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# United States of America Rating Downgrade

Please find below our thoughts on the credit rating downgrade of U.S. long-term debt by Standard & Poor's Rating Services. We anticipate continued volatility in the marketplace over the short run.

**Insight into the U.S. Downgrade by S&P**

On August 5, 2011, Standard & Poor's Rating Services (S&P) lowered its long-term sovereign credit rating on the United States to AA+ from AAA. The two other nationally recognized statistical rating organizations, Moody's and Fitch, reaffirmed their highest sovereign credit ratings for the U.S. in early August prior to S&P's action. S&P maintained its highest credit rating for short-term U.S. debt (i.e. maturities less than one year). On August 8, S&P also downgraded the long-term debt of Freddie Mac and Fannie Mae, the mortgage finance agencies controlled by the U.S., to AA+ from AAA. The long-term debt of the Federal Home Loan Banks and the Federal Farm Credit Banks was also downgraded. S&P, Moody's and Fitch all maintain a negative outlook for U.S. debt, suggesting further downgrades are possible.

S&P states its sovereign credit rating is a reflection of a nation's "ability and willingness to service financial obligations to nonofficial, in other words, commercial, creditors on time and in full."[1] S&P indicates its ratings are determined primarily using a 3-5 year time horizon.[2] The main criteria S&P utilizes to demonstrate a nation's ability and willingness to pay its creditors are:

- Institutional effectiveness and political risks
- Economic structure and growth prospects
- External liquidity and international investment position
- Fiscal performance and flexibility, as well as debt burden
- Monetary flexibility, reflected in the monetary score.

S&P rates each of these criteria on a scale of 1 (superior/extremely strong) to 6 (poor/extremely weak).

As a rule S&P does not publish the scores given in each category it rates, but the specific criterion used to arrive at those scores is known. A review of the criteria suggests that the US will most likely continue to score in the highest category for economic structure, external liquidity, and monetary flexibility. We believe this is due to high per capita GDP in the US, the US Dollar's role as an international reserve currency, and the independence and flexibility of the Federal Reserve.

The U.S. fiscal performance and flexibility is also outstanding as the U.S., over S&P's 3 to 5 year review period, has the means and ability to meet all of its financial obligations. S&P forecasts U.S. debt to GDP

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[1] *Sovereign Government Rating Methodology and Assumptions,* Standard & Poor's, June 30, 2011
[2] [3] *Standard & Poor's Clarifies Assumption Used On Discretionary Spending Growth,* Standard & Poor's, August 6, 2011

will climb from 74% by the end of 2011 to 79% in 2015[3]. While this is higher than the recent past, it is comparable to other AAA sovereign credits, including the United Kingdom and France. Setting aside the fact the U.S. controls the printing capacity to meet any and all of its interest and principal obligations, the intermediate term debt burden is completely manageable even without the printing press advantage.

The United States' ability to pay its obligations is without question. What is in question is the country's willingness to do so. S&P states, "The political brinkmanship of recent months highlights what we see as America's governance and policy making becoming less stable, less effective, and less predictable than what we previously believed. The statutory debt ceiling and the threat of default have become political bargaining chips in the debate over fiscal policy. Despite this year's wide-ranging debate, in our view, the differences between political parties have proven to be extraordinarily difficult to bridge."[4]

Initial capital market reaction to the downgrade was mixed, with U.S. Treasuries yields declining while global equities sold off significantly. Volatility also increased. Major holders of U.S. Treasury debt, such as banks and insurance companies, will not need to reserve additional capital to hold U.S. debt according to regulators, nor will money market and mutual funds need to take action as a result of the downgrade. Still, a debt downgrade is a meaningful event so there could be additional ripple effects from S&P's actions that have yet to become clear.

The fact that Treasury bond yields fell (and prices rose) in response to the downgrade emphasizes the unique standing of the U.S., as not only the most liquid but also the preferred government debt market during times of economic and financial turmoil. The significant drop in U.S. Treasury yields over the past few weeks indicates investors are far more worried about slowing global economic growth and areas of the world facing real debt crises, such as Europe, than they are about the opinion of one private rating agency, whose AAA ratings of residential mortgage backed securities did little to shield investors from losses during the recent credit crisis. This further demonstrates that the markets are not overly concerned that the U.S. will default on its debts. To many, Monday's rise in the U.S. Treasury prices was surprising. A review, however, of prior downgrades of major developed countries, such as Canada and Japan, show that prevailing economic conditions within the country drive the direction of spreads, not the fear of an ultimate default by the country. The difference between the implied risk of the default of an "AAA" entity and one with a "AA+" rating over the intermediate term is de minimis. In addition, the U.S. Treasury is the largest and most liquid market in the world and benefits from times of economic uncertainty. Therefore, the price movement of U.S. bonds on Monday was driven by worries over global economic growth not mainly the action of S&P. We will continue to focus on our indicators of interest rates including inflation, Federal Reserve policy and economic growth to set the duration of your portfolio.

Vanderbilt Research Team

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[4] *United States of America Long-term Rating Lowered to "AA+" On Political Risks And Rising Debt Burden, Outlook Negative,* Standard & Poor's, August 5, 2011