

Market Spotlight: S&P Downgrade

Overview

On Friday August 5, 2011 credit-rating agency Standard & Poor's (S&P) downgraded the long-term sovereign debt rating of the US from AAA to AA+. When the markets opened on Monday stocks fell sharply while gold and Treasuries rallied. Despite those events, we are not making any substantial portfolio adjustments. The downgrade is unprecedented and thus it is difficult to forecast what the longer-term response will be across markets. Given the current economic environment—declining growth and trouble in the eurozone—our current views lead us to believe that our current positioning should be maintained.

- We believe the US dollar remains the world's benchmark currency and Treasuries remain the de facto bear market asset. At this writing, yields have fallen from a week ago and we believe that Treasuries remain unattractive given their historically low yields. We are retaining our bias to corporate and higher-yielding bonds.
- The S&P 500 is at 1153 at mid-day Monday, August 8, close to its 52-week low of 1040. The real risk to equities is the slowing global economic environment, not the downgrade. While we are not especially bullish on equities, we believe that after today, equities are not overvalued and we are maintaining our equity positions.
- We believe that remaining diversified across asset classes makes particular sense in this uncertain environment. While the global economic picture remains weak, security prices balance long-term growth prospects and valuations. Given the current risks and opportunities we believe the portfolios are well positioned.

The Economic Consequences of Utter Stupidity

While the two other major credit-rating agencies, Moody's and Fitch, have maintained their top ratings on US sovereign debt, the downgrade from S&P wasn't unexpected, as the firm had been signaling the move for several weeks. The rationale for the downgrade, however, is telling. In its statement to investors, along with the expected text about the inadequacy of the fiscal consolidation plan agreed to by Congress and the Administration last week, we read the following:

More broadly, the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011.¹

¹ *Swan, N., Chambers, J., & Beers, D., (August 5, 2011). Standard & Poor's, Research Update: United States of America Long-Term Rating Lowered to 'AA+' on Political Risks and Rising Debt Burden; Outlook Negative.*

It's helpful to contrast our debt-ceiling fiasco (and it was a fiasco) with how Europe has been handling its own crisis. Europe faces a significantly darker situation than does the US. The most-troubled eurozone members face liquidity and solvency issues, uncompetitive economies, and demographic challenges. Additionally, the common currency restricts monetary policy to a single path which cannot be tailored to the unique needs of different member countries. That said the ECB, IMF, and Euro member states have acted in a coordinated manner to ensure that a sudden catastrophe doesn't plunge the world into another financial crisis.



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Such statesmanship was notably absent from the recent struggle in Washington over raising the debt ceiling. The need to raise the debt ceiling was known for many months, but politicians on both sides used the deadline for raising the debt limits as leverage to win concessions from the opposing party. Delays in reaching a deal created unnecessary uncertainty for the markets and businesses alike. Efforts to reach a “grand bargain” that may have prevented the downgrade failed, leaving many to question the ability of the parties to craft a lasting solution.

Politics has predictably accompanied S&P's announcement. Treasury Secretary Timothy Geithner and others have accused S&P of getting it wrong. Indeed, the Treasury Department found a \$2 trillion error in S&P's estimates of the size of the long-term debt. Others have suggested that, despite a poor showing by our political system and the lack of a long-term debt-reduction agreement, the quality of US debt remains, in their view, of the highest quality.

What Now?

While the downgrade is unprecedented, it is difficult to predict how it will impact the markets. US Treasuries have current events on their side: an anemic global recovery, reserve currency status, and the aforementioned euro-debt crisis. Moreover, our biggest creditors, Japan and China, are loath to do anything that would impair the value of their portfolios.

Both Moody's and Fitch recently reaffirmed (albeit with reservations) top-tier ratings for US government debt and few investors will rely solely on one rating agency's decision. For example, Barclay's which produces the most widely used US bond indexes isn't reclassifying any debt. It uses the middle rating of Fitch, S&P, and Moody's. This is significant as a huge amount of assets are benchmarked to these indexes and a reclassification would almost certainly trigger selling. That few “active” managers rely solely on the ratings (they rely on their own research) also implies moderate risk to US debt.

Still There Are Risks

A number of “knock-on” effects are to be expected. This morning, Fannie Mae and Freddie Mac were downgraded since they are effectively underwritten by the US government. Although bank regulators issued a statement indicating the downgrade wouldn't affect bank capital requirements, it's not clear how the downgrade might impact futures markets (which use Treasuries as collateral) or currencies tied to the US dollar.

From an overall economic perspective, however, the implications are more serious. The recent debt-ceiling agreement coupled with the downgrade, appear to limit additional short-term fiscal stimulus to spur the economy. That will put more pressure on the Federal Reserve to embark on another round of quantitative easing, even though most believe that would have little impact. Discounted by most economists earlier in the year, the threat of a double-dip recession has risen.

There is one possible bright spot. This crisis may serve as a wake-up call for the public and our politicians to gravitate towards the more centrist, pragmatic path that has traditionally allowed us to overcome the inherent divisions in our political system to make significant progress.



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Definitions

S&P 500 Index: The Standard & Poor's composite index of 500 stocks, a widely recognized, unmanaged index of common stock prices. An investor cannot invest directly in an index.

Credit Quality: A measure of the quality and safety of a bond, based on the issuer's financial condition. Typically, AAA is the highest (best) and D is the lowest (worst).

Credit Rating: An assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities.

Fannie Mae: A security issued by the Federal National Mortgage Association and secured by a pool of federally insured and conventional mortgages.

Freddie Mac: A security issued by the Federal Home Loan Mortgage Corporation and secured by a pool of conventional home mortgages.

Quantitative Easing: A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market.

Sovereign Debt: A debt instrument guaranteed by a government.

Treasuries: Negotiable U.S. Government debt obligations, backed by its full faith and credit.



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