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Commentary

Standard & Poor's Downgrades the U.S.—Not the End of the World

By: SEI Investment Management Unit

- After much anticipation, Standard & Poor's (S&P) lowered the United States government's longstanding AAA rating (its highest rating) to AA+ (the next highest rating).
- The agency also made the same ratings change for long-term U.S. government-backed debt issued by a variety of banks and credit unions, as well as mortgage finance firms Fannie Mae and Freddie Mac.
- The downgrade applies only to long-term debt, as a top-tier rating for short-term debt remains in place. This is good news for money market funds, as they invest in short-term debt.
- The other major rating agencies, Moody's Investors Service and Fitch Ratings, have not yet changed their ratings on U.S. debt.
- While historically significant (and not without controversy), the downgrade does not shed any new light on the fiscal challenges facing the U.S., nor do we believe it spells imminent trouble for the U.S. government, the global financial system or investors.
- It has been SEI's view since the beginning of this crisis that a downgrade would have little impact on the market for U.S. Treasury securities and no impact on our Treasury holdings. Our view remains intact.
- We expect developments in Europe to have a greater economic impact than the Treasury downgrade, and the European Central Bank has announced new measures to support Italy and Spain.

We noted in a recent commentary that "even if the debt ceiling is raised in time to avoid default, there is still a very real possibility that the U.S. will have its sovereign credit rating downgraded." It took less than a week for that to happen. After the U.S. financial markets closed on Friday, credit agency Standard & Poor's lowered its rating on long-term debt issued by the United States government and a variety of government entities from AAA to AA+. The change was not without controversy, as the U.S. Treasury noted that the S&P analysis contained a two trillion dollar mathematical error.

Consensus View: U.S. Debt Still Top Quality

S&P is currently the only one of the three major credit-rating agencies to downgrade U.S. debt. Moody's affirmed its AAA rating on U.S. debt earlier this month. Fitch reaffirmed its rating following the political solution that increased the U.S. debt ceiling and will conduct a regularly scheduled review of the U.S. debt rating by the end of August.

With two of the three rating agencies currently giving the United States top-tier debt ratings, most credit analysts will still view the U.S. government as having the highest credit rating possible. In addition, the U.S. Federal Reserve and several foreign central banks have announced that U.S. Treasury debt will still be accepted as top-rated collateral. This is a key development—perhaps an inevitable one—as U.S. Treasuries make up nearly 60% of the world's highest-rated debt. The next largest AAA-rated issuer is Germany, which accounts for just 10% of the market. For better or for worse, there is simply not enough AAA-rated debt available in the marketplace, meaning that the U.S. government will remain the key issuer of the highest-quality and most liquid securities available, even if they eventually carry a less-than-AAA rating.

No New Worries for Money Markets

Despite the ratings downgrade for long-term debt, S&P affirmed its higher rating for short-term debt issued by the U.S. government. This is a positive development for money market funds, as they invest in short-term debt. We do not expect significant forced selling due to the downgrade, but perhaps more buying from investors who prefer the liquidity of the Treasury market. In line with this thinking, demand for short-term U.S. Treasuries intensified last week even before the announcement by S&P, resulting in negative short-term market rates (yields and prices of fixed-income securities move inversely), as was reflected in the Bank of New York's announcement that it will start charging customers for large short-term deposits. (Should upward pressure on interest rates occur, it would have negative economic implications as banks and other investors face higher borrowing costs.)

The Real Work Lies Ahead, Still

Despite the cuts outlined in the recently passed debt-ceiling legislation, the U.S. deficit is still expected to grow. The current agreement only slows the rate of growth, and S&P does not view the steps taken to date as adequate. The report from S&P states:

> When comparing the U.S. to sovereigns with 'AAA' long-term ratings that we view as relevant peers- - Canada, France, Germany and U.K.- - we also observe, based on our base case scenarios for each, that the trajectory of the U.S.'s net public debt is diverging from the others…we project that the net public debt burdens of these other sovereigns will begin to decline, either before or by 2015.

Our View

We do not expect S&P's decision to have any material impact on interest rates or on funds that invest in U.S. Treasury securities. The direction and level of interest rates will be determined by U.S. economic fundamentals, not the rating of the U.S. government. SEI remains firm in our view that, even if all three agencies issued a downgrade, the dominant position the U.S. government holds in the debt market would still result in a vibrant market for U.S. sovereign debt, as the Treasury market is still the most liquid market in the world, and is still of strong credit quality, if not AAA. From the standpoint of investing in equities, the downgrade should mean even less.

While the situation remains fluid, based on our assessment of the recent events, combined with our view of market fundamentals, we expect no near-term changes in our broader portfolio positioning. Given the expectation for continued choppy equity markets, we have been active over the past year in realigning portfolios by adding fundamental managers that implement strategies that are less reliant on market trends and more reliant on deep research capabilities and stock selection. With portfolio decisions based on longer-term views, manager sentiment, in general, has not shifted given the headlines over the past week. With that being said, expectations of a slower growth environment in the developed world can be seen in the positioning of their portfolios. U.S. large cap, for example, has carried a quality growth bias with Information Technology as a favored market sector. While cyclical growth is fading, a secular growth story remains for the sector which is expected to benefit from corporate spending and attractive valuations. In volatile times such as this, managers will undoubtedly challenge their current investment strategies to ensure validity. To date, positioning across our portfolios has remained consistent as to what we observed entering the quarter. Equities are trading at reasonable valuations and corporations are sitting on record levels of cash. While market volatility is likely to continue, we remain positive on equities versus fixed income on a strategic basis. Within the equity strategies, we are generally positioned for a pro-growth environment (however, we are emphasizing large-company stocks over small).

In our fixed-income offerings, we feel total-return opportunities are limited by low yields. Our portfolios remain underweight Treasury securities and overweight agency mortgage-backed securities and financial obligations. U.S. Core fixed income has added back a modest amount of duration, but remains short of the benchmark. Given the risk of rising interest rates, we are modestly underweight duration. We maintain an overweight to spread sectors (particularly non-agency mortgage-backed securities) and continue to favor the corporate and high-yield markets. Our managers expect to look for undervalued sectors and securities that have resulted from market dislocation. We view this positioning as appropriate based on current market conditions and our strategic outlook. We will work to minimize transaction costs in a less liquid market, and seek to avoid any unnecessary sales and liquidations.

Looking Ahead

The downgrade is an unprecedented event and uncertainty and volatility will remain high. Market liquidity will likely be challenged in all fixed-income sectors. The U.S. will be more vulnerable to a change in the investment strategy of the Asian Central Banks that are the largest holders of Treasuries. While these banks have few alternatives, this will remain a source of market volatility. We do not expect any near-term change to U.S. monetary policy, but will continue to stay tuned to upcoming developments.

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