U.S. Debt Downgrade

Standard and Poor's (S&P) announced on Friday evening that U.S. long term sovereign debt was being downgraded to AA+ from the coveted AAA rating that has been held since 1917. This move comes as little surprise to many financial market participants, who for years have been concerned about the U.S. twin deficits of fiscal debt and trade balances. However, as with any long-anticipated event, actually reaching that day of reckoning can still come as a quite a shock. Following on from our note last Friday, we felt it would be useful to explain the background to the downgrade and the potential affect on both financial markets and client portfolios.

Who is S&P?

S&P is one of three main credit rating agencies who analyze and award ratings to sovereign, municipal, corporate and securitized debt globally. While much maligned for their role in the mortgage debt crisis of 2008, there remains no credible alternative.

Why did S&P downgrade the U.S.?

S&P has been publically stating that the U.S. needed to commit to a $4 trillion reduction in the federal deficit over the next 10 years. They applied a negative outlook (a normal pre-curser to a downgrade) back in April. Despite the politicians 11th hour deal to increase the federal debt ceiling and avoid an imminent fiscal crisis, the negations delivered relatively modest spending reductions of $917 billion, with most of this back loaded until after 2016. Coupled with further potential reductions of $1.5 trillion to be agreed upon by a bi-partisan committee, these measures simply slowed the rate of growth in federal debt and were significantly short of S&P's public demands.

What did S&P downgrade?

It must be emphasized that S&P downgraded the long-term debt rating. The short-term debt rating for U.S. sovereign securities remains A-1+, the highest rating available. This indicates that S&P do not believe that the U.S. is at risk of default.

What are the other main rating agencies doing and does this mitigate the effect?

It is interesting that Fitch Ratings and Moody's Investors Services both re-affirmed their AAA rating for U.S. debt following the debt ceiling deal. As a result, U.S. debt does remain AAA rated within the benchmark Barclays Capital indices. We do not expect institutions to materially reduce exposure to Treasuries as a result of the downgrade.

What is the effect of the downgrade and what impact will it have on borrowing costs?

In terms of long-term borrowing costs, we do not expect the effects of the downgrade to be significant. Historical studies have shown that downgrades within the top echelon of the credit rating scale have very limited impact on borrowing costs, and that any increase is not material enough to affect economic growth.

The U.S. remains the most deep and liquid bond market and there is simply little alternative for investors. While China and other nations that hold significant amounts of U.S. debt can level criticism and announce plans to diversify their Treasury holdings, where would they invest? The next largest sovereign debt market after the U.S. is AA- rated Japan, a country who suffers from greater fiscal debt than the U.S. Additionally, the US dollar remains the reserve currency of the world and there are currently no contenders who could replace the U.S. in the medium term. This is illustrated by the fact that U.S. Treasuries' and the US dollar both rallied on the downgrade news as investors flocked to their perceived safety in a times of distress.

Will there be further downgrades?

Unfortunately, there will be a continued diet of bad news, with government sponsored entities also being downgraded to AA+. This ranges from Freddie May to the Federal Deposit Insurance Company and the Federal Farm Credits Bank. This morning, Israeli sovereign bonds guaranteed by the U.S. were downgraded to AA+. Longer-term, by maintaining a negative outlook S&P leaves the door open for a further downgrade within the next two years. More positively, having affirmed their AAA ratings, it is unlikely that the other rating agencies will alter their view in the short-term.

There is also potential for downgrades within the municipal bond markets. More immediately, pre-refunded bonds are likely to be downgraded. These are bonds where the re-payment is backed by escrows of U.S. Treasuries'. The sector accounts for around 5% of the municipal debt market. Further out, States which have the greatest reliance on federal funding may also be vulnerable to downgrades.

Within corporate debt markets the risk of downgrades should be minimal. Globally, there is plenty of precedent for corporations to attain higher ratings than the sovereign states within which they reside. In the US, there are only four companies with AAA ratings: Johnson & Johnson, Microsoft, ADP and Exxon Mobil.

If the affects of the downgrade are relatively minimal, why has the stock-market corrected?

The downgrade of U.S. debt is symptomatic of the longer-term problems facing the United States. As we have discussed in previous Investment Reviews, future economic growth is being negatively impacted by both the magnitude of federal debt and the inability of politicians to tackle ever-growing deficits. S&P's move graphically highlights the acute situation that the nation is in. However, we do not expect the downgrade to materially affect already poor economic growth forecasts for the U.S.

Notwithstanding this gloom, U.S. equity valuations are now historically attractive and while we are likely to witness continued volatility, a repeat of 2008 style equity market declines must be viewed as extremely unlikely. Analysis by JP Morgan indicates that historically equity markets have actually rallied 12% in the six months following a sovereign debt downgrade from AAA as investors perceive less future headline risk and take relief from the greater clarity.

How is Market Street reacting to this news?

As discussed above, following some short-term volatility we expect the effects of the downgrade to be minimal. The downgrade itself will not prompt us to re-position client accounts. However, as our letter last Friday indicated, we did reduce equity exposure in portfolios during the first half of 2011 given our concerns about economic growth prospects, the potential downgrade of U.S. debt and the on-going European sovereign debt crisis.

Market Street will continue to monitor events closely and align portfolio allocations with our long-term economic and asset class views.

Please feel free to contact us if you would like to discuss these issues further.

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