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STRATEGY UPDATE

Debt Ceiling, USD and Bond Yields

Concern over a possible government shutdown, signs of rising inflation, and continued low short term interest rates sent the U.S. Dollar (as measured by the DXY index) down to its lowest level in over two years this week where it presently trades within four percent of its all-time low against a basket of other world currencies. Meanwhile, longer-dated U.S. Treasury issues have risen in yield to just below the highs seen in early February as major fund managers, including PIMCO's Bill Gross sell U.S. bonds on concern over rising inflation and the ultimate ending of QE2. While it will be hard to fight the tape on rising yields, the greenback is likely to hold support at these levels presuming that the ongoing budget talks continue to point in the direction of some measured budget reduction efforts over time.

The U.S. budget battle came to a head last Friday as the struggle to avert a U.S. government shutdown ended in a short term compromise. However, the latest policymaker agreement may be little more than the warm-up for a bigger battle over the debt limit. The U.S. is projected to hit into the $14.3 trillion cap on borrowing this spring. For the price of allowing the government to go further into debt, Republicans are demanding deeper cuts than the $38 billion they got last week.

Last week, U.S. Democrats and Republicans wrangled over spending cuts leading to concern that government debt levels will soon exceed the legal limits causing a government shutdown. At just over $14.2 trillion, the government is presently only about $94 billion away from the 'allowed' debt level of $14.294 trillion according to Reuters news. With the U.S. government presently operating at a deficit at a rate of $1.4 trillion annually, we are only a short time away from hitting the ceiling. In terms of the markets, Treasury Secretary Timothy Geithner recently stated that the U.S. will hit a legal limit on its ability to borrow no later than May 16, commenting that "the longer Congress fails to act, the more we risk that investors here and around the world will lose confidence in our ability to meet our commitments and our obligations".

Had the government been forced to into a shutdown, this would have been the first occurrence in over 15 years. At the time, the U.S. Government shut down for five days in November 1994 and then again from December 16 1995 to January 6 1996 according to Bloomberg news. Markets reacted at that time by sending the dollar down, some Treasuries yields up, and the volatility index of the U.S. stock market (VIX) significantly up, at least temporarily.

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Rising Rates in Some Regions

Last week on April 7, the ECB joined China, India, Poland and Sweden in raising interest rates even as the Federal Reserve remains reluctant to tighten amid divisions among policy makers. This latest rate increase marked the first time in 40 years that Europe's benchmark was hiked before the U.S. Despite the eurozone lagging the U.S. in employment growth with an unemployment rate of 9.9% versus 8.9% for the U.S., the ECB remains very hawkish citing 'that the risk of inflation is to the upside' in the central bank's latest published statement.

Recommended Actions

1.) Favor commodity currencies over the intermediate term as rising materials prices support the Canadian and Australian dollar while also providing yield pickup. However, given the recent strength, look for pullbacks to initiate new positions.

2.) Over the short-term hold U.S. dollars against the euro as eurozone growth remains stagnant and sovereign debt issues remain while the U.S. continues to work towards a deficit reduction package.

3.) Look for selective value in the municipal bond sector as further supply comes to market and investors pull funds from municipal bond funds.

4.) Favor lower beta, higher dividend paying equities to participate in the broad rotation from bonds to stocks but still retain a defensive posture against further macro-economic shocks and as the S&P 500 retests the February 18th highs.