

STANDARD & POOR'S DOWNGRADES U.S. DEBT

What's happened?

On Friday August 3, 2011, Standard & Poor's ("S&P") lowered the U.S.'s long-term rating from AAA to AA+. The U.S. had held its AAA S&P rating since 1941 and the equivalent Aaa from Moody's since 1917. S&P also attached a negative outlook, which means there is a chance it could be downgraded again within two years, according to S&P, if spending is less than agreed to, if interest rates rise, or "new fiscal pressures" result in higher general government debt. S&P subsequently lowered its credit rating on debt issued by Fannie Mae, Freddie Mac and other lenders backed by the federal government on August 8th, 2011.

The downgrade does not come as a complete surprise as S&P had indicated that to avert a downgrade, the U.S. required deeper spending cuts, increased revenues and more stable, effective policymaking. All of this required an increase to the U.S. debt ceiling. The debt ceiling is the legal limit that the federal government can spend which was written into law in 1917. It was raised on August 2, 2011 following weeks of political debate and highly contentious negotiations. While a more serious debt default was averted, it was not enough to avoid the downgrade.

"The downgrade may light the fire that gets Congress to finally compromise," said Tom Nakamura, Vice President and Portfolio Manager at AGF Investments. "However, having said that, the divergent politics we have observed up to this point may just be the beginning," says Tom. The following days will likely result in increased government rhetoric and intervention across the globe to stem outright fear in financial markets. We have already seen this as the European Central Bank has started purchasing Italian and Spanish bonds to stem contagion fears and concerted efforts by other key governments to calm market fears, including Japan, Germany and France.

What are the short and long term implications?

According to Martin Hubbes, CIO and Portfolio Manager at AGF Investments, we have to separate the short term psychological impact from the real long term implications. "Short term, I liken this to Y2K. I don't see the downgrade itself having a significant impact. Does this mean that pension funds, for example, will be required to liquidate their US Treasuries? Not likely. If anything, we will see policies being re-written to accommodate the rating change". Martin argues that the real issue at hand is the longer term growth implications for the U.S. economy. From an equity perspective, there is still growth in the U.S. Earnings are strong, balance sheets are being repaired and valuations are reasonable. From an economic perspective, the data we're seeing out of the U.S. remains weak. If the U.S. is unable to accelerate their economic growth, and their debt levels continue to rise, their debt/GDP ratio will continue to deteriorate. This will present a longer term challenge for the U.S. and it is unclear at this time how long this will take to resolve itself. "I believe that we are already in the midst of a long-term decline in the U.S. as the world's economic powerhouse. While this downgrade doesn't change the course of events, it does highlight some of the systemic issues that we've known about for some time now".

Martin also cautions investors against reacting to headline news. He notes that despite the country's obvious fiscal issues, we need to consider that S&P was the same institution who rated sub-prime mortgages as AAA prior to the financial crisis. "S&P's opinion did not bring to light any new information about the U.S. government's creditworthiness," Martin notes. At the current time,

Moody's and Fitch have both affirmed their AAA-rating as they continue to review the country's deficit reduction plan for possible downgrades. Also of note is the fact that the Obama administration vehemently pointed out a "\$2 trillion mistake" in S&P's analysis prior to disseminating their decision. S&P subsequently changed their reasoning after the errors were pointed out but continued ahead with the downgrade.

What are the implications for the bond market?

The whole concept of the "risk-free" asset is synonymous with U.S. Treasuries but in fact, they were not actually risk-free because inflation always posed a risk of eroding investor capital. As well, the idea that the U.S. was, or possibly still is, the safest place in the world to invest, has slowly been eroding over time and was exacerbated by the sub-prime crisis in 2007.

This brings about the question of what will now replace them and whether or not U.S. Treasuries will continue to be the safe haven as investors settle for a AA credit rating. Will Treasuries be replaced by other AAA sovereign debt such as German bonds? Likely not, considering that Europe is contending with its own crisis and some of its own members have already encountered a similar fate. Another alternative is that US treasuries will it be supplanted by a well-diversified basket of bonds and currencies that will define a "less risky" asset.

"I don't expect meaningful forced selling of Treasuries. While credit quality is not as sound as it once was, it is relatively sound and Treasuries will continue to enjoy preferred status as being the deepest and most liquid financial instruments". -Tom Nakamura

There are some that see the U.S. paying higher interest rates over time on a wide range of debt, including home mortgages and government debt obligations, as yields are expected to rise. "In the short term, the initial reaction is likely to be curve steepening – strength in the front end reflecting near-term risk aversion and weakness in the long end reflecting concerns about long-run deficit and debt dynamics," says Tom. "I expect that the U.S. dollar will likely exhibit weakness, in particular against safe-haven currencies, like the Swiss franc and Japanese yen," adds Tom.

A key determinant in market reaction and future investment in U.S. Treasuries will also come from foreign investors. Foreigners hold approximately 46% of U.S. Treasuries, according to Bank of America Merrill Lynch, a record high, with China being the largest investor. Compare this to 1945, where foreigners owned a mere 1%. "What the U.S. needs to continue doing is focusing on economic growth, job creation and improving its political effectiveness through increased governance and competent policymaking decisions – the latter of which the world has just witnessed that it is far from accomplishing," concludes Tom.

What does this mean for investors?

These events could result in one of three scenarios. On one hand, we could see QE3 which has the potential to be a catalyst for equity markets. The Federal Reserve is expected to provide some

guidance on this either at the scheduled Federal Open Market Committee (FOMC) meeting August 9, 2011 or at their annual meeting at Jackson Hole scheduled for late August. The last round of quantitative easing fuelled a stock market rally from September 2010 to April of this year, which saw the outperformance of companies with weaker balance sheets that were more leveraged to the global economy. In addition, resource companies benefited from rising commodity prices driven by continued global demand. Another round of quantitative easing could have similar effects. In this scenario, stocks with higher leverage tend to outperform, including small to mid cap companies which are more sensitive to market movements.

In the absence of additional stimulus via further quantitative easing, the U.S. could continue to muddle through at the current stall speed. This scenario could create ongoing headwinds for equity markets and result in somewhat of a return to basics. Historically, moderate to low growth environments have favoured companies with strong balance sheets and strong company specific fundamentals.

Finally, ongoing lack-lustre growth in the U.S. coupled with a continuation of the debt crisis in Europe could result in increased volatility for equity investors. In 2008, the global economic crisis culminated in a flight-to-safety and increased demand for government bonds and hard assets such as gold. Should the economy continue to deteriorate without the support of government intervention, the sub-par economic growth in the U.S. coupled with an elevated inflationary environment is not supportive of equity markets, or even fixed income, depending on how much inflation is present.

“In my point of view, we will likely see the first scenario, above (QE3). The question for me is around the timing of the next round of stimulus,” says Martin. Due to the lack of consensus amongst U.S. policymakers, I think we will have to see the situation deteriorate even further before we see another round of easing.

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