

## The Implications of S&P's Downgrade of the United States

Monday, August 8, 2011

### Overview of the S&P Downgrade

During Friday evening on August 5, Standard & Poor's downgraded its long-term credit rating on the United States from AAA to AA+. Standard & Poor's cited several reasons for the downgrade in its August 5 research update, including:

- **'Budget Control Act of 2011' Had Insufficient Deficit Reduction:** The deficit reduction in excess of \$2.0 trillion in the *Budget Control Act of 2011* passed by Congress and signed by the Administration on August 2 falls short of the amount needed to stabilize the U.S. Government's debt burden by the middle of the decade.
- **Lack of Confidence in the Political Process:** Confidence that the political process can address ongoing fiscal and economic challenges has deteriorated. The political brinksmanship during the debt ceiling debate has demonstrated that governance and policymaking has become less stable, less effective, and less predictable than previously believed.
- **Deterioration of the U.S. Relative to AAA Sovereign Peers:** When comparing the United States to relevant AAA sovereign peers (e.g., Canada, France, Germany, and the U.K.), the United State's net public debt picture is diverging. S&P estimates that these five sovereigns will have net government debt-to-GDP ratios ranging from 34% (Canada) to 80% (the U.K.), with the U.S. debt burden at 74%. By 2015, S&P projects that these net public debt-to-GDP ratios will range between 30% (Canada) and 83% (highest, France), with the U.S. debt burden at 79%. In contrast to the U.S. debt picture, S&P projects that the net public debt burdens of these other countries will begin to decline on or before 2015.

### Near Term Impact on U.S. Government Interest Rates

To date, global U.S. creditors have been patient with the United States as it grapples with its structural budget deficit. That patience was evident as recently as the Friday, August 5 market close, when the 10-year U.S. Treasury yield stood at 2.56%, only 0.48% above its December 18, 2008 financial crisis low (of 2.08%).

The total outstanding U.S. Government debt currently stands at \$14.34 trillion<sup>1</sup> (as of August 3, 2011). We believe it is imperative for United States policy-makers to take immediate action to meaningfully improve its long-term fiscal budget situation in order to sustain low long-term borrowing costs. However, we do not believe that Standard & Poor's August 5 downgrade will have a meaningful *immediate* impact on the United States' borrowing costs.

About \$4.56 trillion of the United States' \$14.34 trillion in debt is from intra-governmental U.S. Treasury holdings, representing accounts administered by the Federal Government, such as the *Trust Funds for Social Security, Medicare, Military Retirement and Health Care, and the Civil Service Retirement and Disability* account. In short, the supply-demand dynamic for this debt should remain unaffected by any credit downgrade.

The remaining \$9.78 trillion is the public debt held by *The Federal Reserve, International Investors, Domestic Private Investors, and State and Local Governments*. In order to determine the likely impact on the public debt, we must look at the objectives of the major U.S. Treasury owners and the actions they are likely to take as a result of the downgrade. For the following reasons, we believe the S&P downgrade is unlikely to have a major near-term impact on the supply-demand dynamics for U.S. Treasuries, and ultimately, the U.S. Government's borrowing rates:

- **Federal Reserve U.S. Treasury Holdings (\$1.65 trillion):** The supply-demand dynamic will remain unaffected for the Federal Reserve, which has increased ownership of U.S. Treasuries since 2008 to raise the money supply (e.g., Quantitative Easing Parts 1 & 2). If anything, the Federal Reserve has the power to further increase its holdings of U.S. Treasuries (or other fixed income securities) by rolling out a "QE3" at a future date if it believes it can help stimulate needed economic growth and employment (without delivering unacceptably high inflation).

<sup>1</sup> *United States Department of the Treasury, Bureau of the Public Debt (August 2011).*



- **Foreign Owners of U.S. Treasuries (\$4.51 trillion)<sup>2</sup>:** The rationale used by S&P to explain its downgrade provides *zero* new substantive information for the largest foreign owners of U.S. Treasuries like China, Japan, and many others. At the present time, there also remains few, if any, substitute investments for large foreign owners of U.S. Treasury debt. While we expect representatives of foreign governments to use the S&P downgrade as an opportunity to publicly chastise American policy-makers, we believe their actions will speak louder than their words. In short, their near-term actions are unlikely to change. Many of these countries have already made attempts to diversify away from U.S. Treasuries, but there are limits to the diversifying action they can take without jeopardizing their own economies.

### Foreign Owners of U.S. Treasuries<sup>2</sup>

Foreign Owner of U.S. Treasuries	Billions of USD (\$)	Foreign Owner of U.S. Treasuries	Billions of USD (\$)
China (Mainland)	\$1,160	Russia	\$115
Japan	\$912	Switzerland	\$108
United Kingdom	\$347	Canada	\$91
Oil Exporters <sup>1</sup>	\$230	Luxembourg	\$68
Brazil	\$211	Germany	\$61
Taiwan	\$153	Thailand	\$60
Carib Bnkng Ctrs	\$148	Singapore	\$57
Hong Kong	\$122	All other countries <sup>2</sup>	\$670
		<b>Total:</b>	<b>\$4,514</b>

<sup>1</sup> Oil exporting countries include Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the UAE, Algeria, Gabon, Libya, and Nigeria.

<sup>2</sup> All other countries' own under \$50 billion each. They include India, Turkey, Ireland, South Korea, Belgium, Poland, Mexico, Italy, Netherlands, France, Philippines, Norway, Sweden, Colombia, Israel, Chile, Egypt, Malaysia, Australia, and all others (\$203 billion combined).

- **Other Owners of U.S. Treasuries (approximately \$3.6 trillion):** The remaining owners of U.S. Treasuries include *State and Local Governments, Institutional Investors (e.g., Pension Funds, Mutual Funds, etc.) and Retail Investors*. We do not believe institutional investors, who have a variety of investment and diversification objectives, have a reasonable alternative to U.S. Treasuries. For example, it is difficult to see how a pension plan with U.S. liabilities can invest in the sovereign debt of Canada, France, Germany, the U.K. and other non-dollar denominated AAA foreign debt and effectively hedge its pension obligations. We also do not see viable alternatives for state and local governments. Retail investors could buy gold or other investments *they believe* are competing alternatives to U.S. Treasuries. However, retail investors only own a tiny sliver of U.S. Treasury debt.

### Near and Long-Term Impact on Confidence and the Economy

S&P's downgrade of the United States is unprecedented, so we lack historical reference points for comparison. However, S&P's *epiphany* that led it to downgrade the United States has been obvious to many (even casual) observers who have been following the United States' fiscal deficits, demographic trends, and the vociferous political rancor. At this point, the other two ratings agencies (Moody's and Fitch) continue to rate the United States' long-term debt with the highest (AAA) credit rating. In summary, we believe the near-term *direct* impact of S&P's downgrade will be relatively modest compared to the ongoing European sovereign crisis du jour and near-term readings of U.S. economic growth.

The possible negative *indirect* impacts are more difficult to quantify and pose potentially greater risk. For example, a *symbolic* national deterioration in confidence over the United States' credit worthiness could have far-reaching

<sup>2</sup> Department of the Treasury/Federal Reserve Board (May 2011)



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consequences. It could give weary, debt-ridden U.S. consumers another reason not to spend. It could add fuel to an already uncertain economic environment, further diminishing the willingness of businesses (large and small) to invest and hire. In short, it could be another ingredient that helps reinforce a self-fulfilling prophecy.

On the other hand, a positive *indirect* impact could be that this event serves as a much-needed wake-up call for policy-makers in the Administration and Congress to make the difficult political decisions to get the United States back on a sustainable fiscal track. While the source of the problem is financial, the solution is certainly political. Hope springs eternal!

***We encourage you to reach out to your consultant at DiMeo Schneider and Associates, L.L.C. to discuss how this event could impact your portfolio's investment objective.***