

DEBT CEILING PERSPECTIVE

Similar to the millennium computer controversy (Y2K) in 1999, the debt-ceiling debate has dominated headlines over the last two months. This media feeding frenzy, built mostly on hot air, has fostered misconceptions and has not focused on some significant realities.

At the outset, the credit rating agencies (CRA's) have a record of poor accuracy on toxic debt (Enron, Fannie Mae, Freddie Mac), mortgage-backed, structured notes, and sovereign debt of insolvent foreign economies. Why the CRA's have come to Jesus on the U.S. ratings is a function of who makes money from the issuance of government debt; which institutions are the biggest users of CRA services; and how shadow banking completely depends on collateral underlying their transactions. The attached *Wall Street Journal* article, "Heading for a 'Haircut' ", provides insight into the significance of collateral and who benefits from it. All said and done, all of the major "too big to fail" institutions have a high interest in kicking the can down the road and not addressing the lack of political leadership in Washington.

In a worst-case scenario, safety is a relative concept and, no matter what rating we have globally, we have the wherewithal to pay the interest and service the debt. Our markets also have the most stability and liquidity worldwide. More importantly, there have been 11 debt downgrades of sovereigns from AAA to AA by CRA's over the last two decades:

- Australia in September 1986
- Norway in July 1987
- Finland in October 1990
- Sweden in January 1991
- Canada in June 1994
- Italy in May 1998
- Belgium in May 1998
- Iceland in May 2008
- Japan in May 2009
- Ireland in July 2009
- Spain in January 2009

Now Canada and Australia are the icons of financial stability. More importantly, in each of these cases the pattern holds that bonds had their roughest days before the event and rallied afterward as shorts covered and indecisive buyers returned to the market committing cash.

In this instance, as the news media coverage has intensified since month-end June, the Treasury curve (table below) has instead rallied and flattened, and certainly not sold off before the event.

The issue here is not default. As stated above, we have an incoming revenue stream and can pay our bills. We also have a printing press. Additionally, the problem is not a downgrade. As noted in the history of downgrades above, a rating of AA is very strong. Whatever alchemy or agenda causes the CRA's to downgrade the U.S. to AA, nobody should then be AAA when one considers our marketplace. If the U.S. is not a AAA credit, then nobody is.

With regard to the U.S. equity market sell-off, default is not the driver. It is rather the realization that if the debt ceiling is not lifted, then government spending implodes as it is brought in line with revenues. A fiscally induced recession at both the federal and state level will increase unemployment and pressure corporate earnings.

UST Yield Curve Comparison	6/30/11	7/28/11	Change
3 Month	0.010	0.066	0.0559
1 Year	0.183	0.199	0.0153
2 Year	0.458	0.418	-0.0394
3 Year	0.796	0.665	-0.1305
5 Year	1.761	1.531	-0.2298
7 Year	2.496	2.234	-0.2621
10 Year	3.160	2.955	-0.2054
30 Year	4.371	4.260	-0.1108

Finally, for all of our clients during this period, precious metals have certainly provided the diversification we have long postulated. Gold has risen to new all-time nominal highs unadjusted for inflation.

Disclaimer: This publication contains the current opinions of the manager and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Such opinions are subject to change without notice. This publication is distributed for education purposes only. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Forecasts are based on propriety research and should not be interpreted as an offer or solicitation, nor the purchase or sale of any financial instrument. No part of this publication may be reproduced in any form, or referred to in any publication, without the express written permission of Smith Affiliated Capital Corp.



Are You Looking for
ACTIONABLE
Market Insights?

Quarterly Market Insights from
Our Chief Investment Officers
[Click Here](#)

Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit www.djreprints.com

[See a sample reprint in PDF format.](#)

[Order a reprint of this article now](#)

THE WALL STREET JOURNAL.

WSJ.com

ECONOMY | JULY 28, 2011

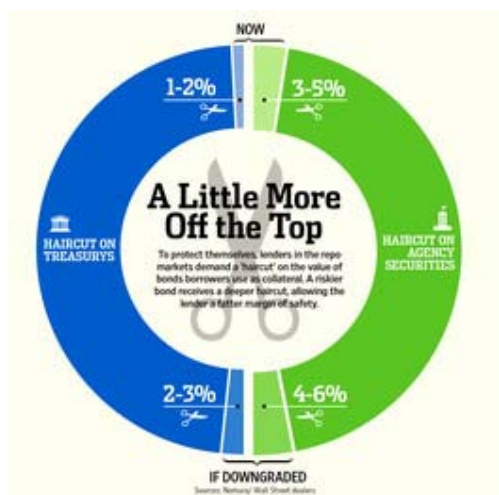
Heading for a 'Haircut'

U.S. Default or Downgrade Could Cost Repo Borrowers; Debt-Ceiling Anxiety

By MATT PHILLIPS, BEN LEVISOHN and SERENA NG

The debt stalemate in Washington is creating stress in a little-known but vital corner of the bond market, increasing the risk that banks, hedge funds and other investors will have to pay billions of dollars in additional costs if the U.S. defaults or is downgraded.

Rates are rising for repurchase agreements, or repos—a roughly \$4 trillion market that greases the wheels of the U.S. financial system—as officials in Washington feud over how to bring down the nation's debt. And Wall Street is now calculating the damage that could ensue if the nation was forced to default on its debt early next month or, more likely, loses its triple-A credit rating.



While many believe a downgrade would have relatively muted effects on the repo market, some worry that the costs to borrow there would rise.

The repo market is the primary source of short-term funding for many in the financial markets: Each day banks, hedge funds and institutional investors come together to borrow and lend cash and securities for short periods.

Borrowers put up some of the safest securities on the market as collateral, such as Treasuries and bonds backed by government agencies. The collateral is worth more than the amount of the loans and functions as a form of insurance for lenders in case the borrowers don't repay the funds. The difference between the value of the collateral and the amount of the cash loans is known as the "haircut."

But if credit-rating agencies follow through on threats of a downgrade of the U.S., lenders might demand additional compensation for the risk of holding that collateral, forcing borrowers to put up more securities or cash for the same loans. The result: banks, hedge funds and investors that rely on debt could be forced to cough up billions of dollars more in collateral, or get less cash in return.

"Given the amount of usage of Treasury securities in these transactions, even just a small change could potentially cause everybody to have to come up with more of their own money to keep trading the way that they have been," said Anil Kashyap, a finance economist at the University of Chicago Booth School of Business.

That could have ripple effects across other financial markets and the economy as borrowers sell other assets such as stocks or commodities to raise cash. The net result could be to reduce the overall amount of money available to make financial bets.

Currently, lenders typically require borrowers to hand them \$102 worth of Treasuries in exchange for every \$100 in cash.

If the U.S. is downgraded to double-A, analysts say, some money-market funds, companies and other lenders may start requiring \$103 in Treasuries for every \$100 in cash they provide in repo transactions. Even if the change in collateral requirements were small, the collective result would be akin to a widespread margin call across banks and other institutions and reduce the cash circulating in the markets and financial system.

For weeks since late spring, the U.S. repo market experienced unusual dislocations in which Treasuries were in such high demand that lenders were willing to make repo loans at interest rates close to zero.

But, in recent days, the debt-ceiling standoff and rising yields on Treasury bills have sparked concerns among some lenders. Traders say some corporations and institutions have pulled away from repos, preferring to hold cash amid the uncertainty, and repo transaction volumes have fallen as a result.

Other lenders are demanding higher interest rates on the cash they provide in repo transactions to compensate for potentially higher price volatility among Treasuries.

The rate for overnight repo transactions was about 0.1 percentage point on Wednesday afternoon, according to Wall Street traders. That compares with a rate of 0.01 percentage point earlier this week, according to FactSet data.

The rate is still low by historical standards, but the recent move is a "noticeable break higher," said Joseph Abate, money-market strategist at Barclays Capital.

"The concern is that everybody wants to remain as liquid as possible, which means holding cash, and so that is part of what we're seeing going on in the repo market," said Mr. Abate.

In a related move, [CME Group Inc.](#) told traders Monday that as of Thursday they would need to post more Treasuries when using them as collateral for futures trading, responding to rising volatility in Treasury markets.

The jitters in the repo market this time are very different from the strains the market saw in 2008, when lenders backed away from providing overnight cash to Bear Stearns Cos. shortly before its collapse, and other Wall Street dealers. The lenders were worried that troubled financial institutions that pledged shaky mortgage securities as collateral for loans wouldn't be able to return the cash, leaving lenders with assets whose values were suspect.

This time the stress focuses on how the market might react to a downgrade.

Related

[Debt-Crisis Vote Goes Down to Wire in House](#)

[Markets Swoon on Debt Fear](#)

[S&P Stays Mum on Rating for U.S.](#)

[Live Blog: The U.S. Debt Battle](#)

[Treasury Crafts a Plan: Who Gets Paid, Who Doesn't](#)

[Contractors Assess Default](#)

[Capital: Gauging the Fallout From a U.S. Downgrade](#)

[Vote: Which side is to blame for stalemate?](#)

For example, few prime brokers—which lend money and provide other services to hedge funds—use ratings to determine haircuts, looking instead at how choppy and volatile the market is.

"Treasuries have risk," says Tomer Seifan, head of prime brokerage, structured product desk at BNP Paribas. "If volatility changes, the haircut may change."

Investment vehicles that rely on a lot of debt to buy bonds could be particularly vulnerable to turmoil in the repo market. Among them: real estate investment trusts that invest in mortgage

securities backed by Fannie Mae, Freddie Mac and other government-sponsored entities .

In the event of a downgrade, the a REIT could see haircuts increase to a range of 4% to 6% from 3% to 5% on the mortgage-backed securities it pledges as collateral, according to Nomura Holdings Inc.

The interest on the loan would likely rise, as well.

—Liz Rappaport and Min Zeng contributed to this article.

Write to Matt Phillips at matt.phillips@wsj.com and Serena Ng at serena.ng@wsj.com

Copyright 2011 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com