consumer confidence. The market’s attention appears to have shifted from debt to growth, and we will be watching closely in the coming weeks for signs of a pick-up in activity.



Source: All data from the Congressional Budget Office, 08/11

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