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WEEKLY INVESTMENT COMMENTARY

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Risks Move From the Fed to Washington, D.C.

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Stocks End a Strong September on a Down Note

When September began, there appeared to be four significant risks that demanded investor focus. Three of the four—a potential contentious battle over who would be the next Federal Reserve Chairman, Fed tapering and U.S. involvement in the ongoing conflict in Syria—never materialized. This backdrop helped stocks to rally for much of the month, with U.S. indices again reaching new highs a couple of weeks ago in the immediate aftermath of the Fed's decision not to taper. Since that time, however, investors have been focusing on the fourth risk—political wrangling in Washington, D.C. over the budget and debt ceiling.

Investors have been growing more nervous about the possibilities of a government shutdown and a failure to extend the debt ceiling, which has caused a downturn in stocks and an uptick in Treasury prices. Last week, the Dow Jones Industrial Average lost 1.3% to 15,258 and the S&P 500 Index declined 1.1% to 1,691. The Nasdaq Composite bucked the trend and climbed 0.2% to 3,781. In fixed income markets, Treasury yields continued to decline (as prices rose), with the yield on the 10-year Treasury falling from 2.73% to 2.63%.

A Government Shutdown Represents a Near-Term Risk

With the government's new fiscal year beginning on October 1, Washington has a deadline of midnight tonight to pass a new continuing budget resolution that would fund the government's discretionary spending. If a resolution is not enacted, the government would be forced into a partial government shutdown, reminiscent of the similar episodes that occurred in the mid-1990s. Over the past couple of days, there have been competing funding bills making their way through the House of Representatives and the Senate, but as of early Monday morning, compromise still appeared elusive.

Should the midnight deadline pass without an agreement, it would likely cause a pickup in volatility and be a short-term negative for stocks since a shutdown would modestly hurt fourth-quarter economic growth and cause a dent in consumer confidence. However, assuming that any government shutdown is resolved within a week or two, we do believe that the longer-term impact will be limited.

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The Debt Ceiling Specter Represents a Larger Threat

In our view, the more significant risk comes about in the form of the debt ceiling—the statutory limit on the amount of debt the U.S. is able to issue. The government is set to hit the current threshold of $16.7 trillion in two to three weeks. If Congress and President Obama cannot come to an agreement that would raise the debt

ceiling before that threshold is reached, the United States may technically default on its debt, an event that has never before happened. Should a debt ceiling breach actually occur, it would tarnish the country's financial reputation and be massively disruptive to the economy and to the entire global financial system.

In our view, breaching the debt ceiling is unlikely, but the persistent threat of it occurring (and the memory of the credit downgrade that accompanied the last such showdown in the summer of 2011) is causing investors to adopt a more defensive stance. This can be seen via the direction of fund flows, with investors withdrawing money from stock funds and moving into bond funds. Additionally, in a stark reversal of the pattern that has existed for much of the year, money has been moving out of U.S. funds and into European and emerging markets stocks. Clearly, investors have shifted the focus of their anxiety onto what will happen in Washington.

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Expect More Volatility as the Drama Unfolds

Our base case outlook is that Washington stumbles toward a temporary solution on the debt ceiling, but the risk of some sort of temporary government shutdown is higher. Under this scenario, investors should prepare themselves for more market volatility, but we would expect only a modest correction in stock prices.

If, however, Washington does fail to raise the debt ceiling, this would be a much more serious situation. A technical default on U.S. debt would cause a significant blow to the global financial system, would almost certainly cause a sharp pullback in stock prices (particularly U.S. stocks) and would be a negative for fixed income credit sectors. In fact, about the only asset class that would benefit from a debt ceiling breach would be gold.

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