Implications for the Credit Rating of the U.S. Government

May, 2009

S&P Warns of a Downgrade in the Credit Rating of the United Kingdom

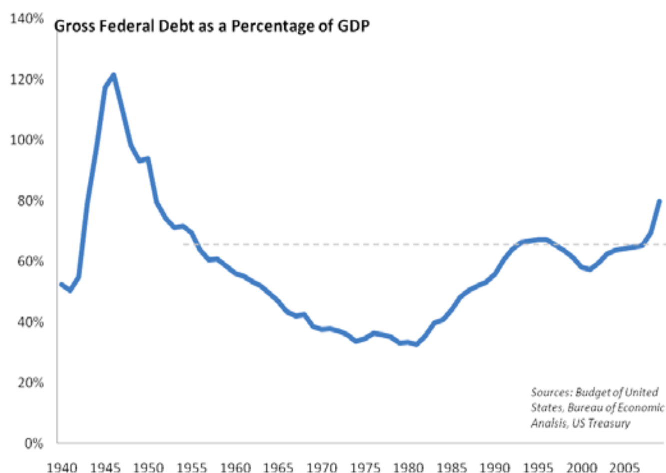
The United States and the United Kingdom share the coveted AAA rating from Moody's and Standard & Poor's rating service. However, this past month Standard & Poor's threatened to downgrade U.K.'s AAA rating, putting the country on negative outlook for the first time ever. While S&P's action came as a surprise to the market, the fiscal and economic deterioration facing the country is obviously pretty bleak.

The UK is expecting to issue over €200 billion in debt to stabilize its financial system and stimulate economic growth. While the UK Treasury forecasts debt peaking at 79% of GDP, S&P is concerned that the real borrowing level could approach 100% of GDP. In addition, once the country assumes that level of debt, it is extremely difficult to unwind quickly without impacting the country's standard of living. The Treasury has also uncovered further weaknesses in the economy's ability to generate sustainable tax revenue over the next few years. With a heightened debt burden and reduced tax receipts, the pristine AAA rating is under stress.

Will the United States Lose its AAA Rating?

The short answer is: Probably not, at least in the near term.

The economy of the United States is much broader than that of the U.K. However, the circumstances that currently face the U.S. are strikingly similar to the U.K. First, the Federal budget is out of control. The current deficit is running at $1.1 trillion and is expected to top $1.8 trillion by the end of fiscal 2009. However, our concern with the deficit is out in 2010 and 2011 when the administration asserts that the deficit is supposed to shrink to half its size. Historically, it has proven difficult to reduce a debt burden once it has been incurred. As of April 2009, we estimate the total debt is roughly 80% of adjusted GDP, and we expect it to go higher before it stabilizes.



Second, the consumer and corporate sectors of the U.S. economy are extremely fragile. As a result, we expect tax receipts will be challenged in this environment in which capital formation and business development will remain suppressed. Ultimately, the government's ability to raise revenue through an increase in tax receipts will be a challenge, especially with a low level of expected inflation over the foreseeable future. Fiscally challenged state and local governments are also struggling to balance their budgets effectively diluting tax receipts further.

Under a scenario in which additional government assistance is required to prop up the financial system, the debt burden would increase, putting further pressure on the rating.

What Are the Ramifications of a Downgrade in U.S. Treasury securities?

The credit worthiness of the United States government has been rock solid since World War II. We've lived in a world where the US dollar is the world's reserve currency and the US Treasury has always been rated AAA. While we don't expect to see a downgrade in the near future, the market is quick to discount the deterioration in any credit, and that includes the U.S. government. Any conjecture on the potential impact of a downgrade assumes, in a large part, there is rational investor behavior in the market. Yet, in this market, that too may be a stretch.

1. Yields on U.S. Treasury securities will likely increase. Foreign investors hold roughly $3.1 trillion of U.S. government securities. As a result of any threat of a downgrade, rational investors will demand a higher yield for the increase in credit risk. While we don't expect foreign central banks to start selling U.S. Treasury securities, we do expect that they will demand higher yields in order to maintain their existing pace of Treasury investment.

2. U.S. Treasury yields represent the "risk free" rate in many valuation models. The risk free rate is the rate at which a borrower would earn for lending money in a riskless transaction. Sadly, with the balance sheet and economy of the US government in a shambles, the Treasury is no longer the riskless investment it once was. As a result, prices of securities that utilize a risk free rate as an input in the pricing model, will adjust lower as the rate on U.S Treasury securities increases.

3. As a result of a downgrade, higher collateral will be required to support transactions. Certain transactions, such as repurchase agreements, margin, and derivative transactions, require that securities - including U.S. Treasury securities - are posted as collateral. Assuming a downgrade in the credit worthiness of the collateral, it is likely that higher amounts of collateral will be required to support the same notional amount of the transaction. This will have a further effect of deleveraging in the capital markets since more collateral ultimately means less leverage to support the transaction.

4. The yields on government guaranteed and GSE debt will likely increase. Assuming that the interest rate on Treasury debt increases, it is rational to assume that the yields on government guaranteed debt and Government Sponsored Enterprises, including Fannie Mae and Freddie Mac, will also increase. Yields on the debt of Ginnie Mae (GNMA) the largest guarantor of mortgage loans will increase. As a result of increased borrowing costs, the cost of mortgage loans will also increase.

5. Rising interest rates will impede progress on an economic recovery. We believe the U.S. economy will not show sustainable growth until there is stability in the financial system. Higher interest rates will have a muting effect on an economic recovery as borrowers pay a higher rate for capital. As a result, business formation and capital development at the margin will be impeded.

6. The value of the U.S. Dollar will decline versus other currencies. We expect that with a downgrade, investors will likely diversify away from U.S. dollar denominated securities. While higher interest rates will, at the margin, be required to attract investors to U.S. securities, downward pressure on the U.S. dollar will be a consequence of further diversification.

7. We expect that the price of gold will rise. Gold is an emotional investment whose price rises as insecurity around the dollar increases. We would expect that a downgrade in the credit quality of the U.S. government will likely result in a flight to quality toward gold as a haven for risk adverse investors.

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