



SHEPHERD FINANCIAL PARTNERS
EXPERIENCE TRUST COMMITMENT

Debt Ceiling Update

The debt ceiling issue is front and center on everyone's mind. Here are our thoughts and actions surrounding the situation.

Many believe this is a "manufactured" crisis. The United States has raised the debt ceiling 80 times since the ceiling was established in 1919 without this level of rancor. However it is a crisis nevertheless and we are taking a threat of a sovereign default seriously.

Our base case is that there will be an 11th hour deal and default will be averted. However we believe at least one ratings agency (most likely S&P) will downgrade the U.S. debt rating from AAA to AA+. The effects of this scenario are most likely currently reflected in Market prices.

Having said this there is a possibility that a deal will not be reached before the August 2nd deadline. In this scenario these alternatives could occur:

- i. A short term debt ceiling raise will be passed by Congress and approved by the President and a more permanent deal will be hammered out eventually.
- ii. The president will invoke the Constitution's 14th Amendment and unilaterally raise the debt ceiling and debate will continue on a bipartisan agreement in Congress.
- iii. No deal is reached, the ceiling is not raised and the United States will effectively enter into default on its obligations.

None of the 3 scenarios listed above are good for global markets nor are they priced into current securities prices. All 3 scenarios would result in dramatically increased volatility and equity prices would be hardest hit. Scenario iii. would be the absolute worst case and Markets could easily sell off dramatically across asset classes.

As we discussed in our late June client update, we cut exposure to High Yield Bonds and increased exposure to lower duration (less interest rate sensitive) corporate bonds and levered loans. This effectively reduced the beta of portfolios and placed us in a more defensive position.

Most recently we have also reduced or eliminated agency mortgage bond exposure which could be susceptible to a U.S. debt downgrade due to the reliance of Freddie and Fannie Mae as guarantors of these mortgages. We have also reduced non-agency mortgage bond exposure to avoid any type of collateral fallout if the agency markets get hit.

We are monitoring the situation closely. Second quarter earnings season remains ongoing and company announcements have generally been positive. We remain concerned over the European debt situation as well as the ongoing inflation problem in Emerging Markets. In both these latter cases we continue to have low to no direct exposure.

As always we value the trust you have placed in us as we remain stewards of your wealth.

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