August 8, 2011

S&P Downgrades United States Long-Term Debt Rating

In a historic move this past Friday, Standard and Poor's (S&P) downgraded the United States' long-term rating from AAA to AA+. This is the first downgrade since the three major rating agencies (S&P, Moody's, and Fitch) started rating the United States. Further, S&P left the credit on negative outlook.

What happened and why?

First, the fiscal plan Congress passed last week is projected to reduce U.S. spending by approximately $2.1 to $2.4 trillion over the next ten years. However, prior to the passage of the deficit reduction plan, S&P stated the United States would need to reduce its deficit by approximately $4 trillion over the next decade to maintain its prestigious AAA rating. With the current budget agreement, S&P projects that U.S. government debt, currently at 69%, will rise to 85% of GDP by 2021.

Second, S&P stated that the prolonged debate over the debt ceiling by members of Congress reflects a substantive gap between the two U.S. political parties. The ratings agency noted that with such political disagreement, it will be difficult for the U.S. to achieve the increased revenues and entitlement reforms previously assumed in its prior rating.

Is this move a big surprise?

No. On July 14, 2011, S&P announced they had placed the United States on CreditWatch Negative. This signaled that a potential downgrade would be likely over the next few months. S&P's projected debt-to-GDP levels over the next decade reflected a need for a $4 trillion reduction in expenditures to maintain the AAA rating. Once the $2.1 to $2.4 trillion expenditure reduction plan was passed, the downgrade became more imminent.

What are the implications for the taxable fixed income market?

Recently, market discussion centered on the risk of "forced and sizeable selling" of U.S. Treasuries by foreign central banks, mutual funds, insurance companies and U.S. banking institutions. We anticipate the following results:

- Foreign central banks will likely continue to maintain a large share of their foreign exchange reserves in U.S. Treasuries as it is the deepest and most liquid fixed income market.

- Many mutual fund and insurance company investment mandates provide flexibility in handling this event. This flexibility is provided within the investment guidelines stating that "a security must be rated triple-A by at least one Nationally Recognized Statistical Rating Organization (NRSRO)." Both Moody's and Fitch have affirmed their triple-A rating, however both left the U.S. on Negative Watch subsequent to the Congressional agreement on August 2, 2011. In addition, many investment policies treat most U.S. government debt as a separate security class altogether, independent of a credit rating.

- The Federal Reserve, on Friday evening, was quick to issue a statement that U.S. banks do not need to change the risk weighting of their holdings of U.S. government-backed debt.

We do not expect there will be significant forced selling of U.S. government securities over the near term. We anticipate minimal volatility on corporate debt due to our expectation that corporate spreads will continue to reflect the overall economic outlook.

To be clear, a U.S. downgrade from AAA to AA+ does not imply a meaningfully higher risk of default. As a rule of thumb, the expected default rate is gauged at 0.0% when an entity is rated AAA. The expected default rate is approximately 0.1% at AA+.

What are the implications for the tax-exempt market?

The downgrade of the U.S. government could lead to small rating revisions on a number of tax-exempt issuers. Specifically, this will affect state and local governments whose rating is correlated to a significant reliance on Federal funding. In 2010, more than $470 billion was transferred to states and municipalities for areas such as education, unemployment and Medicaid. Any significant reduction in federal funding will place additional stress on state and local governments. Relative to Treasuries, ratios on tax-exempt bonds should remain consistent to recent levels.

How are Glenmede's fixed income portfolios positioned to protect principal value?

We are insulated from market volatility in our municipal portfolios due to our concentration in high-credit, quality callable "kicker" bonds, as well as pre-refunded bonds. Fixed income portfolios are balanced with the proper mix of short defensive bonds and longer duration securities. These strategies should protect principal in a volatile interest rate environment.

In our taxable bond portfolios, we are significantly underweight the U.S. Treasury sector. The combination of a potential credit downgrade and low absolute yields on U.S Treasuries caused us to invest in more attractive alternatives. We continue to overweight high-credit quality corporate issuers. In our mortgage allocation, we have maintained our defensive, high coupon positioning.

Our process is constant. We will continue to focus on high-credit, quality themes in all of our fixed income portfolios. In this unprecedented environment, we will be vigilant over market risks as they arise.

Are there other concerns?

There is some concern that the already fragile European markets may experience dislocation from this downgrade. We will continue to monitor this as we move through the day on Monday, keeping our clients informed along the way.

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