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Caprin Commentary: U.S. Debt Ceiling Update

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Highlights:

- The debt ceiling stalemate in Washington continues into the final weekend before the August 2nd deadline
- Ratings agencies expand downgrade threats to Muni issuers with highest federal dependencies
- Liquidity in Caprin portfolios provides flexibility to respond to the situation as it unfolds

Introduction

The debt ceiling debate continues to escalate as the stated August 2nd reconciliation deadline approaches. As we enter this last weekend, Congress and the President continue to battle in dueling press conferences and behind closed doors. Commentary and news releases abound and we strive to sort out the frustrations and political maneuvering to gain an appreciation for potential outcomes.

The U.S Government bond market though has shown no signs of concern via higher interest rates and lower prices. In fact, emerging concerns over a potentially weaker U.S. economy and ongoing anxiety over European developments have helped anchor Treasury and Agency yields.

Recent Developments

Legislative Gridlock

House Republicans are on the verge of passing their second debt reduction bill focusing on spending cuts and shorter term debt ceiling extensions; their first bill was immediately voted down by the Senate and the second likely faces a similar fate. Meanwhile, the Senate has proposed its own version of a bill more in line with the President's view, seeking to extend the debt ceiling with proposed spending cuts and revenue increases sufficient to last through the 2012 elections. Caucuses on the wings of both parties remain entrenched and overtly opposed to compromising their core principles seemingly regardless of the consequences.

We enter this weekend expecting significant 11th hour pronouncements as the three branches jockey for position, wheeling and dealing right up to the deadline. Despite the heated rhetoric, we *do* expect a default-avoiding solution prior to August 2nd. We, however, remain concerned with how the ratings agencies view Washington's ability (or inability) to legislate in a prudent, civil manner and whether we have the fortitude to be fiscally sound.

Rating Agencies

Since our July 15th update, Moody's has extended its downgrade risk metrics to State and Local Government debt with revenue, entitlement, and employment exposure to the Federal Government. Five Aaa-rated states (Virginia, Maryland, Tennessee, South Carolina, and New Mexico) and 177 Aaa-rated local issuers were placed on watch for downgrade given the aforementioned close ties. As of today, S&P has not released any official updates since our last publication.

The timing and sequence of ratings agencies action remains uncertain. They may offer Congress and the President some flexibility beyond August 2nd to reach a broader debt and deficit reduction plan. On the other hand, they could react with an immediate downgrade given the fractious nature of the process over the past few weeks. Most importantly, we do not foresee any risk of delayed principal and interest payments, nor do

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we have concerns about the safety of any U.S. Government obligation or those of the high quality Aaa issuers mentioned by Moody's. As we stated earlier, a minor downgrade from Aaa to the Aa category should not materially alter our view or our portfolio holdings. Should adjustments be required to conform to an average rating requirement, our portfolios have the flexibility to deliberately and efficiently manage change.

Money Market Funds

Money Market Funds have historically owned large quantities of U.S. Government debt. Based on publicly available analysis and reports, a ratings downgrade would not force Money Market Funds to sell U.S. Government debt to comply with their investment policies. In addition, Funds have been raising cash to build contingent liquidity, with an estimated 70% of Government-only Funds and 40% of Prime Funds in 7-day liquidity. The events of late 2008 caught investors by surprise and Fund managers appear to be taking a conservative stance though we do not believe Fund direct or repurchase Government investments are at risk. With that said, Money Market Funds offer a range of objectives and guidelines so investors should be informed about the Money Market Fund(s) used in their investment accounts.

Summary

Rhetoric is getting louder, and time is getting shorter as we approach the stated deadline. We continue to believe a solution will be reached, but uncertainty remains about how markets and ratings agencies will react. Though some portfolio holdings would be impacted with a U.S. Government downgrade, we remain comfortable with the overall credit quality and safety profile of our portfolios. We continue to monitor the situation and will update you as further events unfold.

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