Weekly Market Commentary

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The Downgrade: What You Need To Know

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Highlights

We view the U.S. rating downgrade from AAA to AA+ as a disappointing, but lagging indicator of the pressures already reflected in the markets. We find plenty of historical evidence that markets have priced in the events that led to the downgrade much earlier than when the downgrades took place.

While there are some negative consequences, there are not triggers stemming from the downgrade that would spark a chain of events leading to a financial crisis.

Could this mark a "Sputnik moment" for policy makers tasked with finding the additional savings stipulated in the debt ceiling legislation?

The initial beneficiaries of the downgrade include precious metals and Treasuries given the hit to investor sentiment and the desire to seek safety and liquidity. Stocks, led by Financials, may initially suffer. However, low valuations and efforts to address the debt problems in Europe combined with improving economic data may put a halt to the stock market's decline.

Despite passing the debt ceiling and spending cut deal anticipated by the markets, last week's data and events pulled bond yields lower and left the S&P 500 now down about 10% from this year's high. This slide may seem all too familiar. Market participants are worried about a repeat of the 2008 financial crisis. While the message from the markets is important, in last summer's soft spot the 10-year Treasury note yield fell below 2.4% and the stock market fell 15%, but no recession took place. Instead, as the market became too pessimistic on the prospects for growth in the second half of the year, stock returns and bond yields moved to new post-crisis highs. The summer of 2010 is the more relevant comparison to the current market slide than the summer of 2008, in our opinion.

Friday's news that one of the three U.S. rating agencies was downgrading the U.S. credit rating from AAA to AA+ hit the markets and sapped the gains fueled by the report of better-than-expected job growth in the month of July (and positive revisions to prior months). As the rumors of a downgrade hit, stocks slumped. Is this a killing blow for a market and economy already suffering from a series of disappointments or a disappointing but lagging indicator of the pressures already reflected in the market's path and level of recent years? We favor the latter assessment.

Here we will present our views on the downgrade from; why it happened and what it means for investors and policymakers, and what is next for the markets. For more insight, please see the *Bond Market Perspectives* publications from July 19 and August 2 where we discussed the details surrounding the pending downgrade.

Why did it happen?

While the imbalance in the U.S. long-term fiscal situation is no mystery, the reasoning for the downgrade at this time is best left in the words of Standard and Poor's. The first news of a near-term potential downgrade came on April 14 of this year. Standard and Poor's rating agency stated, *"We believe there is a material risk that U.S. policymakers may not reach an agreement on how to address medium- and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation is not begun by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer 'AAA' sovereigns."*

On July 14, the outlook for a downgrade became even clearer as Standard and Poor's clarified their position with the statement: *"The CreditWatch*

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placement of the U.S. sovereign ratings signals our view that, owing to the dynamics of the political debate on the debt ceiling, there is at least a one-in-two likelihood that we may lower the long-term rating on the U.S. within the next 90 days." Standard and Poor's cited $4 trillion in savings as part of the debt ceiling bill as the number that would be a trigger to avoid a downgrade. As it became apparent that a "grand bargain" of around $4 trillion was off the table, a downgrade by Standard and Poor's became likely.

On Friday, August 5, the rumor of a downgrade announcement negatively impacted the markets. The announcement of the downgrade was delayed by the Treasury pointing out an error to Standard and Poor's in their calculations of $2 trillion as it related to the size of the total debt-to-GDP ratio which was a prominent component of their economic justification for the downgrade. S&P acknowledged the error and removed that component and focused on the political environment for the justification for their downgrade and announced it on Friday evening, after the markets had closed.

What does it mean for government bonds?

Historically, downgrade announcements do not mean much to the markets. They have priced in the events that led to the downgrade much earlier. We can find plenty of evidence of this in the downgrades from AAA of large countries and companies over the past 20 or so years.

Bond prices did not plunge as yields were flat to down when countries lost their AAA ratings in the past. There are a number of smaller countries that lost their AAA ratings, but they are not really comparable to the United States. The big three of Canada, Japan, and Australia are far more important comparisons. In both Australia and Canada, yields fell when the downgrade from AAA came after having run up in the months before. Both of these countries eventually regained AAA status. Yields also declined following Japan's downgrade from AAA.

In the early 1980s, 60 companies in the S&P 500 were rated AAA, today there are only four: Microsoft, Exxon Mobil, Johnson & Johnson, and Automatic Data Processing. In general, the downgrade from AAA came after the market had already reacted to the drivers that made the rating downgrade an obvious next step. Companies like Berkshire Hathaway, General Electric, and Pfizer all lost their AAA status during the recent financial crisis. But the markets had already priced in the prospects for these companies well before they were downgraded leaving no reaction to the news when it finally came.

We see the prospects for Treasuries more influenced by the outlook for economic growth than by this downgrade. We do not expect sharply rising yields in response to the downgrade, but instead a steady move higher over the remainder of the year as economic growth proves to be better than is currently being priced in the market.

Are there triggers that would cause a financial crisis?

There are not triggers stemming from the downgrade that would cause forced selling of Treasuries or a chain of events leading to a financial crisis. In fact, Treasury yields may decline as investors seek safety and liquidity.

Nearly half of U.S. government bonds are held by foreigners. The biggest holder of U.S. government debt, China, holds U.S. debt as part of their currency management and trade policy and growth strategy rather than as a traditional investment. They are not constrained by ratings as a condition of their holding. In fact, China's rating agency, Dagong, downgraded the U.S. last year. Importantly, with no other high-quality, liquid bonds of sufficient size to absorb the demand and with other AAA-rated countries on review for downgrade these investors have nowhere else to go.

The next largest holder is the U.S. Federal Reserve who is unlikely to sell the Treasury bonds acquired under the quantitative easing programs until it believes the economy is strong enough to absorb the potentially higher interest rates that would result from the sales.

Insurance companies are required by law to hold a large portion of their portfolios in very safe and very liquid securities. However, they are generally allowed to hold U.S. government bonds no matter what they are rated. For example, the New York life insurance law stipulates obligations issued by "the United States of America or any agency or instrumentality thereof."

Money market funds will not have to sell. The U.S. short-term debt rating has not been changed. Regardless, money market mutual funds must hold "top-tier" securities with no stipulation for rating.

Banks do not need to raise capital, as they were forced to do after the failure of Lehman Brothers triggered losses that forced additional selling. This was made clear by the Federal Reserve, FDIC, and other bank regulators on Friday, *"For risk based capital purposes, the risk weights for Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities will not change."*

Even those entities that are required to hold AAA-rated debt can still hold Treasuries since two of the three U.S. rating agencies still rate the United States as AAA. Unless S&P cuts the credit rating further or Moody's and/or Fitch also cut the U.S.'s long-term rating (both have reaffirmed the U.S. AAA rating) the debt is still considered AAA.

What are the consequences?

The lagging nature of downgrades, coming after the drivers have already been discounted by investors and reflected in the economy, do not usually carry much in the way of major negative consequences. However, there are some negative consequences that while not dire do pose some challenges and should not be completely overlooked.

First, a lower rating may mean that interest rates will be higher over the longer term as investors demand more yield for taking on the perceived greater risk of Treasuries. However, this is not a near-term threat to economic growth or the markets.

It is possible that the municipal bond market may be impacted. The 15 AAA-rated states could be subject to a modest downgrade given some funding sources that are dependent upon the Federal government. It is hard to see what the market impact of this rating change may be; however, it is unlikely to be sizable.

A higher cost for collateral in repo, derivative, and swap transactions may result from the downgrade. These agreements are typically collateralized by Treasuries. As a result of the downgrade, counterparties would likely have to post slightly more of these securities as collateral slightly increasing costs.

The United Kingdom and France are likely the next countries to see downgrades from AAA. However, markets have discounted this outcome. French credit default swaps, essentially an insurance policy against the risk of default, are over three times that of the United States.

Finally, the United States is still on negative outlook despite having been downgraded to AA+. Without additional actions to put the United States on a path to fiscal sustainability the United States will likely be downgraded further. This could have ramifications for those entities required to hold AAA-rated bonds even if the other two rating agencies do not change their ratings.

What does it mean for policymakers?

The downgrade adds another point to fuel the increasing divisiveness between the political parties. In addition, Timothy Geithner, who was already considering leaving his post as Treasury Secretary (as is common after more than two years), may have to stay on so as to not appear as the scapegoat for the downgrade.

Washington has repeatedly shown the ability to miss opportunities to address the long-term U.S. fiscal imbalance. However, perhaps the moment has arrived. Could the downgrade of the U.S. credit rating be a Sputnik moment for policymakers? Probably not. But Washington has the ability to address this in the November 23 and December 23 deadlines for agreement on finding the $1.5 trillion in additional savings stipulated in the debt ceiling legislation and for Congress to pass them. They are tasked with finding a minimum of $1.5 trillion, but there is no limit on them finding more than $1.5 trillion in savings. Two weeks ago a bipartisan proposal delivered by the Republican Speaker of the House, John Boehner, and the Democrat Majority Leader in the Senate, Harry Reid, to save nearly $4 trillion over the next 10 years was rejected by the President. Could that plan get dusted off and find new support in light of the downgrade? The markets would welcome a larger bipartisan plan.

What is next for the markets?

The announcement of a downgrade of the U.S. credit rating from AAA to AA+ added to the list of disappointments investors have suffered in recent months, including: softer economic growth (although data has been more mixed than consistently weak as it was last week), European debt problems spreading, and Washington's debt ceiling demagoguery.

The initial beneficiaries include precious metals and Treasuries given the hit to investor sentiment and the desire to seek safety and liquidity. AAA-rated German bunds may also be winners as investors seek quality while the debt of France and the United Kingdom may suffer as investors' price in the likelihood that they are next in line for a downgrade.

Stocks may suffer from investors seeking a safe haven. Stocks may go down due to some selling as investors who own Treasuries to diversify riskier positions in their portfolios may want to sell some stocks to recognize that their Treasury holdings are riskier. Among stocks, the banks may suffer the worst — not that they would have to raise capital — but since not only is the "Washington put", or the willingness of policymakers to intervene with a bailout to avert a crisis, already called into question but now its ability to back stop a failure is also questioned.

However, stock prices reflect a wall of worry. Stocks are inexpensive on both a trailing and forward basis compared to history. The S&P 500 trailing price-to-earnings ratio (measuring earnings over the past four quarters) is 13, the lowest since 1990. The S&P 500 forward price-to-earnings ratio (using earnings forecast over the next four quarters) is 11, the same as it was at the bottom of the financial crisis in March of 2009. While valuations could compress further, the spring is already tightly coiled. The solid second quarter earnings season suggests the market is too bearish with the price it is putting on earnings. Notably, S&P indicated it is not planning on downgrading companies' AAA ratings despite the agency's policy not to have a company's rating be higher than its home country's sovereign rating.

Finally, while much of the world has been focused on the downgrade of the United States by Standard and Poor's, the more important credit situation for the world economy is in Europe right now. Both Italy and Spain have been under intense pressure recently after the debt crisis for the peripheral nations of Greece, Ireland, and Portugal was addressed with a second rescue package for Greece. This past weekend the European Central Bank (ECB) announced plans to buy Italian and Spanish debt in the markets, pending fiscal reform commitments. Rather than tap the European Financial Stability Facility (EFSF), which has a flexible mandate but limited funding, the ECB has stepped in. Unlike the EFSF, the ECB has the scale to address bond markets of countries the size of Spain and Italy.

The stock market is likely close to making the low point of the year as events in Europe stabilize and earnings and economic growth prove better than the now overly gloomy expectations priced in for the third quarter.

IMPORTANT DISCLOSURES

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Stock investing may involve risk including loss of principal.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

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Debt-to-GDP is a measure of a country's federal debt in relation to its gross domestic product (GDP). By comparing what a country owes and what it produces, the debt-to-GDP ratio indicates the country's ability to pay back its debt. The ratio is a coverage ratio on a national level.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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