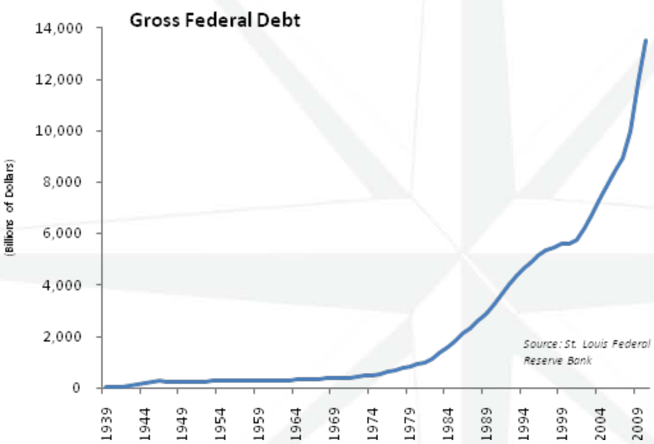
The Implications of the Downgrade of the United States

Standard & Poor's downgraded the credit rating of the United States from AAA to AA+ after Congress was unable to make substantial spending cuts when it passed a bill to raise the debt ceiling to $14 trillion. Since the first rating service was established in 1909, this is the first time that the United States was ever downgraded from its AAA rating. In this article we discuss the impact of the downgrade on the financial markets. *However, this is not about the downgrade of the credit rating of the United States; this is about the ongoing systemic deterioration in the credit quality of this country.*

US Treasury securities are still some of the most liquid and safest investments in the world. However, S&P indicated in its release that the rating may be cut further if government spending reductions are smaller than the ones agreed to, interest rates rise or "new fiscal pressures" result in higher general government debt. One of our primary investment themes remains that we need to see a credible plan to reduce the deficit before we can become constructive on long term investments in risk assets.

Up until now, the global financial system operated under the implied assumption that the United States government is the highest quality credit and had the ability to back-stop financial institutions to protect the financial system when needed. The government proved its role during the Financial Crisis of 2008 when it stepped in and infused capital into banks in order to prop up the banking system. With the high quality stature of Treasury securities, financial institutions such as banks, credit unions and insurance companies are not required to post as much capital to support these investments as other risk assets. Immediately after the downgrade announcement, the Federal Reserve, Treasury and FDIC released statements indicating that the risk weights for US Treasury and agency securities will not change as a result of the downgrade.



It took the US government nearly 200 years to accumulate $4 trillion in debt. It took a mere sixteen years to triple it to $14 trillion. History shows that when a sovereign country accumulates debt at such a rapid rate, it takes a significantly longer time to reduce it. *The downgrade in the credit rating simply codifies the deterioration in the credit fundamentals of the United States.* It is another step in our journey into a new paradigm in which the operational assumptions of the capital markets have changed. The downgrade implies a higher risk for the credit; and, a rational investor would expect to earn a higher return for accepting that risk.

The conundrum we now face is that in order to reduce the deficit, we have to cut spending and raise government revenue. It's not one or the other, it's both. However, raising government revenue requires increasing tax revenues, and cutting expenses implies lower consumption either of which will have the effect of reducing economic growth. Given the outrageous size of the debt and the extraordinary level of government spending that currently support entitlement programs, there is simply no way to address the problem without negatively impacting future economic growth. In addition, the interest expense to service the debt grows larger as interest rates rise.

The Downgrade of the U.S. Government - The Implications for Investors

We are in a new paradigm for investors. In our view, the role of banks in the economy has changed, leverage in the capital markets is massive, financial regulation is not keeping up with the complexity of the markets, and the credit quality of the US government is deteriorating. In addition, the structural problems in our economy and capital markets are impeding business development and the expansion of credit. Listed below are several of the issues that will impact investors as a result of the deterioration in the credit.

<u>Repurchase Agreements and Collateral Transactions</u> While there may be some initial pressure on the repo market, US Treasury securities are still some of the most liquid and safest investments in the world. As a result, we expect collateral transactions in the money markets backed by US Treasuries will remain stable over the near term. US Treasuries also are the primary collateral for the swaps and derivatives markets and given the unregulated nature of these transactions, we expect to see higher margin requirements over time. Higher collateral requirements will ultimately restrict credit growth which will negatively impact credit expansion and economic growth.

<u>Interest Rates will Increase</u> We live in a world with government manipulated interest rates. With the deterioration in the credit fundamentals of the United States and the rise in the expected rate of inflation, a rational investor should expect the nominal rate of interest to increase. Yet, we have historically low interest rates.

<u>The Marginal Cost of Credit will Rise</u> The deterioration in the credit quality of the United States is first and foremost a *credit* issue. US Treasury securities are used as collateral for all types of global securities transactions including credit derivatives, certain swap agreements and repurchase agreements. To the extent that any bank around the world requires a counterparty to post a higher level of collateral against a US Treasury position, we expect to see a marginal tightening of credit. As a result, we would expect over time to see higher interest rates which would further impair the expansion of credit, business development and economic growth.

<u>Volatility will Increase</u> As we adjust to a new paradigm where the debt of the United States is rated AA+, we expect volatility will increase. *Buy and Hold investment strategies will suffer in a range bound market given the low expected returns for cash and fixed income asset classes.* Tactical strategies that take advantage of the dislocations in the market or changes in the value of risk should perform well if volatility increases.

<u>Equity Prices will Remain Range Bound</u> We expect corporate earnings will continue to show strength; however, the structural problems in the economy will limit the incentive for business investment and employment growth. The downgrade of the United States will not immediately affect the earnings of Johnson & Johnson, Caterpillar and other domestic companies. However, until there is clarity to corporate tax policy, regulation and the solution to the global debt problem, management will focus on stock buy backs, dividends and their own compensation. Given the recent sell off, with the S&P 500 trading at 1220, we believe equities offer good relative value.

<u>The Municipal Bond Market will Survive the Downgrade</u> A significant portion of the $2.9 trillion municipal bond market is prerefunded or escrowed to maturity with US Treasury bonds. With the downgrade of Treasury securities, these municipal bonds will also be downgraded. However, since most of these securities are held by individuals, we expect the downgrade to be a manageable event for the municipal bond market.