

## Thought for the Week: Monday, April 18<sup>th</sup>, 2011

### Should You be Worried by the Downgrade in U.S. Credit Outlook?

It happened - it actually happened...the world's most powerful economy received a slap on the wrists and a verbal warning.

This week, Standard & Poor's, S&P to most investors, **cut its long-term credit outlook for U.S. Government debt to Negative from Stable** as a result of mounting concerns over the long-term financial health of our country.

With this change in credit outlook, S&P gave notice **that if the current trend of government deficit spending continues, the U.S. may lose its AAA rating**. S&P also made it clear that the **current political gridlock was a key determinant** in the outlook downgrade.

This is not a downgrade of the rating itself; **our debt is still rated at AAA**. It is a stark warning for those who thought the credit of the U.S. government could never be downgraded. It will hopefully serve as a **catalyst for compromise and joint action from both sides of the Washington divide** in their on-going arguments over the country's debt ceiling and budget deficit.

**If our actual credit rating is downgraded**, investors will require a larger yield from Treasuries to compensate for the greater implied risk. This will increase the interest rates payable on Treasuries, which are a benchmark for other consumer and business borrowing interest rates. **The cost of borrowing would therefore rise.**

In addition, the deficit will tend to grow larger as the government will have to pay more to its borrowers and a very difficult period for U.S. politics and economics will begin.

#### What is the difference between the Long-term Credit Outlook and Credit Rating?

Think of the long-term credit outlook as a smaller step in the middle of a downgrade from say AAA to AA in the headline credit rating. It's the smallest change in the S&P rating system and relates to the economic outlook six to twenty-four months from now.

Should this condition persist, the next step may be placing U.S. debt on "Credit Watch"; a stronger downgrade indicating concerns over short-term economic conditions.

#### What Next?

First and foremost, **America has just about reached its credit limit** and Washington is dragging its feet over applying for an increased credit facility. Should no agreement be reached, we may have to default on

#### China Spends...

Lamborghini will probably sell more supercars in China than in the U.S. for the first time this year.

The new Aventador LP 700-4, priced at \$364,000, has sold out with China accounting for a fifth of all buyers so far.

"I believe that China will become our most important market this year," Lamborghini CEO Stephan Winkelmann said.



our debt payments during July of this year. We feel this is highly unlikely and **the debt ceiling will be raised after both sides of the house finish rattling their sabers.**

Secondly, our deficit is exceptionally high compared to most financially “healthy” countries. The 2010 budget deficit is 10.6% of GDP compared to 3.3% for Germany. **Congress must take action fairly quickly to reduce the annual deficit “bleeding”** if we are to avoid being put on Credit Watch. Again, it is difficult to see our government system failing to come to agreement on these issues given the consequences.

But this does appear to be another nail in the coffin of “easy money”.

Most retail markets are currently agreeing with the assumption that everything will end well and **the Government will reduce the deficit before it’s too late.** Despite a knee-jerk fall on the day of announcement, Wall Street equity markets recovered the day after.

Treasury prices should have fallen sharply; however, they too had a small drop then recovered on hopes that the S&P warning will hasten a deficit deal.

**A more telling indicator of market sentiment was Credit Default Swaps (CDSs)** which are derivative securities bought to cover the probability of Treasury default – essentially the financial instrument used to insure U.S. debt holders if they fail to receive their interest or principal payments.

CDSs on U.S. bonds jumped about 15% on the news, a sign that the stakes have been raised in the political infighting over deficit reduction.

### **Bottom Line**

The **Government & Municipal Fixed Income asset classes are risky places to be invested** at the moment. Investors with a significant exposure to these areas, particularly within bond funds, may want to review their risk/reward potential. Although the risk of default is still negligible, **the risk of losing value equivalent to a few years income is high.**

**Diversification away from these areas should be considered;** we continue to feel those issuers of debt with strong balance sheets and cash flows remain relatively low risk areas of income generation.

With the general economy continuing its recovery and another satisfactory earnings season already underway, **it might not be a bad time for the Government to reduce the stimulus dosage.**

**If Ben Bernanke can make good** on his promise of keeping interest rates low without further Quantitative Easing measures, **economic growth may not be hit as hard as many will think.**