US Treasuries Have Been Downgraded

Silver Lining May be Seen in the Long Term
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Consider this:

While near-term market volatility is to be expected, we do not expect the intermediate term effects to be material.

The ratings downgrade could spur a credible plan of action that results in an upgrade to US debt back to AAA.

Executive Summary

On 5 August 2011, Standard & Poor's Ratings Services (S&P) lowered its credit rating of the United States' long-term debt from AAA to AA+, with a "Negative" outlook. S&P reaffirmed its top (A-1+) rating on the government's short-term debt.

The bulk of US government agency debt has been downgraded to AA+ as well, with the remainder likely to follow in the near-term. On the whole, agency credits are backed by the US federal government.

While the downgrade is likely to cause near-term market volatility, we believe that the downgrade may have a silver lining over the longer term.

S&P based its downgrade on two key conclusions:
The spending cuts agreed to as part of the debt ceiling increase were insufficient to put the federal debt on the path to sustainability.
→ The partisan divide in Washington makes it less likely that a solution can be reached.
→ The first conclusion is not controversial. Almost no one has suggested otherwise.

The second conclusion may be debatable, but we think the S&P downgrade can only improve the chances that US Congress makes serious progress on cutting the deficit.

Quibbling about the details doesn't matter

Needless to say, the White House and US Treasury are unhappy about the downgrade and highlighted the fact that there was a disagreement about the size of projected future deficits (the headline of the article on the Treasury Website was "Just the Facts: S&P's $2 Trillion Mistake.")

We believe that this is a smokescreen, nothing more. The dispute was only whether future deficit projections should be based on the Congressional Budget Office's (CBO's) "Baseline" or "Alternative" Fiscal Scenario. As S&P pointed out; the difference is between debt of $14.5 or $14.7 trillion in 2015 and a Debt/GDP ratio of 85% or 93% in 2021 (up from 62% at the end of 2010).

The Treasury stated; "S&P's $2 trillion mistake led to a very misleading picture of debt sustainability." We disagree. Under even the more optimistic set of assumptions, the US are in big trouble if they don't change course.

S&P stated "Our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising US public debt burden in a manner consistent with a 'AAA' rating and with 'AAA' rated sovereign peers." It is hard to disagree with that assessment.

Why did they do it ...and why now?

On 18 April, S&P publicly called for $4 trillion in deficit reduction over the next decade. On 14 July, they put the US on the 'watch list' (indicating a substantial likelihood of it taking a rating action within the next 90 days), citing a lack of progress on deficit reduction. On 19 July, they said the chance of a downgrade within three months was 50% and that the downgrade might happen as soon as August. Congress did not deliver. S&P followed through.

Given the apparent unwillingness/inability of Congress to either raise taxes or meaningfully cut spending (S&P professes to be agnostic as to the appropriate mix of spending and revenue measures), S&P apparently judged that there was little to be gained by waiting until after the 2012 elections to revisit/cut the US debt rating.

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The downgrade may have put S&P on the White House's "enemies list," but the firm also has to deal with European governments (many of which it has downgraded recently). S&P made a point of contrasting the US with Europe, pointing out that the UK, France, Germany and other AAA-rated sovereigns are doing more than the US to address deficits in a credible way. The UK and Germany suffered recessions almost twice as severe as the US, but the UK has enacted a credible path to cut its deficit to below 5% of GDP by 2013, Germany enacted a constitutional amendment that requires balanced budgets over the economic cycle and had reduced its deficit to 3% of GDP last year, and France's deficit is projected to be down to 5% of GDP by 2013.

Why $4 trillion?

S&P answered that question by saying that the number came initially from the Bowles-Simpson fiscal commission and was embraced by President Obama in his 13 April speech and Paul Ryan, Chairman of the House of Representatives' Budget Committee, in his counter-budget proposal. They added that $4 trillion would not be large enough to stabilise the Debt/GDP ratio but it would signal the "seriousness" of policy makers. The apparent lack of "seriousness" about getting deficits under control implied by the debt ceiling negotiations was the primary trigger for their debt downgrade decision.

What about Moody's and Fitch?

Each of these firms reaffirmed the US's triple-A rating after the debt ceiling agreement was signed by the President. They had not been as transparent as S&P about their criteria (neither had articulated a deficit reduction target), so had less credibility at risk when they reaffirmed the US's triple-A rating.

S&P's move may, however, increase the pressure on the other rating agencies to downgrade the US. This morning, Moody's said: "For the Aaa rating to remain in place, we would look for further measures that would result in the ratio of federal government

Debt/GDP, for example, peaking not far above the projected 2012 level of near 75 percent by the middle of the decade and then declining over the longer term.

Last week's agreement suggests that coming to an agreement that would meet this criteria by early 2013 will be challenging, given the political polarisation, but not necessarily impossible." In essence, Moody's do not appear to be disagreeing with S&P, they are just moving more slowly.

What is the risk of default? Still essentially zero.

While it has not yet been tested in court, we believe the 14th Amendment to the US Constitution (which says, in part, "The validity of the public debt of the United States, authorized by law…shall not be questioned.") means that debt service must be prioritised above discretionary federal spending and even entitlement programs (In *Flemming v. Nestor*, the Supreme Court ruled that Social Security Benefits were not contractual obligations of the government and could be reduced or eliminated by Congress.)

Finally, US government debt is issued in US dollars, a fiat currency created by the US, so an actual default is 'easily' avoidable through the route of printing money (QE). The result might well be inflation, but that's not technically a formal default. This option is, of course, not open to Greece or other eurozone countries.

Will the downgrade matter to the markets? Probably Not that Much.

The timing of the downgrade is a news event and near-term market volatility is to be expected, but we do not expect the intermediate term effects to be material.While the downgrade itself was news, none of the reasons for the downgrade were news.

If the ratings downgrade serves as a "wake-up call" or a "call to action" and results in a credible plan to reduce deficits enough to at least stabilise (and better, reduce) the Debt/GDP ratio, then the US will be upgraded to AAA and our financial future will be more secure than if S&P had continued to rate the US AAA while the situation continued to deteriorate.

Further, rating agencies do not define reality. They only seek to describe it. Their views are, legally, nothing more than opinions and every investor knows those opinions are not always correct.

The reaction of foreign governments was relatively predictable. The Chinese, for example, again criticised the US deficits and called for them to keep the currency strong, while US allies reaffirmed their faith in them. We do not expect any foreign government to materially change its policies as a result of the downgrade.

Capital markets theory suggests that a lower credit rating drives up borrowing costs. It is not clear that this will be true for US government debt. After all, Treasury yields rates fell precipitously during the debt ceiling dispute when the word "default" was (however incorrectly) being widely used. If fear leads investors to sell ("de-risk" their portfolios), what will they buy? Is there something else investors would prefer to hold as collateral?

We do not expect the downgrade will force institutional investors (pension funds, banks, insurers, mutual funds, etc.) to materially reduce their use of Treasuries. Only S&P has downgraded the US – Moody's and Fitch have not – so very few portfolios will be forced to act. Finally, because S&P did not downgrade the short-term debt of the US, absolutely nothing changes for money-market funds.

The potential silver lining

S&P stated: "Our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising US public debt burden in a manner consistent with a 'AAA' rating and with 'AAA' rated sovereign peers."

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Appendix: A Classic Market Panic

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Consider this:

The 500-point drop in the Dow on 4 August was not an isolated event but the culmination (though not necessarily the end) of a sell-off which started two weeks ago.

Remember that market timing is difficult. It wasn't predictable that it would be a good move to sell on 22 July; many people wish they had, but were not able to call the top.

When investing for the long term (as opposed to market timing), focus on relative value. As investors know, "lower risk" investments like government bonds currently offer extremely low yields and limited opportunity for price appreciation.

A Classic Market Panic

The Dow Jones fell more than 500 points on 4 August 2011, its biggest one-day decline in almost three years. The last instance was on 1 December 2008, the day the National Bureau of Economic Research (NBER) announced that the US was officially in a recession, the Dow Jones fell 680 points.

What Was the Cause? We May be Seeing a Classic Market Panic

The news media has a tendency to confuse investors. The 4% one-day market decline was not a reasoned market reaction to a sudden rise in US recession risk, although the market action (and the media's mislabeling of the cause) does increase recession risk by panicking consumers into saving more and consuming less. Although some part of the market's decline over the past two weeks is probably attributable to rising recession risk.

Instead, Pioneer Investments believes that the root cause of the 5 August sell-off is the negative market reaction to the most recent Greek sovereign debt bailout package, compounded by investor reaction to the market decline itself.

We feel the market is vastly overreacting to the actual news flow, which is why we think it is a panic. Panic is contagious, investors are selling out of fear and ignorance and markets are, as they tend to do, overreacting.

Economic News Flow Review

There was not much bad economic news on 5 August or earlier that week. In fact, the news was, on balance, modestly upbeat. Last Wednesday's weekly unemployment claims number and ADP Employment change numbers were encouraging. Bank lending to businesses continued to rise. Small business conditions, in particular, seemed to be improving, according to the Thomson Reuters/PayNet Small Business Lending Index and the ADP payroll data. The ISM manufacturing and non-manufacturing indexes were soft, but each remained above 50 (above 50 signals expansion, below 50 signals contraction). Corporate profit announcements have continued to come in above consensus, although company guidance is becoming less upbeat.

There was disappointing news about past US GDP growth last Friday, with the preliminary estimate of second quarter growth (1.3% annual rate) that was below-expectations and sharp downward revisions to prior periods (a deeper recession and much lower first quarter growth than previously thought).

Also, the debt ceiling deal was made. Neither the far left nor the far right liked the deal, but it got enough votes from moderates and pragmatists to become law. Pioneer Investments believes this deal is not bad for the economy in the short run. Spending cuts in 2011-12 are negligible, and taxes did not go up. The outcome may not be popular, but it is hard to persuasively argue that the near term economic impact will be meaningfully negative.

Two weeks ago (21 July) a new Greek sovereign debt restructuring package was unveiled. As with the debt ceiling deal, it may not accomplish much in the long run, and at its core it may be a Brady-bond-like "extend and pretend" deal, but it did essentially eliminate the risk of a disorderly Greek default this year.

Inflation has remained benign, interest rates and oil prices have been coming down, there were no natural disasters and, while the headlines from Syria have been very distressing, there have been no major terrorist attacks or new wars.

In summation, the economic backdrop has been mixed. And while there are rising concerns about global economic growth, there has been nothing that, on its face, would seem to justify a 500-point fall in the Dow Jones.

Why was there a 500-point Down Day?

The decline did not come out of nowhere. The S&P 500 had rallied 7% between 24 June and 7 July, traded sideways from 7 July to 22 July, then gave back all of those gains and more as it fell each day over the next seven trading sessions.

It is important to put the market decline on 5 August into context. The decline did not come out of nowhere. The S&P 500 had rallied 7% between 24 June and 7 July, traded sideways from 7 July to 22 July , then gave back all of those gains and more as it fell each day over the next seven trading sessions.

In both the week before and after the 22 July market peak, domestic headlines were dominated by the debt ceiling debate, but it is hard to identify specific domestic news developments on, or after 22 July, which could explain the market reversal. Ten-year Treasury yields certainly showed no sign that investor fears of a default could explain the market correction: they were 3.1% at the end of May, 3.2% at the end of June, and 3.0% on 21 July. Their subsequent fall to 2.6% on 3 August and 2.4% on 4 August has all the hallmarks of a classic "flight to quality"— the exact opposite of what would be expected if a default was feared.

Was it because of the threat that US Treasuries might be downgraded by the rating agencies? We do not believe that to be the reason. Yields would be rising if that were the case. Further, a recent survey by the CFA Institute showed that most CFAs (Chartered Financial Analysts) discount the influence of the rating agencies.

While the debt ceiling debate was raging in US Congress, European leaders were focusing on the Greek debt situation as yields on Greek 10-year bonds approached 18% and yields on 10-year Irish and Portuguese government bonds approached 14%.

On 21 July (the day the S&P 500 peaked), European leaders announced a new "rescue package" which included additional funds for Greece, lower interest rates on European Financial Stability Facility (EFSF) loans to Greece, Portugal and Ireland and a "managed default" by Greece.

Under the terms of the deal, Spain and Italy (whose finances have also been under critical scrutiny) bore some of the pain from this "rescue", but enjoyed no direct benefits from the deal. The result was consistent with what should have been expected from a fiscal transfer: a tightening of spreads between, on the one hand, the bailed-out countries and, on the other, those assuming the liabilities. The spread between Greek and Spanish 10-year bonds, for example, fell from 11.5% on 19 July to 8.5% on 22 July. The magnitude seems larger than the fundamentals would justify (which is typical of a panic), but the direction is right.

The spread tightening came from both ends. Yields on Greek, Portuguese, and Irish government bonds peaked the week before the announcement (the fact that a deal was under discussion was not a secret), and fell sharply in the week after the announcement. Yields on Spanish and Italian government bonds, which had generally remained within a trading range in the first six months of the year, rose in July and August, especially in the aftermath of the 21 July announcement. The rise in Spanish and Italian yields has now become a dominant concern in Europe – the bailout appears to have created contagion.

Finally, it is worth noting that the MSCI Europe stock market index, whose daily moves tend to be highly correlated with those of the S&P 500 (but opens and closes earlier in the day) also peaked on 22 July. Its decline since then has been quite similar to that of the S&P 500 (slightly less on August 5, but slightly more from 22 July through 5 August). MSCI Japan and MSCI Emerging Markets have also declined over this period, but less than half as much as Europe and the US.

While there have, of course, been plenty of headlines emanating from Europe since 21 July, no news event has been of comparable importance, and there was no news event anywhere as significant as the "Greek rescue" announcement.

It therefore seems reasonable to conclude the following:

→ The 500-point drop in the Dow Jones on 4 August was not an isolated event but the culmination (though not necessarily the end) of a sell-off which started two weeks prior.

→ The trigger for the market correction was the "Greek rescue" announcement which worked through the "contagion mechanism" of an investor flight from Spanish and Italian government bonds.

The Flight to Safety – and the High Price of Safety

As previously mentioned, 10-year treasury yields have fallen, but it is even more extreme in the safest asset, which is cash. US money market funds have suffered massive redemptions[1], in part because investors knew/thought/feared that those funds had lent money to European banks and might "break the buck" in the aftermath of a Greek default. These investors would prefer cash in the bank to a money market fund.

The situation reached the point on 4 August where at least one large US custody bank started charging its clients to accept unusually large demand (overnight) deposits. The situation seems as though, they (a) have to pay deposit insurance to the government, (b) cannot earn a high enough yield in the overnight market to earn back the insurance fees and (c) cannot invest it for longer terms because the clients might want their money back the next day.

[1]In the week ending August 3, money market funds record their second largest weekly outflow ever, -$65 billion, (second only to Sept '08 outflow of -$144 billion). To put that into perspective, US equity mutual funds suffered net redemptions of $3 billion.

What Happens Next?

The market will probably find a bottom and boune as longer term, value-oriented investors buy from panicking sellers.

A market sell-off should not cause a recession and the global financial market probably will not collapse just because the rest of Europe lent Greece a little more money, permitted Greece to extend the average maturity of its debt, and lowered the interest rate on some of that debt. The stockmarket will probably find a bottom and bounce as longer term, value-oriented investors buy from panicking sellers. It would be nice to be able to call the bottom, but who is that good of a market timer?

US Monthly Job Numbers – 5 August Update

5 August 2011 monthly jobs numbers came in better than expected:
- July payrolls rose 117,000, above the consensus forecast of 85,000.
- Private payrolls rose 154,000 in July, also above consensus, 113,000 forecast and prior month private payrolls were revised up by 49,000, so the effective net number was 203,000.
- Public sector payrolls shrank, but the numbers were exaggerated by some one-time factors like a $20,000 drop in Minnesota which will be reversed next month.
- Average hourly earnings rose 0.4%.

What Should Investors Do Now? Nothing Different Than What They Should Always Do.

1) Remember that market timing is difficult. It was not predictable that it would be a good move to sell on 22 July; many people wish they had, but were not able to call the top. If investors sell now, they may or may not be selling at the bottom. If it is not the bottom yet, the sale will look good for a while, but it will not really be a successful trade, unless they get back into the market at a lower price than the price at which they sold.

2) When investing for the long term (as opposed to market timing), focus on relative value. As investors know, "lower-risk" investments like government bonds currently offer extremely low yields and limited opportunity for price appreciation. Many corporate and municipal bonds offer significantly higher yield, especially when compared to the incremental risk of default. Many equities offer far higher earnings yields (E/P) and high dividends, backed by strong balance sheets.

3) It is important that investors have a strategy and stick to their strategy. If investors sell simply because the market has fallen since 22 July, investors should not have been in the market on 21 July.

Important Information