

## Questions & Responses

July 2011

### U.S. Budget Deficit / US Government Default

#### 1. What would a default on U.S. Treasuries mean?

Most importantly, the U.S. is not insolvent, nor would it repudiate its debt. While the U.S. government is capable of paying its bills, it may temporarily delay making payments as Congress debates a broader solution. This would result in what is referred to as a 'technical default.'

The U.S. technically defaulted on its obligations in 1979, although for purely mechanical reasons — postage difficulties. Ultimately, not a single payment was skipped. While most did not view this as a true default, ratings agencies and investors will likely construe today's situation differently.

#### 2. Will the U.S. really default on August 2<sup>nd</sup>?

The answer is 'no'. The U.S. Treasury has the ability to prioritize its fiscal responsibilities and redirect payments meant for government pension funds, military payrolls and other such recipients to pay creditors. However, this tactic may only buy a few weeks. Increasing the debt ceiling is the only real way to prevent an eventual default and we believe the U.S. government will pursue this course of action.

#### 3. What about a debt downgrade – how does this come about?

Creditworthiness is often judged on the basis of ability and willingness to cover existing debt burdens. Rating agencies could become concerned about the U.S.'s willingness to service its growing debts. If the U.S. defaulted, even on a technical basis, rating agencies have stated they will lower the nation's credit rating from AAA. However, even an AA rating conveys very minimal risk of a true default. Even without defaulting, U.S. debt could still be downgraded if a meaningful deficit reduction plan is not enacted.

#### 4. What is the probability of U.S. Government default/downgrade?

The probability of a true default with skipped payments is nearly 0%. The U.S. Treasury has multiple levers to pull and ultimately will not renege on its debts. We believe a technical default would be more likely given the short-term cash-flow disruptions that could result should negotiations drag out further than expected.

Although not our base case assumption, the even more likely outcome would be a rating agency downgrade. Fiscal policy negotiations have been volatile and Washington sources remain divided on whether Congress and the President can produce a budget agreement by the necessary deadline. We believe there is a 30% probability that this deadline will not be achieved.

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## 5. How will markets react to a default/downgrade?

Either a downgrade or a missed debt payment would cause creditors to fundamentally reassess (raise) interest rates on U.S. debt. In such a case, we imagine both equity and fixed income markets would sell off as a result. Higher interest rates on Treasuries, which are used as the benchmark for risk-less investments, would cause a cascade of valuation adjustments throughout the capital markets. In light of the government's inability to manage though critical decision making, investors would likely reassess the risk profile of all assets.

## 6. How does the U.S. budget affect municipal bonds?

State and local governments are heavily dependent on the Federal Government. In 2010, more than \$470 billion was transferred to states and municipalities for areas such as education, unemployment and Medicaid. Any disruption in fund transfers could additionally stress state and local governments.

## 7. Is an AAA-rated corporate bond (Johnson & Johnson) a better credit than the U.S. Government?

Normally, the answer is 'no' given the U.S. government both raises taxes and prints money. However, these are not normal times and the U.S. is perhaps not as "risk-less" as thought. Many large multinational corporations are adequately diversified and have more prudently managed their finances. It is possible a large multinational corporation could be a better credit than the U.S. government at a future point, although we are not yet there. Perhaps a more interesting question is whether a corporate credit is a better investment than a U.S. Treasury Bond. In this case, our answer is 'yes' given such investments offer higher yields and are one step removed from U.S. debt dynamics.

## 8. How will Glenmede navigate this situation?

Throughout 2011, we have sought to reduce portfolio risk to more reasonable levels, although we have not adopted an overly defensive allocation since our base case for the economy and markets is one of continued growth. In recognition of thinning fixed income yields, we have positioned portfolios to defend against rising rates. We have done so by shortening the duration of fixed income portfolios and investing in callable "kicker" bonds and pre-refunded bonds within our municipal portfolios. Further, we have favored risk-reducing alternatives to traditional fixed income, such as high quality equities, high-yield bonds, secured options, global bonds and absolute return strategies — these investments, to varying degree, are more defensive than equities and can serve as an alternative to increased allocations to expensive/rate-exposed fixed income.

Should there be a U.S. Government default or Treasury bond downgrade, it will force legislators to act decisively. Transitory economic and market disruptions provide patient investors with opportunity. Depending on the size and flavor of the opportunity, we could be inclined to buy on the longer end of the Treasury curve, as well as in either credit or equity markets. At this point, such statements are hypothetical. Ultimately the surrounding events and market actions will determine our response.

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