# Beacon's Point: Floor to Ceiling

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## Floor to Ceiling

The week of April 18, 2011 dawned with news that rating agency Standard & Poor's has revised its long-term outlook on U.S. debt from stable to negative, citing the current size of our country's fiscal obligations and the lack of clarity from government on how to deal with its long-term budget problems. Markets reacted swiftly that day by retreating almost 2% on the news (although they have recovered since then). This outlook revision announcement added fuel to a jittery market that was already concerned about the ongoing budget disputes, issues with the U.S. debt ceiling, and the expiration of the QE2 program on June 30, 2011. Investors are clearly worried that failure to come to a bi-partisan agreement on the floor of Congress may result in a fiscal crisis that could once again threaten to destabilize the global economy.
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In its report, the rating agency reaffirmed the U.S.' current AAA rating (the highest rating possible), but lowered its outlook to "negative", stating that "there is a material risk that U.S. policymakers might not reach an agreement on how to address medium and long-term budgetary challenges by 2013. If an agreement is not reached and meaningful implementation does not begin by then, this would, in our view, render the U.S. fiscal profile meaningfully weaker than that of peer AAA sovereigns." The agency further stated that the U.S. faces a one-in-three chance of a downgrade in the next two years. While not very likely, this could conceivably happen if the White House and Congress fail to agree on a credible debt-reduction plan. Commenting on the news, Wells Fargo cited a similar announcement in 1996, when Moody's downgraded the U.S. debt outlook to negative, ahead of congressional Republicans' threats to not raise the debt ceiling.

According to a report by the Associated Press:

- Treasury Secretary Timothy Geithner has said that, as things stand right now, the government will reach its debt limit no later than May 16. He can manage funds to keep the government running until about July 8, after which the government could not pay its bills.

- If Congress refuses to raise the nation's debt limit and the U.S. Treasury lost authority to borrow additional money, the government would not be able to pay its bills and would default on its debt.

- Furthermore, the U.S. government is on pace to run a record $1.5 trillion deficit this year, which is the third consecutive fiscal year deficit exceeding $1 trillion.

- There are two competing proposals to cut $4 trillion from future deficits over the next 10 to 12 years from either side of the political divide. The White House wants to reduce the deficit through spending cuts and by ending the Bush-era tax cuts for the "wealthy". Republicans seek to narrow the deficit largely by overhauling Medicare and cutting spending elsewhere.

Unquestionably, the coming weeks will prove both eventful and very important. The direction and pace of financial assets' price movements will be determined not only by company-specific fundamentals, but also by the eventual outcome of the debate on the Congressional floor regarding the budget deficit, the crucial upcoming vote on raising the debt ceiling, and - last but not least - the uncertainty surrounding the end of the Fed's QE2 program on June 30th. In this environment, news out of Washington will likely be more important than the growth in aggregate sales and earnings, the shape of corporate America's balance sheets, the latest readings of various economic indicators, and other fundamental factors. We acknowledge that macro risks are elevated, but we also see a silver lining.

Beacon Pointe does not believe that the U.S. government is likely to lose its AAA credit rating. However, we agree with many observers who argue that the S&P rating agency's announcement will be the wake-up call government needs in order to act more decisively to solve the serious fiscal problems we face. The likely impact of the outlook downgrade, we think, will be to:

1. Force Washington's two sides to work harder together toward fiscal discipline and a credible deficit-reduction plan;

2. Rein in economic growth and corporate profit expectations, which - we would argue - were getting ahead of reality; and

3. Generate higher volatility in financial markets that will make for a bumpy ride, but should also create opportunities for disciplined investors with the ability to take advantage of more attractive valuations.

As discussed in prior client letters, Beacon Pointe's investment managers are intensely focused on valuation and invest with a "margin-of-safety" mindset. As equity markets broadly and significantly advanced since the March 2009 lows, these firms saw a number of their positions approach their fair value estimates. Staying true to their strict pricing discipline, the managers either trimmed or sold the positions. Indeed, the two-year old bull market has had a very positive effect on investors' wealth and confidence, but has also driven valuations higher, making it more difficult for our managers to identify attractively priced high-quality investment opportunities. Rather than overpaying for stocks for the sake of fully participating in the upward market momentum, these managers are willing to remain disciplined and patient until markets adjust and once again begin to offer high-quality companies at entry prices with a sufficient margin of safety.

Money management firm GMO, one of the most respected authorities on asset class valuations and return prospects, recently stated that today's markets are overvalued (although not to the same extent they were in mid-2007) and are considerably less attractive than they were at the March 2009 lows. This might very well change if markets continue to be choppy and risk tolerance gives way to risk aversion, driven by an increasingly complex fiscal, regulatory, and geopolitical global environment. In such an environment, valuation-focused managers should find many more opportunities to invest at attractive prices and to showcase their stock-picking acumen. Beacon Pointe's research philosophy and selection process has led us to recommend these types of investment managers for client portfolios, positioning them well for the road ahead.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.