Capstone Comments

A forum for communicating information about the management of assets

Q:

A:

Capstone
Wealth Management

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If you have questions that you think would be interesting for our readers, please call Kerrie at 406-259-4939 or email your questions to kkern@capstoneretire.com.

Why was U.S. debt downgraded?

On Friday, August 5, after the market closed, Standard & Poor's (S&P) announced that it would downgrade the U.S. sovereign debt rating from AAA to AA+. On Monday, August 8, S&P carried this downgrade through to U.S. government agencies, including Fannie Mae & Freddie Mac. This downgrade should have come as no surprise as Standard & Poor's has stated publicly for some time that it was considering a downgrade to U.S. government obligations, citing concern over increasing debt loads without sufficient revenue increases as well as the drawn-out and difficult negotiations over raising the debt ceiling. Moody's Investor Service confirmed its "Aaa" government bond rating of the United States following the deal, but assigned a "negative outlook" to the rating – indicating there would be a risk of downgrade if there is a weakening in fiscal discipline in the coming year; further fiscal consolidation measures are not adopted in 2013; the economic outlook deteriorates significantly; or these is an appreciable rise in the U.S. government's funding cost over and above what it currently expected. Fitch Ratings also maintained its "AAA" rating following the deal, but said the agreement was only a "first step" toward putting in place a plan to reduce the budget deficit to a level that would secure that rating over the "medium-term." (Vanguard – "Downgrade should mean little to long-term investors", August 8, 2011)

"While a change in credit rating is indicative of the issues that are confronting the United States, it's not indicative of the safety or liquidity of the underlying securities. There is no substitute for depth and liquidity of the U.S. Treasury market. It's the deepest, most liquid market in the world," said David Glocke of the Vanguard Group.

Equity markets around the globe experienced sharp downturns the Monday after the announcement. In addition to the downgrading of U.S. debt by an influential ratings agency, a number of other concerns have been negatively impacting equity markets, including a string of poor economic news at home and continued sovereign debt issues in Europe. A sharp increase in volatility in equity markets reflects this ongoing uncertainty. The sovereign debt strains in the U.S. and Europe, together with renewed worries over financial institutions and fears of another recession, are leading market participants to apply a higher discount to risky assets.

According to Jim Parker of Dimensional Fund Advisors, "…markets are unpredictable and do not always react the way the experts predict they will. The recent downgrade by Standard & Poor's of the U.S. government rating, following protracted and painful negotiations on extending its debt ceiling, actually led to a strengthening in Treasury bonds." This was observed as investors around the globe flocked to the safety of U.S. Treasuries the week after the S&P issued the downgrade of U.S. long term Treasuries.