

## **McDonnell Investment Management, LLC**

### ***The S&P U.S. Treasury Downgrade – Wake-Up Call or a Non-Event? August 9, 2011***

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On August 5<sup>th</sup>, Standard & Poor's ("S&P") lowered the United States of America's sovereign credit bond rating one notch from its top "AAA" standing to "AA+." The newly assigned rating is defined by S&P to mean that the borrower has a very strong capacity to meet its financial commitments. The additional "+" sign indicates that within this category, the credit falls within the high end of this range. Normally, a rating change of this magnitude would be seen merely as a slight tweaking of a borrower's credit standing, but that's not the case when it comes to the U.S. Treasury bond, which is used as the global risk-free benchmark security and proxy for investment safety. Simultaneously, S&P affirmed the nation's short-term rating at its top level of "A-1+." The strongest short-term rating plays an especially important role in the money market and repo arenas. The Federal Reserve, in turn, stated that the downgrade does not have any effect on bank capital quality. The "AA+" is also considered NAIC 1 by insurance regulators; hence the downgrade is unlikely to impact insurance company capital.

S&P's rationale for changing the long-term rating focused on a combination of debt, fiscal and political dynamics that it says were moving in the wrong direction. Further, S&P indicated that recent political brinksmanship made the agency more pessimistic about the Federal Government's ability and willingness to reduce the debt burden by the middle of the decade. It was particularly critical of recent Congressional and Administration interactions involving the fiscal consolidation plan that S&P said "falls short of what, in our view, would be necessary to stabilize the government's medium term debt dynamics."

In making the rating change, S&P took the U.S. Treasury bond rating off its CreditWatch Negative list while maintaining a negative outlook on its rating. A negative outlook means that if a rating is changed within the next six months to two years it would likely be a downgrade (to "AA"). S&P warned that it would likely downgrade the U.S. to "AA" if various conditions occur, including: (1) additional budget cuts are not enacted; (2) new fiscal pressures arise (e.g. lower GDP growth) that result in higher government debt than currently expected; or (3) interest rates go up significantly, thereby increasing the Treasury's borrowing burden.

#### ***Moody's and Fitch Treasury Bond Ratings***

Moody's and Fitch still rate U.S. Treasury bonds at their highest rating level ("Aaa/AAA") but both agencies sounded warnings stating that they are tracking progress on dealing with the nation's debt, which means that downgrades could occur if current trends are not reversed. In affirming its top rating on August 8<sup>th</sup>, Moody's cited the breadth of wealth and resources that the nation had at its disposal but also noted that liabilities are growing faster than the economy and action needs to be taken to bring the trend under control. It has assigned a negative outlook to the nation's debt. Moody's retained the "Aaa" but warned in a statement that foreshadowed comments made later by S&P that "there would be a risk of a downgrade if (1) there is a weakening in fiscal discipline in the coming year; (2) further fiscal consolidation measures are not adopted in 2013; (3) the economic outlook deteriorates significantly; or (4) there is an appreciable rise in the U.S. government funding costs over and above what is currently expected." Fitch released a statement on August 2<sup>nd</sup> that the debt ceiling passage and spending cuts decision was a key first step to improving the nation's debt picture, but it also stated that it expected to complete its review by the end of August.

What remains to be seen is whether S&P's rating change will make it easier for the other rating agencies to make downward changes of their own. Often, a rating change by one will be imitated by the others so that there may be an eventual confluence of ratings.

## *What the Rating Change May Mean to Bondholders and the Markets*

Bond ratings are an opinion based on different but often similar criteria by the rating agencies. Ratings also are more of an art than a science so it is not unusual to get opinions based on factors that are not necessarily quantifiable and perfectly comparable from one credit to another. There are many common fundamental principles that all rating agencies use to make their decisions. In essence, a rating is a determination of a borrower's ability and willingness to repay. The details usually encompass an assessment of the size of accessible resources, debt, finances, economic conditions and political/management factors. Ultimately, it is not uncommon to have ratings from different agencies converge as factors are identified and begin to exhibit similar chords.

Traditionally, when bonds are split-rated by the rating agencies (e.g. "AAA" vs. "AA"), bondholders expect yields to be a little higher than a credit showcasing two identical ratings ("AAA" vs. "Aaa") in order to price in the weakness expressed by the most cautious rating agency. At the same time, bondholders maintain the hopeful advantage that the bond that is viewed as stronger by one or more other credit agencies is actually fundamentally sounder than the pricing suggests.

The bond market's initial reaction on August 8<sup>th</sup> to the S&P downgrade did not trigger common bond re-pricing expectations as 10-Year Treasury bond yields rallied significantly with yields falling to a two-year low of 2.31%. While the bond market's apparent disregard of the downgrade may seem to undercut the credibility of S&P, the explanation is not that simple because the rating occurred within the context of other important market issues that have to be factored into the equation. First and foremost, the downgrade occurred during a vulnerable time in the market when economists and investors already are worried about the sluggish economy, the European debt crisis and the potential for another global downturn or recession. The stock market was in the process of correcting in the two weeks preceding the downgrade. The confluence of a host of economic and market uncertainties prompted the market to take refuge in the sanctuary which investors have viewed as the strongest fortress in the world for decades – U.S. Treasuries. Despite the fiscal pressures facing the United States, the Treasury bond has remained the global safe haven because of the nation's extensive wealth and monetary powers and the seat of the global reserve currency. Whether the Treasury bond and related bonds backed by the Treasury will maintain their "flight-to-quality" safe haven standing remains to be seen.

The prospects for an additional U.S. rating cut are dependent, in the words of the rating agencies, on bringing debt levels down and maintaining economic growth. There are formidable challenges to overcoming these hurdles. Recent economic weakening and the potential for another recession may be factors contributing to the recent stock market correction. The federal government may be between a rock and a hard place in standing ready to tackle the federal deficit while being prepared to use its powers to pump prime the economy if it begins to falter. This dilemma may eventually force the government to choose between its highest rating and rebooting the economy. When Japan lost its "Aaa" standing, it chose to continue to use fiscal stimulus for its economy while it settled for a "Aa2" Moody's rating in order to mitigate the economic pain. Other nations, like Canada and Australia, bounced back from their downgrades to restore their "AAA" standings while holding tight on their fiscal reforms.

## *Current Market Implications for Treasuries, Agencies and Municipal Bonds*

The S&P downgrade of United States Treasury Bonds has resulted in additional ratings action affecting Federal Agency securities and certain areas of the municipal market. Sectors of the municipal bond market which were downgraded on August 8, 2011 include Pre-Refunded bonds (escrowed in Treasuries or Agencies) and municipal bonds with federal or agency guarantees. Certain "AAA" rated State governments and selected credits which rely heavily on Federal Funding to support debt-service may be impacted with downgrades going forward; these might include certain credits in the Hospital, Transportation, Housing and Water and Sewer categories. It is important to note, however, that aside from Pre-Refunded bonds as a class, future ratings actions are expected to be taken on a case by case basis and should not result in a wholesale

downgrading of large segments of the municipal market as happened during the demise of the monoline bond insurers. S&P issued a separate commentary on August 9, 2011 that declared that state and local government ratings are not directly constrained by that of the U.S. Sovereign rating. We concur that individual municipal credits may deserve on their own merits to be worthy of a “flight-to-quality” credit standing because they have fundamental characteristics that provide extremely strong support to their debt.

We do not anticipate that the potential downgrade rating changes by S&P will result in significant valuation shifts near term in the fixed-income market. The timing of the U.S. announcement coincided with a steep selloff in global equity markets and added to investor anxiety regarding future economic prospects. As a consequence, Treasuries and other high quality fixed income sectors have benefited from an enormous flight-to-quality rally.

It will also be interesting to observe what happens to debt instruments either backed directly or indirectly by a federal guarantee (e.g. FNMA, Freddie Mac and municipal related debt) if additional rating downgrades occur. If the market moves toward a more forward, risk-based assessment on credit, Government Sponsored Enterprise paper that only carries the implied support from Treasury might experience wider spread levels from Treasury bonds. The precedent for seeing a divergence between full faith and credit secured by annual appropriation secured obligations has occurred during times of fiscal stress in the municipal market, specifically with respect to situations in which the guarantor credit (individual state or local government) experiences fiscal stress.

Finally, we anticipate that an investor preference for higher rated, more liquid securities will likely prevail over the near term. In this environment, yield premiums versus Treasuries may expand as investors seek the safety and liquidity of U.S. Treasuries. Globally, we would expect perceived safe haven currencies such as the Swiss Franc will continue to benefit versus the U.S. Dollar and will likely hold up well versus commodity based currencies and other non-safe haven currencies. Ultimately, we expect that underlying economic fundamentals will dictate the absolute and relative performance of U.S. Treasuries, agencies and municipal debt.

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#### **Notes and Disclosures**

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