

The events in Washington over the past six weeks have shaken investor confidence. Negotiation ended at the last second on August 2nd and Congress passed the Budget Control Act of 2011. This bill raises the debt ceiling. The bill includes an agreement to reduce fiscal spending by slightly less than one trillion over ten years. The bill also calls for the creation of a Congressional “super committee” to recommend another \$1.5 trillion in deficit reduction steps over the same ten year period. The recommendations would need to be acted on by December 23rd or else \$1.2 trillion of additional cuts over ten years would automatically kick in. Apparently these actions failed to impress all the rating agencies; after the market close on Friday, August 5th, Standard and Poor’s (S&P) reduced the U.S. sovereign credit rating from AAA to AA+ and left it on watch for further downgrade. Moody’s and Fitch still have U.S. Sovereign debt rated AAA.

The action by S&P represents the first downgrade of U.S. sovereign debt since a rating was first applied over 70 years ago. Investors are trying to work through all of the potential implications of this action. What follows is a brief summary of some of the practical considerations related to a downgrade.

Money Markets

The downgrade of Treasuries is not expected to create forced sellers in the money market sector. Treasuries will still be assigned to the first tier. Additionally, short-term ratings are more relevant for money markets and the U.S. short-term rating remains unchanged at A1+. Related to the money market sector, repo markets will also be impacted. Initial expectations are that Treasury repo markets will face little disruptions. The likely effect of a down grade on the repo market would be a modest increase in collateral haircuts. The increase is not expected to be material such that it causes forced selling by levered investors.

Additional Downgrades

S&P warned that several AAA rated insurance companies with ties to the government are now at risk of a downgrade. Additionally, S&P indicated that government agencies Freddie Mac and Fannie Mae were also put on review and will likely be downgraded. An agency downgrade has the potential to increase spreads in the mortgage market. Importantly, S&P noted that the downgrade would not have an immediate impact on banks or other corporate borrowers.

Collateral Requirements

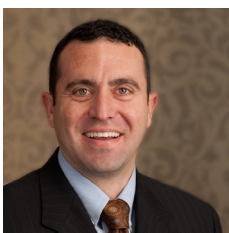
Both initial margin collateral and variation margin collateral are required to support overlay positions. Initial margin is posted with the exchange and can be in the form of cash, short-term Treasuries, or Agency debt. Non-cash securities are haircut between 1-10% depending on the volatility of the underlying assets. As in the repo market, we expect the downgrade to potentially increase the haircut on non-cash securities

that are posted as collateral. Any increase in haircut would be modest. Posting cash for initial margin however, would not be expected to change post downgrade. Variation margin is margin held in a cash or money market account in order to meet daily liquidity requirements of futures positions. It is not explicitly required by the exchange and is simply a convenient means of establishing a liquid pool of assets in order to meet daily mark-to-market margin calls. Therefore, variation margin requirements would not be directly impacted by a downgrade beyond any broader impact on money markets as noted above.

Summary

The S&P downgrade of U.S. credit puts all market participants in uncharted waters. The one certainty is that markets will remain volatile in the near term as investors work through all of the implications. Please feel free to contact The Clifton Group directly if you have any additional questions or would like to discuss this topic further.

Clifton Contacts



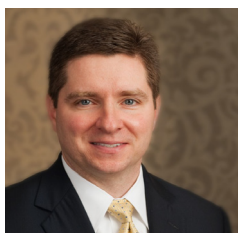
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