August 2011

Comments from BlackRock Fixed Income on the US Debt Ceiling Crisis

The debt ceiling crisis came down to the wire as Congress voted on a framework to raise the debt ceiling and reduce spending over the next decade. These developments are clearly positive in terms of reducing the risk of a US debt default or a need to prioritize payments. Although these actions have reduced the likelihood of a downgrade by one or more of the rating agencies, that risk is still not at zero.

Significant Uncertainties Remain

After it became clear that a deal was in the works, an immediate (and brief) relief rally took place; however this has already largely reversed. There are three main reasons for this.

1. Ongoing Risk of Downgrade

There is still the risk that one or more of the credit rating agencies will downgrade the US credit rating. The rating agencies have expressed that even if the US raises the debt ceiling, they are concerned that the US is not doing enough to reduce spending and/or increase revenues to bring down the trajectory of the country's mounting debt.

2. Composition and Timing of Cuts

Despite the assertion that the debt ceiling will be raised and the US will not default, significant policy uncertainties remain as well as a lack of confidence in the process. These ambiguities include the composition and timing of reduced federal spending (which will have a direct effect on US GDP) and the actions of the proposed super committee that will be charged with identifying additional cuts.

3. Household and Business Confidence

Additionally, I am uncertain what the impact of these talks will have on household and business confidence. Will investors breathe a sigh of relief that we have gotten past the immediate dangers, producing an uptick in confidence; OR, as news surrounding the debt ceiling continues to grab attention, will confidence decrease?

Economic Growth Remains Weak

In terms of the US economy, I believe the sharply revised first quarter GDP number of 0.4% is of greater significance than the recent debates in Washington, DC. With the weakness of the US economy becoming increasingly apparent, consumption and investment decisions are rising to the forefront. The low second quarter 2011 real GDP number announced on July 27, 2011 of 1.3%, as well as large downward revisions, made it abundantly clear that the US recovery is weak. Many wondered why, if the economy is improving, job numbers were not picking up earlier this year. The recent GDP release gave us a clear answer: the economy is not as strong as previously thought, and therefore job growth and the economy are actually in line.

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Prior to joining BlackRock in 2004, he served from 2001 to 2003 as Under Secretary of the US Treasury for Domestic Finance. Before joining the Treasury, Mr. Fisher spent 15 years at the Federal Reserve Bank of New York.

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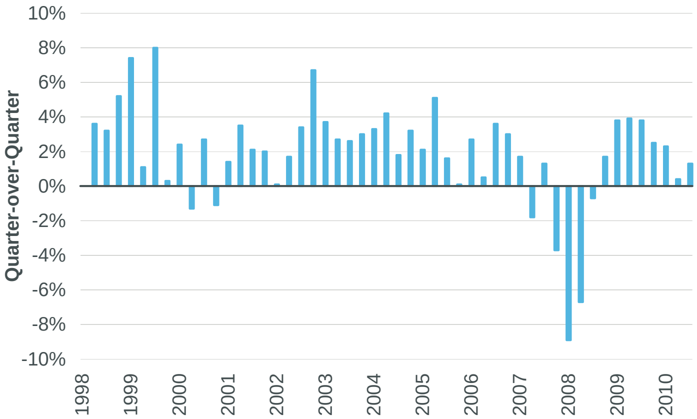
The views expressed are those BlackRock Fixed Income as of August 2011 and may change as subsequent conditions vary.

US GDP illustrates weakness of the economy



Source: Bloomberg, Bureau of Economic Analysis, data as of 2 August 2011

As the US economy is very close to stall speed, I believe the Fed may begin to change its attitude and think hard about whether they want to signal an even longer commitment to leaving rates low. Additionally, I believe the Fed is dusting off contingency plans if the economy does not improve—this is not to say that the Fed will launch a new easing program, but determining a way to invigorate the economy is clearly of paramount importance.

Implications of a Possible Ratings Downgrade are Difficult to Predict

If a credit downgrade of the US AAA rating were to occur, it would not be the cause of an increase of credit risk in the world; rather it would be a reflection of the rating agency's views of the risks we already know. The rating agencies are just announcing their opinion based on facts.

When considering the implications of a credit rating downgrade, it is important for investors to consider options with the following in mind: we have already seen the FACT of a downgrade of the US growth path, while we face a RISK of a downgrade to the US credit rating.

If the US were to be downgraded by one or more agencies, the odds are very high that there would be knock-on consequences of other borrowers getting downgraded—both corporate and public, in the US and overseas. What really ends up happening is a downward shift of the entire spectrum of fixed income securities. Additionally, although we do not learn any new information from a rating downgrade, a change in the credit rating by one or more of the credit rating agencies would be a signal to all types of investors to re-examine their risk appetite.

Three Options in the Event of a Downgrade

There are three ways that fixed income investors may want to respond to a downgrade in the context of sector allocation and risk appetite.

1. No change to Guidelines

A US downgrade would cause the average credit rating of an investor's portfolio to shift down, assuming unchanged sector and risk allocations. If investment guidelines remain unchanged, it is likely that they will end up selling riskier securities to maintain the average credit quality. Ironically, that may imply selling lower-quality assets, such as high yield and corporates, and buying US Treasuries as well as other government and government-backed securities. Of note is that the vast preponderance of the investable AAA universe is US Treasuries. In other words, there just are not enough AAA-rated securities to replace Treasuries.

2. Move to Higher Quality

A second approach investors could take would be to consider a downgrade in combination with the economic weakness and regulatory uncertainty. With this approach, investors would consider a downgrade as a signal to raise the average credit quality of their portfolios. This would result in an even larger selling of lower-quality assets.

3. Shift Down in Quality

Thirdly, investors could adjust the average credit rating to reflect the downward shift in the average rating. In other words, the portfolio would shift down in credit rating consistent with a US downgrade and other securities that are downgraded in tandem (potentially other state governments, sovereigns, and US dollar-based corporates), but retain the existing sector allocations. This approach reflects a change in the overall investable universe.

Each of these three approaches represents rational options for investors to adopt depending on their risk appetite going forward.

While a large number of investors around the world have already made these decisions, a downgrade would prompt others to consider these options. In the context of an anemic US economy, each investor should evaluate their risk appetite to identify the most appropriate action.

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