Clearbrook Perspectives

August 9, 2011

The U.S. Debt Downgrade and Market Implications

Background

On Friday evening, August 5th, Standard & Poor's (S&P) downgraded the U.S. long term debt ratings by one notch from AAA to AA+. The ratings outlook was deemed negative, implying that another downgrade is possible. The rationale for the rating action was the agency's forecast for growth in U.S. debt coupled with a greater level of political uncertainty in dealing with the country's overall level of debt. The purpose of this paper is to highlight the potential short and long term consequences of the S&P downgrade of U.S. debt ratings.

Investment Impact

Only S&P has taken action. Moody's and Fitch affirmed the current U.S. debt ratings at AAA but with a negative outlook. Securities impacted by the S&P rating downgrade are expected to be:

- U.S. Treasury Securities
- U.S. Government Agency Debt (i.e., GNMA, FNMA, FHLMC, FHLB, Farm Credit)
- Securities backed by U.S. Treasuries (i.e., pre-refunded municipal bonds)

Market Impact

The U.S. has the deepest and most liquid capital markets in the world. U.S. Treasury and Government Agency Debt Securities accounted for more than 50% of the world's AAA paper before the downgrade. As such, the downgrade of U.S. Treasuries to AA+ should not impact liquidity or, in our view, the safety of the investment. Clients should not engage in outright sales of Treasury or U.S. government securities based on this news alone. We believe that economic weakness, equity market volatility and flight-to-quality flows due to the European debt crisis should provide continued demand for U.S. government securities for the foreseeable future. However, there are a number of "knock-on" effects related to the downgrade of which clients need to be aware.

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Short Term Impact

The Fed and other government agencies such as the FDIC and the Office of the Comptroller of the Currency, issued a statement indicating that risk weights for U.S. government securities as it relates to capital requirements for banks would not change. This should alleviate any concerns surrounding bank capital. However, elsewhere in the markets, it is likely that collateral posting requirements of U.S. government securities will increase to some extent, particularly if volatility increases. This would be felt primarily in the repo market where the haircut on U.S. government backed collateral would increase from 102% to approximately 103%. This would effectively reduce leverage in the market.

With the end of QE2 on 6/30/2011, a major buyer of Treasury securities has been taken out of the market. We believe Treasury yields, particularly around the time of Treasury bond auctions, could be at risk for increase should demand weaken on the heels of the rating downgrade. This combined with the offsetting forces of economic weakness and flight-to-quality flows would suggest an increasing level of interest rate volatility as market participants begin to assess the desirability of Treasury security holdings. With respect to risk assets, we believe any short term weakness in Agency MBS, investment grade and speculative grade credit could present buying opportunities as yield spread compression has been significant in recent years extracting most of the value out of these markets. We have already witnessed a widening of spreads during this “de-risking” phase of 33% to 50% in High Yield and Emerging Market spreads. We also expect short term volatility and downward pressure on equity markets on economic weakness, a deterioration of consumer confidence and financial contagion in Europe.

Given the current macroeconomic and financial market environment, we believe short term strength will be seen in gold, safe-haven currencies such as Yen and Swiss Franc, higher rated non-European sovereigns such as Mexico, Brazil, Canada and Australia, and in high quality U.S. company stocks and bonds. This movement into higher quality credits has been exacerbated by the realization that a global economic slowdown is upon us, particularly in the U.S. and Europe.

There may be some negative “knock-on” effects on markets such as municipal bonds as states that rely heavily on the U.S. government for employment or financial disbursements (i.e., Medicaid) also experience potential downgrades. Moody’s placed several AAA rated states on watch for possible downgrade including Maryland, Virginia, New Mexico, South Carolina and Tennessee. Municipal bonds such as healthcare and housing bonds, backed by the agencies or reliant on government disbursements, could also see a negative impact on ratings.

The recent one notch downgrade was for long term debt ratings and should not significantly impact money market fund holdings other than collateralization of repurchase agreements. We will monitor the impact on money market funds and fund flows for any signs of significant outflows but do not expect that there will be difficulties in this market as there was in the fall of 2008.

Long Term Impact

In the long term, we believe the political brinksmanship on Capitol Hill followed by a ratings downgrade could heighten the focus of foreign central banks in diversifying away from the U.S. Dollar. Dollar weakness, the potential for an increase in inflation and pressure on interest rates are the most likely long term outcome. Given this long term outlook, we believe a traditional balanced portfolio of U.S. stocks and bonds should also include allocations to real assets, alternative strategies (hedge funds, fund of funds) and diversification into emerging markets.

Concluding Thoughts

While we expect short term volatility in interest rate and equity markets to increase, we believe thoughtful asset allocation based on long term capital market assumptions, disciplined rebalancing around policy targets, and considering a modest allocation to a tactical or opportunistic investment bucket will serve clients well over the long term. The dramatic short term decline in risk assets presents an opportunity to rebalance these allocations back to within policy targets and potentially profit from their rebound in value. Specifically, equities as represented by the S&P 500 are now trading at a 11.8 times 2011 earnings and many stocks carrying a AAA credit rating are yielding above 3%. With economic growth estimated to slowdown to a steady but middling 1.5%, this would be a good environment for High Yield debt which has seen yields rise back up to 7.50% to 8.00%, approximately 6.00% plus above Treasury rates. Emerging Market Bond Index (EMBI) spreads have increased by 50% over the past several weeks, and Sovereign Debt of highly rated countries on a local currency basis would provide a competitive yield as well as the potential of currency appreciation versus the USD. Lastly, Bank Debt has declined in value during this correction, as such they could provide a competitive yield that would reset as interest rates rise as they are LIBOR based, and could also give investors some capital appreciation.

We continue to believe in the long term strength, depth and liquidity of the U.S. capital markets and would urge clients not to overreact to a one notch downgrade by one rating agency. The significant correction in a number of markets are creating attractive return opportunities versus the risk, not seen since early 2009. We will be monitoring markets closely and encourage clients to contact their investment consultant with any questions.

About The Author

MaryAnn DiMaggio is a Managing Director and Head of Global Fixed Income Research at Clearbrook.

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