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Weekly Investment Commentary

Markets Will Look Past Debt Issues, But Not Yet

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Equities markets dropped sharply last week in the face of continuing gridlock in Washington over debt and deficit issues, some renewed problems for euro-area sovereigns and a very weak gross domestic product report. For the week, the Dow Jones Industrial Average lost 4.2% to 12,143, the S&P 500 Index dropped 3.9% to 1,292 and the Nasdaq Composite fell 3.6% to 2,756.

The parties in Washington worked through the weekend, and by Sunday night a framework for a deficit and debt deal was reached. As of the time of this writing, the final voting on the deal has not yet occurred, but it is looking like the multi-part agreement will be passed. The debt deal will raise the debt ceiling, will provide a set of spending cuts over the next ten years and would be enough to remove the specter of a US debt default.

Even with the immediate risk of the debt ceiling issue likely fading for now, however, there remains a risk that one or more of the credit ratings agencies could downgrade the credit rating of the United States. It is unclear whether any agreement on long-term debt issues will reverse the trend of debt growing faster than GDP — an issue on which the ratings agencies remain highly focused.

Financial market volatility has increased as the debate has escalated, but at this point, it is very unclear how markets would react to any sort of credit downgrade. Investors loathe uncertainty and the fixation over the debate in Washington has been enough to disrupt markets. For politicians, however, ambiguity and last-minute compromise have become standard tools of the trade.

The circus in Washington has taken attention away from economic and earnings data. Friday's GDP report showed that second quarter growth came in at a lower-than-expected 1.3% rate. Furthermore, first-quarter growth was revised downward sharply to 0.4% from an original reported rate of 1.9%. While this report certainly confirms that the economy has slowed, there has also been some positive news. Initial unemployment claims fell in July to their lowest level in several months, suggesting that we should be seeing some labor market improvements.

Corporate earnings have also continued to show resilience. At this point, approximately two-thirds of companies have reported second-quarter earnings, and over 70% have delivered results that were ahead of expectations.

Over the past several months, stocks have been stuck in a fairly narrow trading range, with strong earnings pushing prices higher and macro risks and the growth slowdown acting as counterweights. Once the debt and deficit pictures become more clear and once investors are able to price in the effects of the final deals, markets may be able to again focus on fundamentals.

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From an economic perspective, the US economy remains vulnerable, which is not a comfortable backdrop for risk assets, but we continue to believe that the probability of recession remains low and that economic data should improve in the coming months. To us, all of this suggests that the positive forces for the markets should win out, but for that to happen additional clarity is key.

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