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Here We Go Again, Again: The S&P Rating Downgrade

Presented by Investment Partners, LTD

When Standard & Poor's initially threatened to downgrade the U.S. credit rating, many commentators said that the rating agency was late to the party—that it wasn't providing any new information. Now that the downgrade has actually occurred, the estimation remains valid; S&P is not telling us anything that we didn't already know.

The U.S. economy is not as strong as it was five to ten years ago. We know this. And in the short term, the effects of this downgrade on the markets and economy could be substantial. But over the mid to long term, we believe that the fundamentals, rather than one agency's opinion, will prevail. Given current global economic and market events, the downgrade is one small piece of a much larger puzzle, and the attention it has received is, arguably, exaggerated.

Anatomy of a downgrade

First, let's get the basics out of the way. S&P has downgraded U.S. federal long-term debt from AAA to AA+. This is not a surprise. S&P had stated that it was looking for at least a $4 trillion reduction in the deficit. Instead, the reduction agreed to in the debt ceiling deal equated to a mere $2.4 trillion, leaving S&P little choice but to cut our rating. Many economic consultants had suggested that a downgrade could come as early as this week. Bloomberg reported that rumors were floating around the markets Friday afternoon that the downgrade was pending. While the specific timing was unknown, the action itself was well telegraphed.

Second, let's look at this in a rating agency context. S&P is one of three major rating agencies. The other two, Moody's and Fitch, have not downgraded the U.S.; instead, they confirmed our AAA rating this week. So, two of three major rating agencies say no change. That alone indicates that the call was not clear-cut, and any decision to cut the rating was at least arguable.

Putting it into perspective

From an economic standpoint, there is no reason for the U.S. to default. Briefly, debt servicing is a small part of total revenues, and default would result in far more pain than benefit. In addition, the U.S. could, as a last resort, simply print more money to cover obligations. Any default would, therefore, have to be a political decision, not an economic one. As evidenced by recent activity on Capitol Hill, the U.S. government even now is unwilling to default for political reasons.

From a market standpoint, we need to take performance over the past week into account. As previously noted, the downgrade did not come as a surprise, yet demand for U.S. Treasuries has continued strong; interest rates have actually fallen to a nine-month low. If investors are panicking, you certainly can't tell from the bond markets, which suggests that the markets may well have priced in the downgrade already. Economically, nothing has changed, and the fixed income markets have so far supported this conclusion. Yes, the equity markets have been sliding, but one could argue that the downturn has had far more to do with the fundamentals—emerging evidence of a slowing U.S. economy and the worsening European debt situation—than with the rating agencies.

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Also, keep in mind that no country with an AAA or AA rating has ever defaulted—indeed, the revised rating suggests that the U.S. has an "extremely strong" capacity to meet its obligations. Countries, including both Australia and Canada, have lost and regained AAA ratings before. This is a warning sign and a bellwether; as such, the downgrade may end up being beneficial if it helps Congress focus on solving the nation's budget problems.

The road ahead

Could this downgrade result in damage to the U.S. economy? Certainly. We expect that many investors will assume more cautious positions, and risk assets may become less attractive. Longer term, the results will certainly include a more cautious environment, probable higher borrowing costs for all borrowers, including the U.S. Treasury, and a generally higher level of uncertainty. This process has already started. On Monday, August 8, S&P downgraded mortgage giants Fannie Mae and Freddie Mac, from AAA to AA+, due to their direct reliance on the government. The result could be higher mortgage rates across the board. Other downgrades are also probable. The damage of this decision will play out over time, and, at a minimum, investor confidence will take another hit.

Looking forward, market reactions seem inevitable as well, but it remains to be seen exactly what those reactions will be. Market commentators range from those predicting Armageddon to those predicting a relief rally—"sell on the rumor; buy on the news." It looks as if the short-term effect on the equity markets will be negative. U.S. stock futures were down about 2 percent in Sunday night trading after a very difficult week last week. The short-term effect on the fixed income markets is uncertain as well, as noted above, while the effect on the dollar appears to be negative.

Investors would do well to remember that two of three agencies still think the U.S. is AAA, there is no economic reason for default, and the fixed income markets—those most directly affected—are not panicking, at least as of August 5. While the stock market is down, it is still in normal correction territory, and performance can best be attributed to the slowing U.S. economy. As "crises" go, we've seen much worse in the past.

Again, it comes down to putting things into perspective. This is one more piece of the fallout from the global financial crisis, but it's probably not the most important one. Although it is the highest-profile event at the moment, in the end, it will probably have a relatively small long-term effect. In the face of short-term uncertainty, the best wisdom for investors is to continue a well-diversified investment plan and to focus on the long term. This too shall pass.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results.*

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