Weekly Market Summary, Aug. 8, 2011

Standard & Poor's downgraded the U.S. debt rating from AAA to AA+ on Friday. The news is likely to impact markets in the coming days.

In our opinion, the largest holders of longer-term Treasuries (the Federal Reserve, China, and Japan), along with some of the largest funds in the world, still consider U.S. Treasuries to be the safest security globally. Read more now.

The Budget Control Act and Debt Ceiling

After months of political posturing and debate, it looks as if the August 2011 debt ceiling issue has finally been resolved.

The Budget Control Act was passed by the U.S. House of Representatives 269 to 161, with Democrats split evenly and Republicans voting174 infavor and 66 against. In the Senate, the bill also passed, with 74 senators in favor and 26 against. Both the president and Republican leadership in the House claimed victory, while rank and file members of Congress on both sides of the aisle maligned the bill as a betrayal of party policies.

Leading up to the deal, Republican goals broadly included no tax increases, significant spending cuts to nondefense expenditures, including entitlement programs, and a balanced budget amendment.

Democrats hoped to either raise taxes or close loopholes, cut defense spending, and protect entitlements such as social security and Medicare. Leaders of both parties claimed to want to avoid government shutdown or default, as well as to avoid a downgrade ofU.S.debt from AAA status.

Over the months leading up to the Treasury's debt ceiling deadline, Republican and Democrat leadership nearly came to agreement on a number of iterations of a "grand bargain," which would have potentially saved $4 trillion over the next 10 years and included both tax increases and cuts to entitlement programs. This would likely have been the most effective long-term solution to reducing our national debt. But with Tea Partiers putting pressure on the Republican right and Progressives lobbying on the Democrat left, a second-best deal was agreed upon instead.

In this deal, both Democrats and Republicans had to make concessions, but both achieved some key goals. The passage of the debt ceiling may have helped avoid an immediate crisis in financial markets, but the long-term compromise that was reached lacked the level of spending cuts and/or tax increases that many had hoped for.

Details of the bill

In total, the bill is expected to raise the debt ceiling between $2.1 and $2.4 trillion, which should be enough to last past the 2012 elections and into 2013. Deficit reduction is expected to total at least $2.1 trillion over the next 10 years ending in 2021.[1] Immediately following the passage of the bill, the Treasury was granted $400 billion of new borrowing authority to raise the debt ceiling. The additional $1.7 to $2 trillion in debt ceiling increases will come in two stages, both of which will originate from the desk of the president and be subject to

a two-thirds disapproval vote by both houses of Congress

As for the spending cuts, these will come almost entirely from discretionary spending, meaning that entitlement programs such as social security, Medicare, and Medicaid will be left almost untouched. Initially, $917 billion in savings from spending caps have been approved. Of these initial cuts, $350 billion will come from defense[2] and the balance will come from a variety of discretionary programs, including subsidized student loans for graduate students and loan repayment incentive programs.[3]

A Congressional Joint Select Committee on Deficit Reduction will also be formed, whose goal it will be to identify an additional $1.5 trillion in savings over the next five years. This Committee will be handcuffed in that it cannot cap spending on the wars inAfghanistanandIraqand in that Medicaid and social security will be exempt from consideration. Although tax increases may technically be allowed under the deal, Republicans are unlikely to agree to any tax hikes. Finally, Medicare may be subject to cuts of no more than 2 percent. If the Committee fails to come to an agreement, automatic reductions in spending will reduce deficits by $1.2 trillion over 10 years.

Spending Cuts Coming Only from Discretionary Spending

Source: Congressional Budget Offic

Implications of the bill

As investors, many of us are keenly interested in the economic impact of the passage of this bill. Given the initially poor market reaction after the bill's passage, one might conclude that the overall effect of passage was negative. But some negative market developments should be attributed to weak economic reports, including ISM Manufacturing and GDP, which

were published almost concurrently with the bill’s approval.

On the whole, from the perspective of the financial markets, passage of the Budget Control Act is at the very least a lesser among evils. Had a bill not been passed—forcing government officials to prioritize spending and avoid default—markets could well have reacted in a much more negative way.

Although this bill must be described as a relief from short-term crisis, its medium- and long-term implications may be less positive. With GDP growth averaging less than 1 percent annualized over the first half of the year, even the modest reductions in spending set to go into effect in 2012 could cause some drag on economic growth.

In the long run, the cuts made in the Budget Control Act may not be sufficient to turn federal budgetary habits in the right direction. In a scenario where deficit savings amount to $2.4 trillion over the next 10 years, this averages out to a deficit reduction of just $240 billion per year.

Current Congressional Budget Office projections are for average deficits of $947 billion per year over same time frame, based on President Obama’s April 2011 budget. This means that the savings will likely not exceed continued deficit spending and that, eventually, we may face another round of budget-related debate.

Closing thoughts

It is difficult to call the Budget Control Act a clear victory for either party, but it does represent a step in the right direction. At present, the immediate concerns about debt have been alleviated. In addition, regardless of political leanings, everyone can agree that it is encouraging to seeWashingtonaddressing these issues now while the public debt is manageable.

Investors will do well to recall that theU.S.economy remains the largest—and is among the most stable—in the world. Our economy and stock market have weathered volatility in the past. Although it may not boost media ratings, there is a case for optimism. The government is under pressure to provide viable solutions for the long-term, rather than a short-term fix. So, too, should investors consider their long-term goals and strategy when evaluating their personal financial situation. We, too, will be monitoring the activity inWashingtonand the markets with an eye toward the future.

Authored by Simon Heslop, CFA®, director of asset management, and Sean Fullerton, investment research associate, at Commonwealth Financial Network. ***© 2011 Commonwealth Financial Network®***

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[1] Source: Congressional Budget Office

[2] Source: *Wall Street Journal*

[3] Source: Congressional Budget Office

Weekly Market Update, July 20, 2011

Continued concerns over Europe's sovereign debt hit equity markets hard last week, leading the S&P 500 to lose a little more than 2 percent in a volatile week.

Italy's borrowing costs have become dangerously close to

unsustainable levels, in what looks to be a contagion effect in the region. This is precisely what the European Union and the International Monetary Fund were hoping to avoid by helping Greece, Portugal, and Ireland.

Read more now.

Weekly Market Summary, July 5, 2011

Treasuries sold off the most they have in months, and yields reached levels we haven't seen since April. The longer part of the curve moved the most as the second round of quantitative easing (QE2) came to its official end.

Municipals had the best-performing quarter since 1992, returning 4.45 percent in the last three months, as institutional investors found attractive yields.

Read more now in our Weekly Market Summary.

Weekly Market Summary, June 27, 2011

Equity markets were mixed during a volatile week; riskier

indices like the MSCI Emerging Markets Index increased, while developed markets lost ground.

Technical factors have continued to influence equity markets. The S&P 500 has bounced off its 200-day moving average twice recently. If it were to close below that level, 1,250 and 1,220–1,225 are the next support levels that could be strong tests.

Read more in our Weekly Market Summary.

Weekly Market Update – 6/22/2011

Economic data was mixed last week. Reports showed some slowing in retail sales and manufacturing, although the numbers were better than forecasters had predicted. Read more now in our Weekly Market Update.

Weekly Market Update – 6/15/2011

The Federal Reserve's Beige Book was released last Wednesday. The report focuses on economic activity in all 12 major districts and is the basis for topics to be covered during the

next FOMC meeting on June 22.

Comments by Fed Chairman Bernanke did little to inspire equity investors, and equity markets fell for the sixth week in a row. Read more now in our Weekly Market Update. (PDF, new window)

Weekly Market Summary – 6/8/11

Equity markets started strong in the holiday-shortened week, but they fizzled quickly after weak economic reports were released. The S&P 500 declined 2.30 percent

to rest just above 1,300. Last week's declines marked the fifth consecutive week in which most domestic equity indices have lost ground. Read more in our Weekly Market Summary. (PDF, new window)

Weekly Market Summary – 6/1/11

The European debt crisis, combined with somewhat disappointing economic numbers that point to a slowdown in the second half of the year, contributed to a Treasury rally. he 10-year was as low as 3.04 percent early Friday morning, its lowest point since Dec. 7, 2010. Read more in our Weekly Market Summary. (PDF, new window)

Weekly Market Summary, May 23, 2011

Last week, two-year Treasuries ended at 0.521 percent, close to this year's lows. The 10-year began last week with a strong rally, as yields dipped below 3.10 percent for the first time in 2011. Read more in our Weekly Market Summary.