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General Re–New England Asset Management

Continuing Fiscal Uncertainty in Washington and the Impact on the Investment Markets

November 14, 2013

Presented by Bill Rotatori

Recent US Fiscal Crisis – Recipe for a Shutdown and a Showdown

"**Let me be clear**: This is President Barack Obama's government shutdown. This president consistently refuses to negotiate with Republicans about a piece of legislation that is confusing, drastically unpopular with the American people, and poisonous to our way of life.."

John A. Boehner, House speaker

"I want to be absolutely **crystal clear**: Any bill that defunds Obamacare is dead, dead."

Harry Reid, Senate Majority leader

"Let me be clear: I don't trust the Republicans. And I don't trust the Democrats"

Ted Cruz, Senator Texas - R

"But let me be clear — no option is good in that scenario"

President Barack Obama

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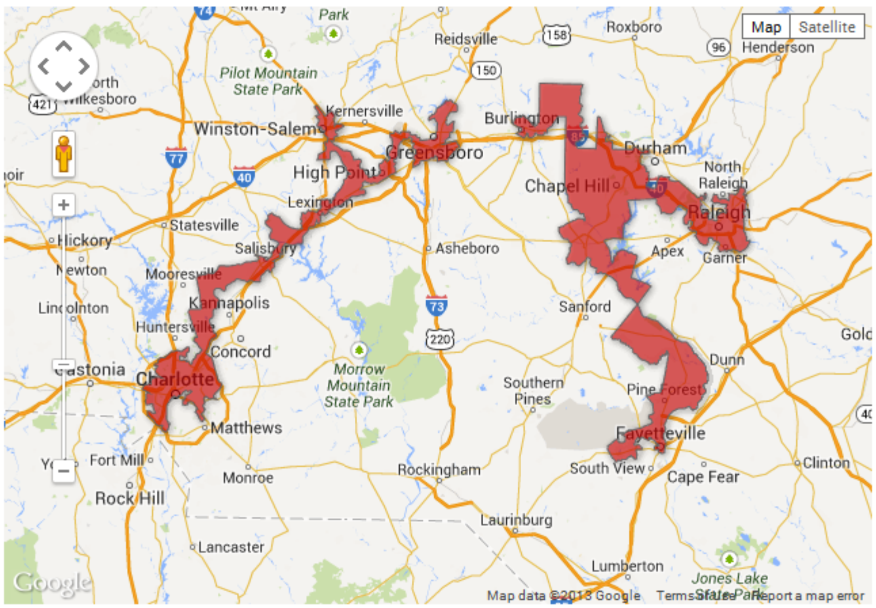
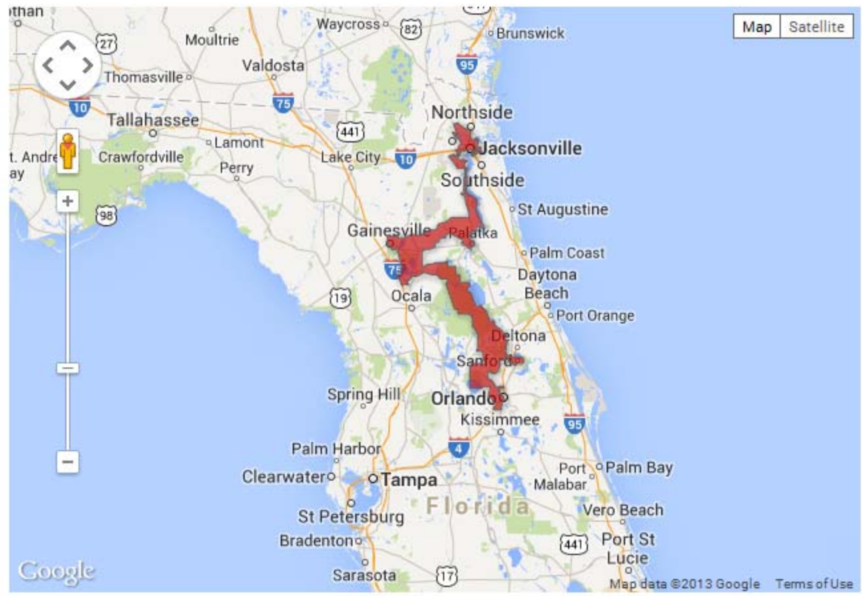
Fiscal Uncertainty – Gerrymandered Districts

"Voters used to choose their politicians but now politicians choose their voters" – Jim Cooper (D- TN)

North Carolina's 4th & 12th Districts



Florida's 5th District



Source: Governing.com

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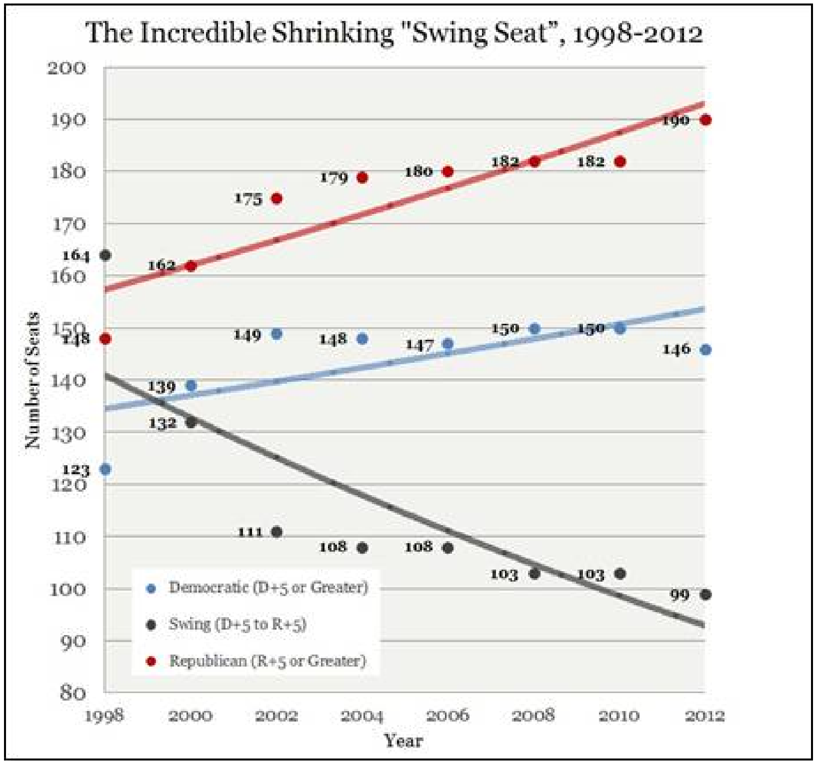
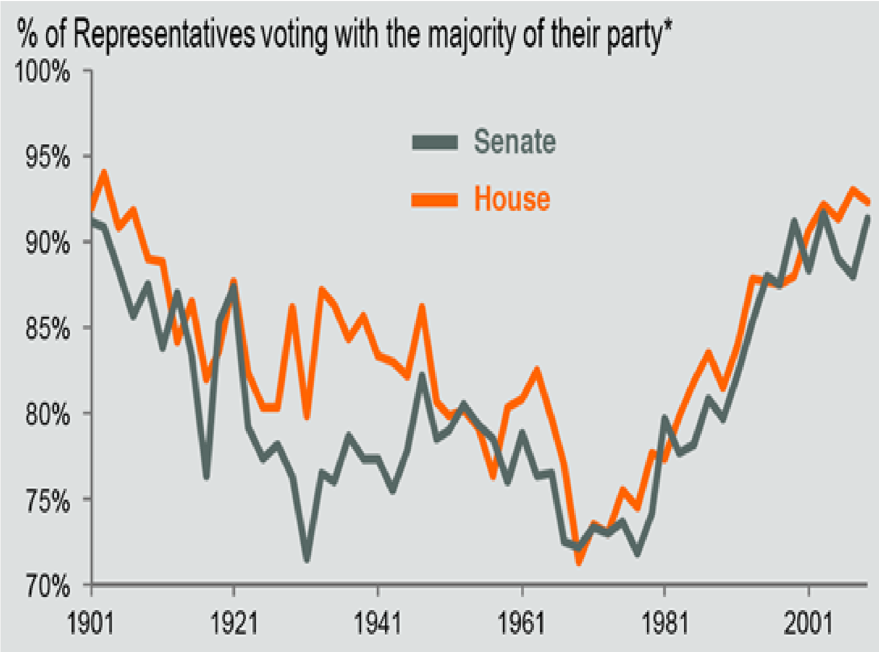
Fiscal Uncertainty – Fewer Swing Seats and More Partisan Voting





Source: Cook Political Report

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Fiscal Uncertainty

- The resolution of the recent government shutdown created three important dates :

  1. December 13th – Deadline for agreement on Budget Resolution

  2. January 15th - Expiration of the Continuing Resolution for Funding the Government

  3. February 7th - Expiration of the Debt Ceiling Suspension

- Our view of the current situation is :

  - Extreme partisanship and government dysfunction will continue.

  - The risk of government shutdown and potential default still exists but the odds are lower.

  - A broad fiscal deal that will meaningfully impact the economy or future deficits is highly unlikely.

  - The most likely case is that a very limited in scope agreement is reached to fund the government and lift/extend the debt ceiling through the mid-term elections.

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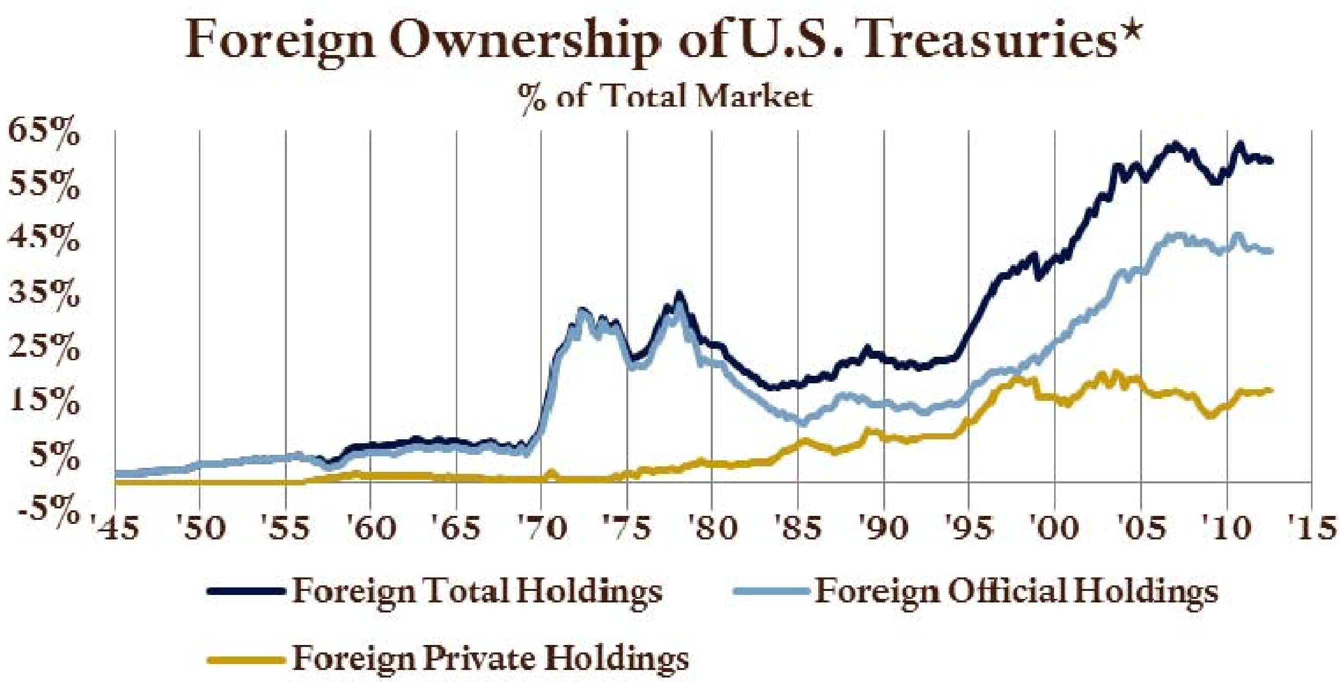
Capital Market Considerations – Foreign Ownership of Treasuries



* Marketable, Net of Federal Reserve Holdings

Source: Federal Reserve and CFR.org

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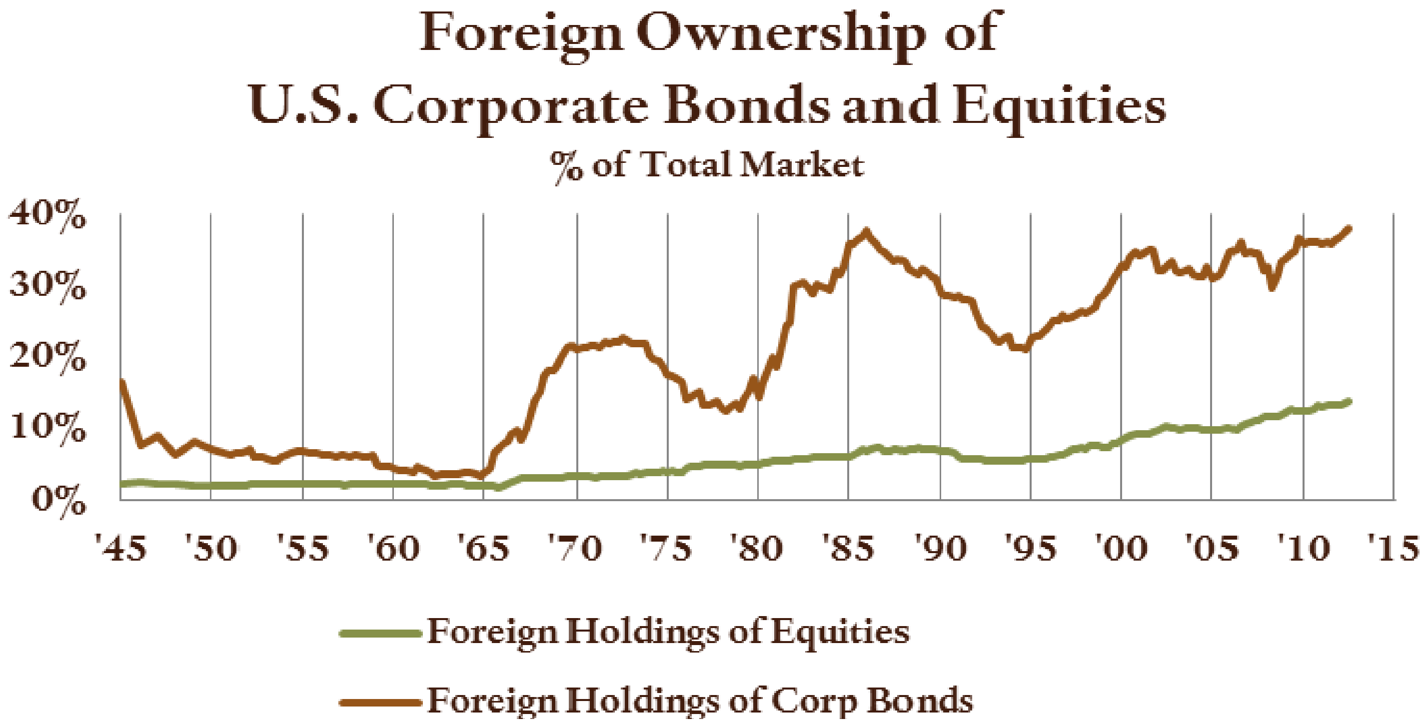
Capital Market Considerations – Foreign Ownership of Treasuries



Source: Federal Reserve and CFR.org

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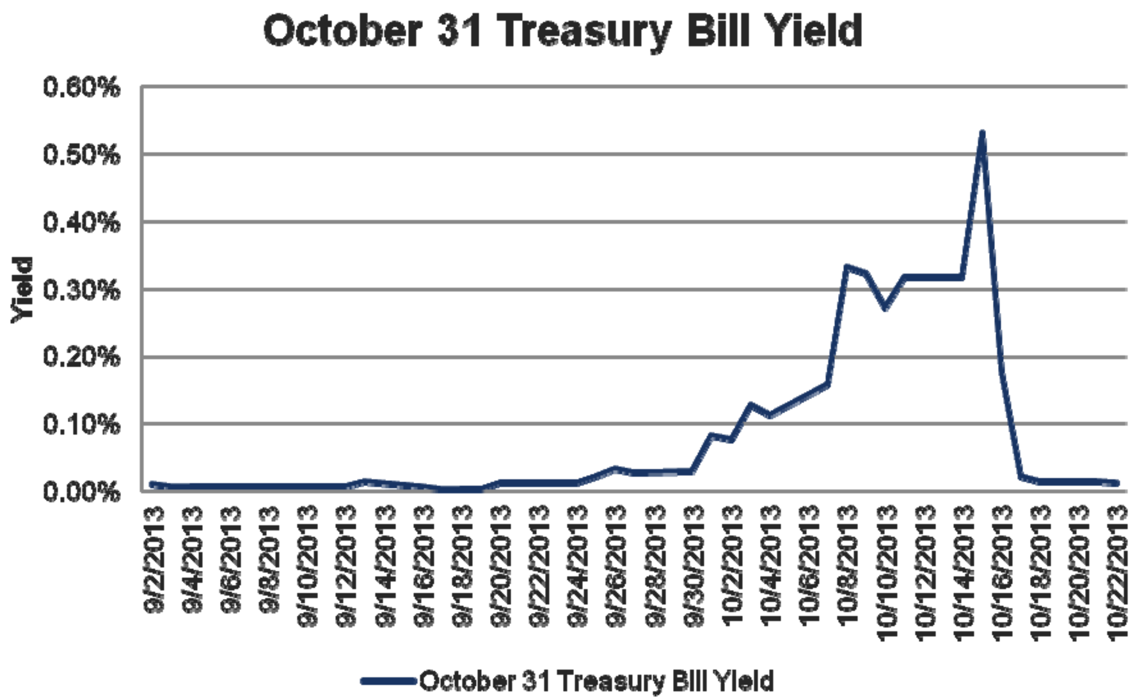
Capital Market Reaction to Recent Fiscal Crisis

The U. S. Government T- Bill Market Spiked but Healed Very Quickly . . .



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Capital Market Reaction to Recent Fiscal Crisis

Long Term Treasury Yields Trended Lower Throughout the Crisis . . .

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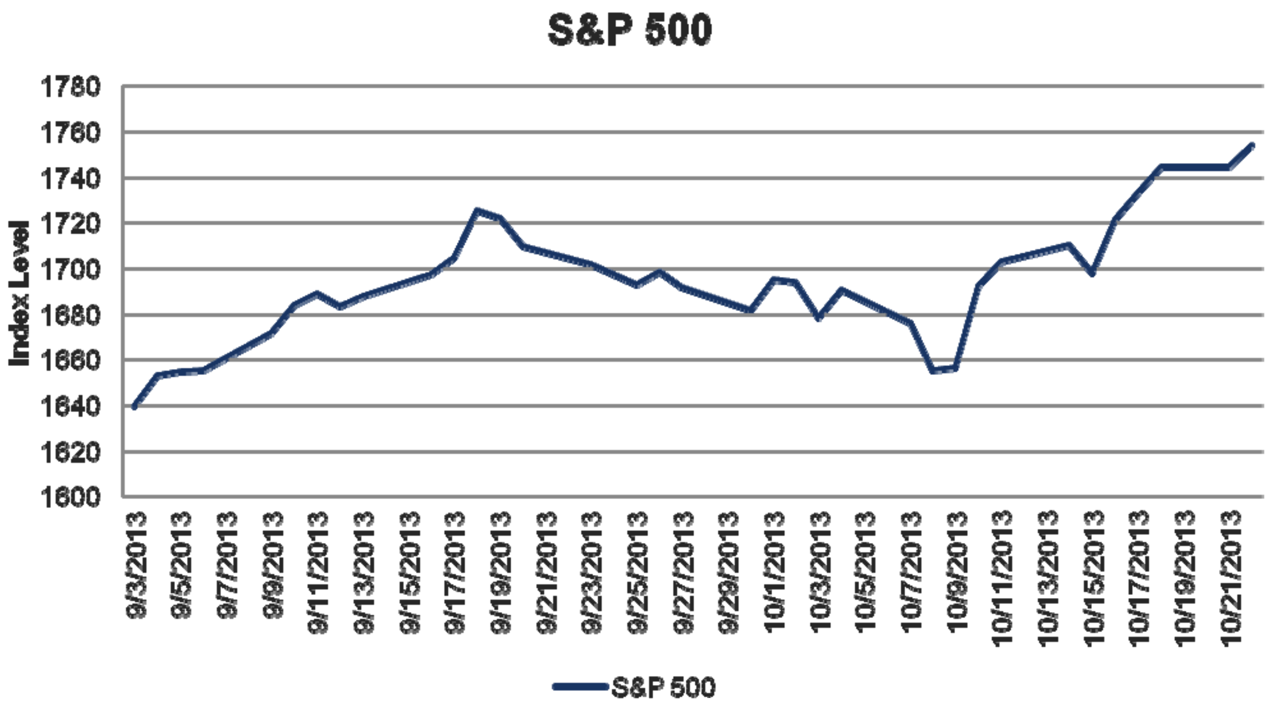
Capital Market Reaction to Recent Fiscal Crisis

The Equity Markets Experienced Some Volatility but Reached New Highs Shortly After the Agreement…



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Capital Market Reaction to Recent Fiscal Crisis

The U.S. Sovereign Credit Risk Spread Rose but Stayed Well Below the Level Reached During the 2011 Budget Showdown . . .

2011 Max = 68 bps

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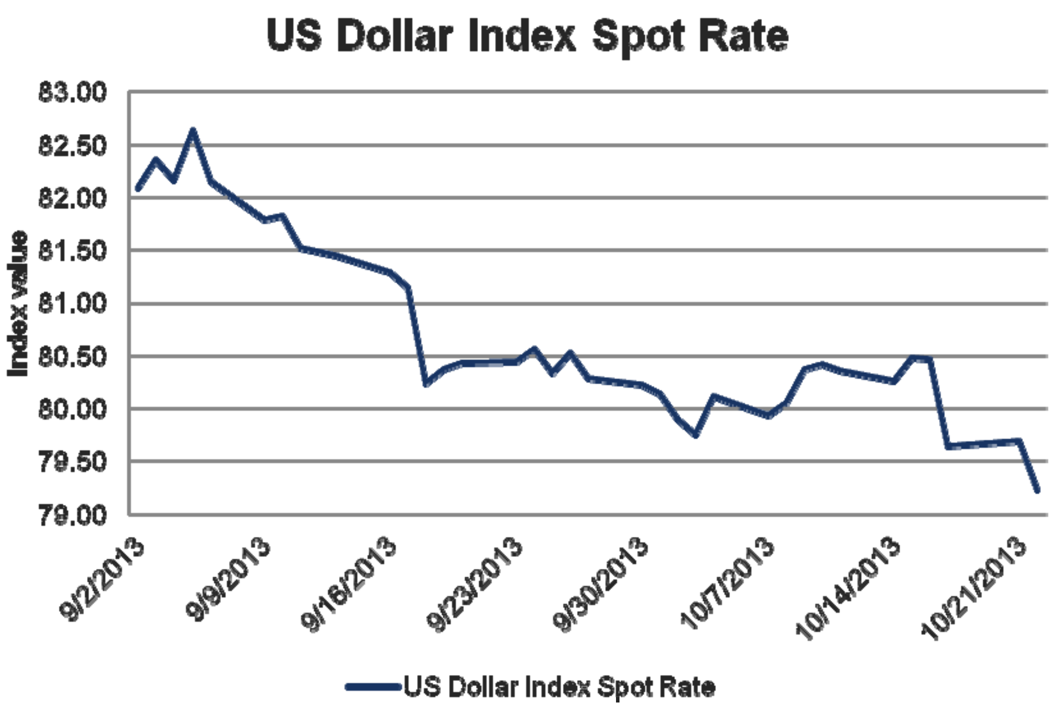
Capital Market Reaction to Recent Fiscal Crisis

But the Value of the U.S. Dollar Declined Across the Board.



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Implications

- The implications of this situation are:
  - There will be limited change on major issues such as Entitlements and Tax Reform
  - Government debt as a percent of GDP will likely continue to grow
  - Extreme politics raises the probability of a tail risk event for the capital markets
  - We cannot rule out additional downgrades of the U.S. Credit Rating or another threat of payment default
  - Confidence in the US as a safe haven and reserve currency diminishes over time
  - Unfortunately, it looks like it will take a crisis for real policy action to be taken
  - The U.S. fiscal situation will continue to be a source of volatility for the capital markets
  - By having this continue to overhang the markets, it fosters uncertainty which reduces confidence, dampens hiring activity and ultimately impacts the level of economic growth.

This on going issue supports GR-NEAM's policy conclusions of a persistent slow growth economic environment

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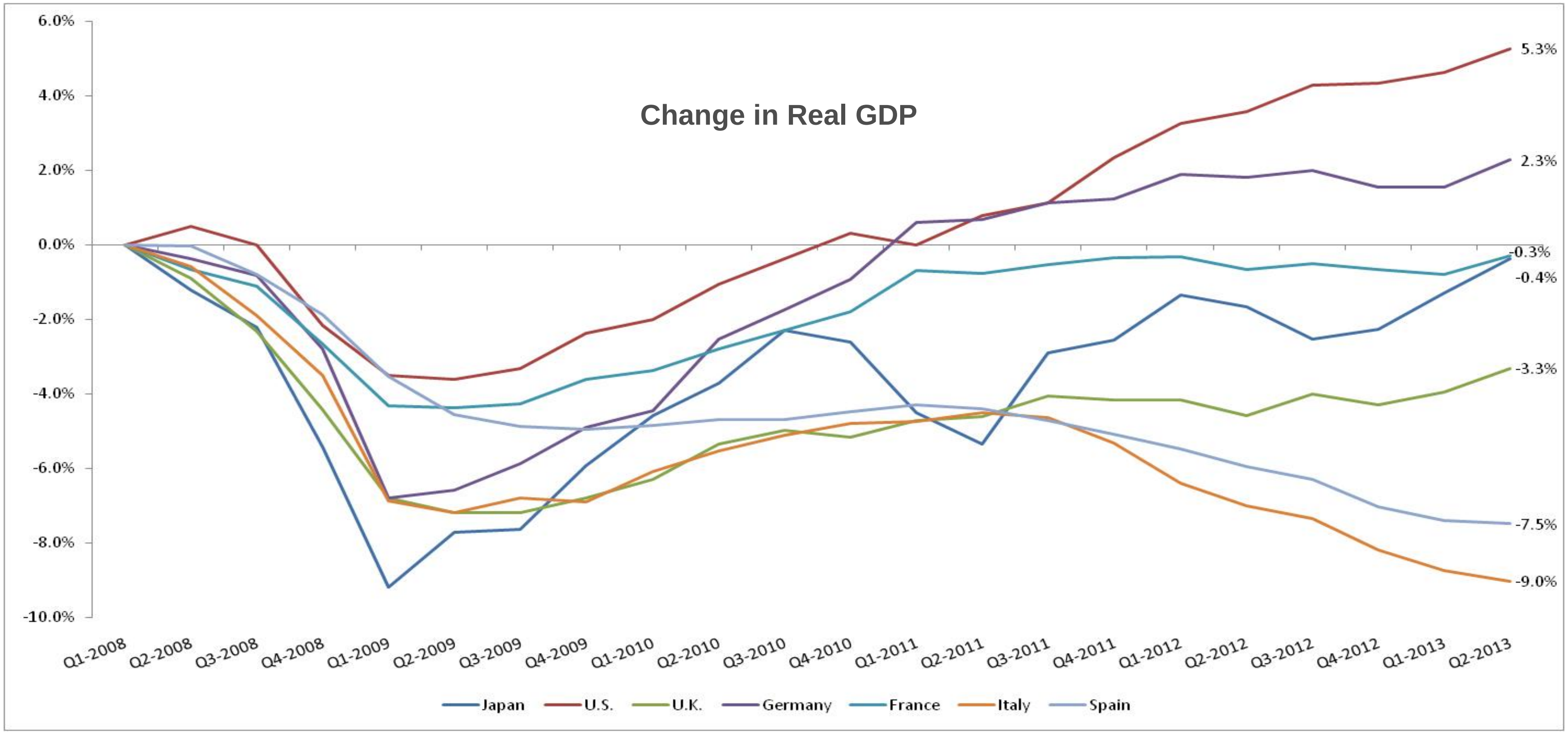
Economic and Capital Market Outlook

State Compensation Insurance Fund
Investment Committee – November 14, 2013
Open Agenda Item 6a – Continuing Fiscal Uncertainty in Washington and the Impact on the Investment Markets

Developed World Real Growth



Source: Haver/ Cabinet Office of Japan / Bureau of Economic Analysis / Office for National Statistics / Deutsche Bundesbank / Institut National de la Statistique/Economique / Istituto Nazionale di Statistica / Instituto Nacional de Estadística / GR-NEAM

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Structural Elements of the Growth Problem

- Debt
- Demographics
- Unemployment

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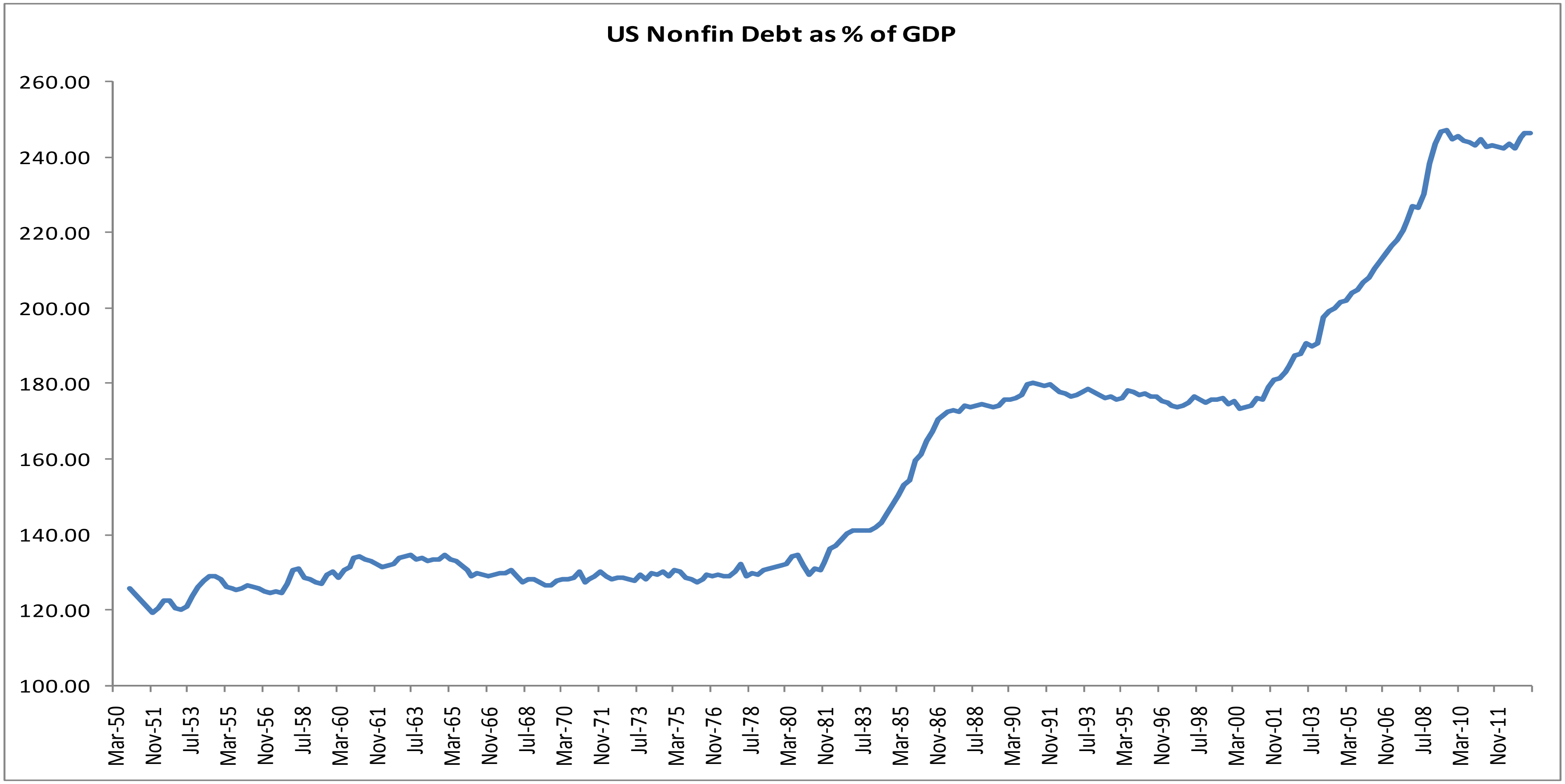
Debt : U.S. Nonfinancial Debt as a % of GDP



Source: Federal Reserve Board/ Haver/ GR-NEAM

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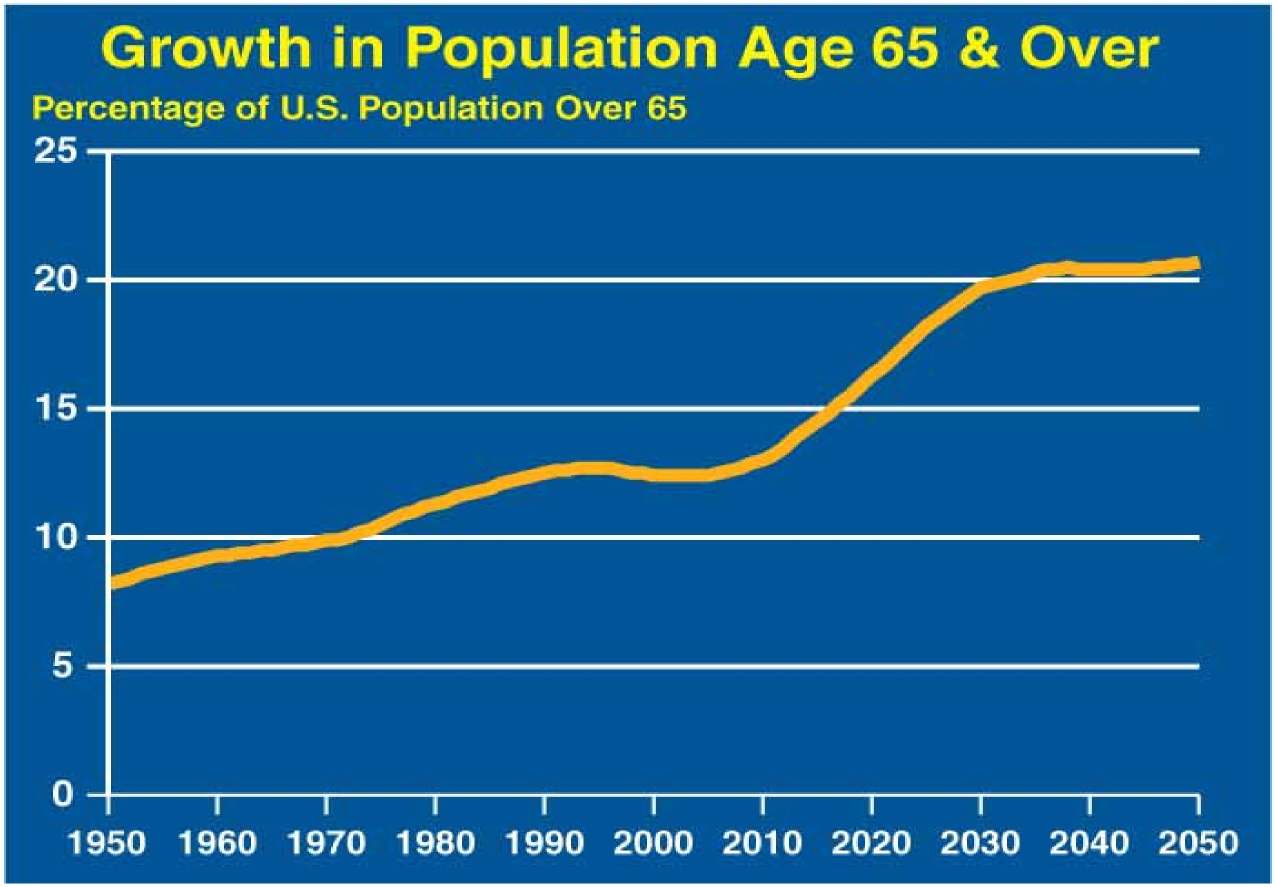
Demographics: Aging US Population



Source: US Census

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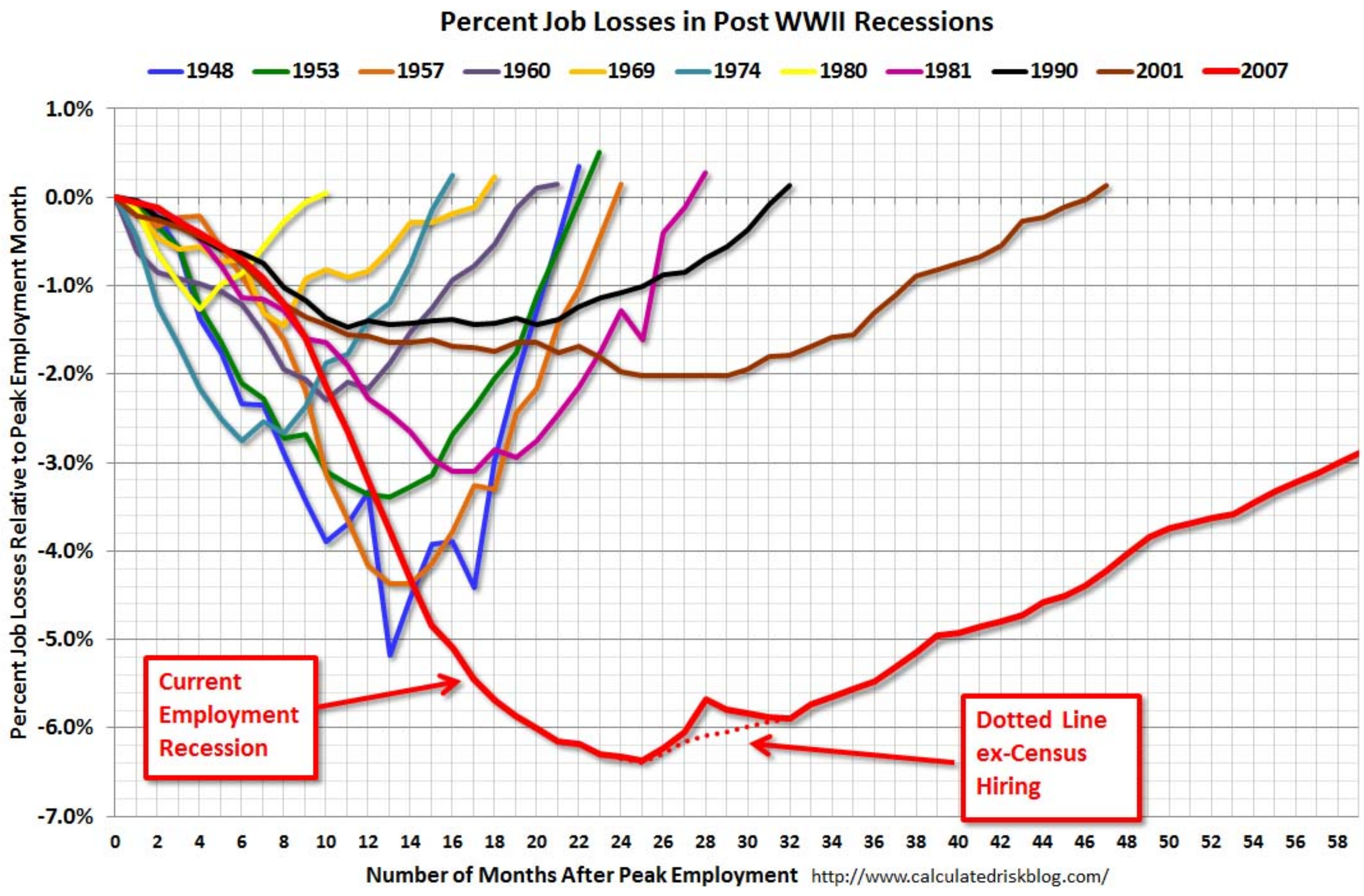
Unemployment: Post WWll Recessions



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Monetary Policy – The Big Experiment

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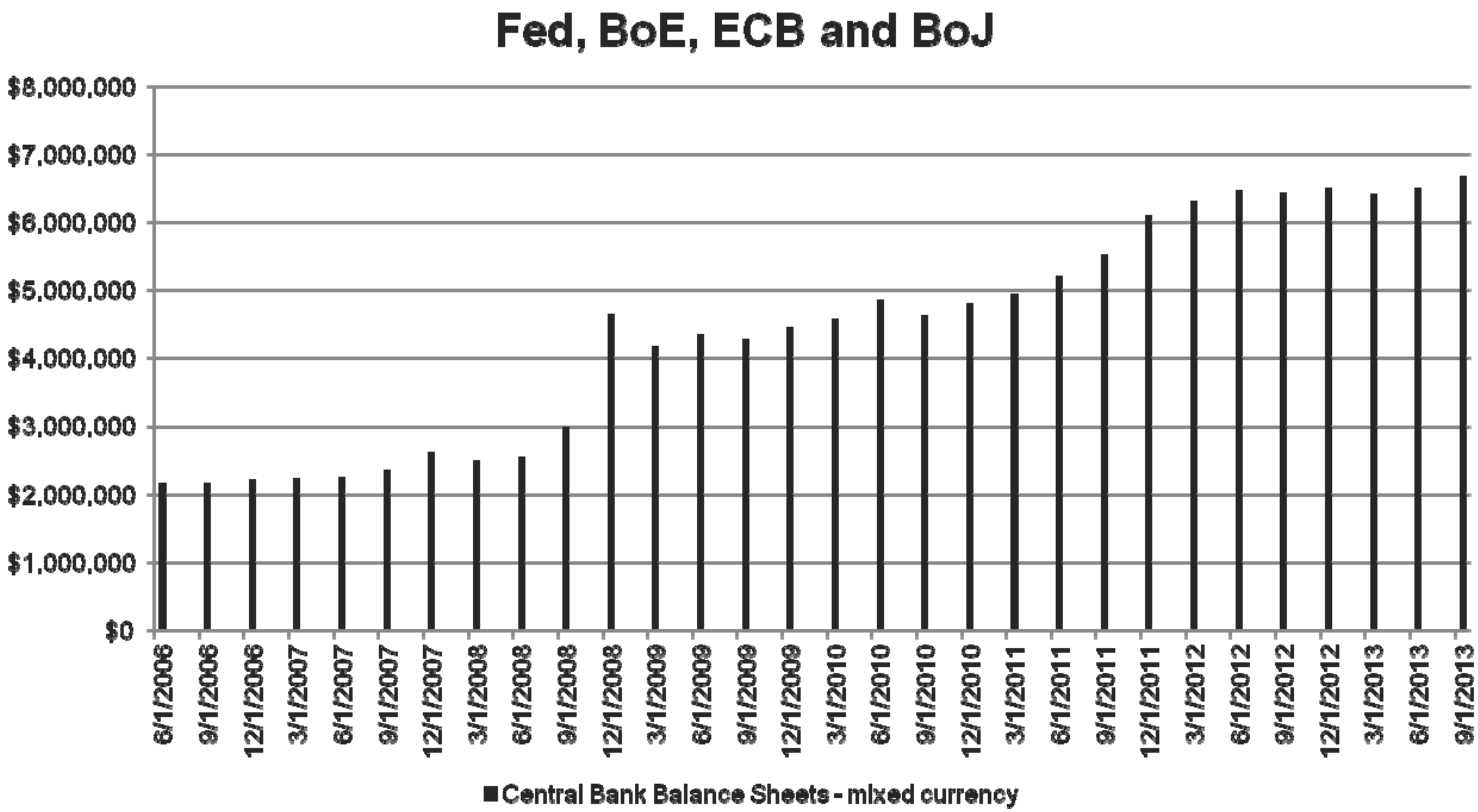
Developed World Central Bank Balance Sheets



Source: *Haver Analytics*

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Economic Conclusions

- The developed world has reached the limit of debt driven expansion.
- On going deleveraging and other structural elements continue to constrain growth.
- Cyclical elements of the economy are reasonably strong, but many potential catalysts for volatility persist.
- Central Banks remain highly accommodative and unwinding of the non traditional policies will be gradual.
- The most likely path forward is for a slow transition to a self sustaining expansion with limited inflation pressures near term.

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Capital Market Implications

- We have seen the lows in interest rates in this cycle but significant rate increases from here are not the base case.

- 2014 will likely see modest upward pressure on yields, mostly in the intermediate and longer maturities as the Fed tapers asset purchases.

- Risk premiums (in the form of spreads over Treasuries) should remain below average but there are many potential sources of volatility for risk assets (unwind of central bank balance sheets, US Fiscal Situation, etc.) .

- Our return expectations for fixed income assets are modest but holding cash remains an unattractive alternative (guaranteed negative real return).

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