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## S&P DOWNGRADE OF U.S. CREDIT RATING CHANGES NOTHING

On Friday evening, Standard & Poor's downgraded the U.S. federal government credit rating from AAA to AA+ and kept the U.S. debt on a negative outlook, implying that a further downgrade is possible. The decision should not have been a surprise, as S&P had been clear during the debt ceiling debate that they would downgrade the U.S. government if a credible medium-term plan was not tabled. While the debt ceiling was ultimately lifted, the final outcome fell short of the grand deal that the rating agency was calling for. Moreover, the intensity of the political fighting left S&P with reduced confidence in the ability of the U.S. government to deal with its future fiscal challenges. So, on Friday, S&P lived up their promise and downgraded U.S. government debt.

While S&P had warned markets, the timing of the decision could not have been worse. Last week's equity market correction seemed to reflect a crisis in confidence, both in the outlook for the U.S. economy and the ability of Europe to deal with its own fiscal crisis. In regards to the latter, contagion concerns to a wider number of nations placed substantial upward pressure on Spanish and Italian bond yields.

Markets had the weekend to digest the decision by S&P and to think through the implications. The rational perspective is that while the S&P decision is unprecedented for America, the downgrade changes absolutely nothing. It is simply a confirmation of market concerns about the fiscal situation. Much of the sell-off last week was pricing in a weaker U.S. economy and continued fiscal challenges. However, the most important point is that even with a lower credit rating, the U.S. government is still solvent. Investors in U.S. Treasuries will still get paid the interest they are owed and they will get the principal back upon maturity of the bonds. We argued in a research note on the U.S. debt situation put out on [July 28th](#) that the downgrade by S&P should not have major financial implications unless the other credit rating agencies follow suit.

On August 2nd, Moody's reaffirmed its rating of U.S. government debt. It did warn that there were four factors that could result in a downgrade in the future: (1) if there is a weakening in fiscal discipline in the coming year; (2) further fiscal consolidation measures are not adopted in 2013; (3) the economic outlook deteriorates significantly; or (4) there is an appreciable rise in the US government's funding costs over and above what is currently expected. So, these are key

trends to watch for in assessing the risks of a broad-based credit downgrade that would be more impactful.

One segment of the U.S. financial system that may be impacted by the federal credit rating downgrade is debt of Government Sponsored Enterprises (GSEs). A lower rating for the federal government will likely flow through to that of GSEs, raising the cost for them to borrow. A few municipal credit ratings may also be affected. But, the major near-term impact of the downgrade is on confidence of investors, businesses and consumers.

The good news is that markets do not seem to have panicked. The knee-jerk reaction is that global equities have generally experienced a 2-3 percentage point correction. That is significant but not a free-fall. While the credit rating downgrade does ultimately warrant a weaker U.S. dollar and slightly higher yields on long-term U.S. Treasuries, the current sell-off in equities has led to a shift towards the safety of fixed income assets, pushing U.S. bond yields lower for the time being. The interpretation is clear. Markets know the U.S. government will make its payments, but the credit rating downgrade and the continuing fiscal contagion pressures in Europe reinforce market fears of a renewed period of financial turmoil and the possibility of economic contraction. These concerns have not been fully alleviated by G7 statements on Sunday about the readiness to act, but pressure on European bond yields was, at least temporarily, alleviated by renewed buying by the ECB. See our [Observation](#) put out this morning on European developments.

As argued in the research note entitled "[Hoping Rationality and Leadership Win Out Over Politics](#)", we are not really out of the financial crisis that started in 2008. We are in the political crisis stage of this balance sheet recession. Europe is gradually grinding towards a fiscal union, but the process is slow and painful. There are risks that the financial pressures will continue to build until the European Financial Stability Facility is expanded enormously, and Eurobonds are likely part of the final resolution. This will take considerable time and if political leadership is not achieved and progress is not made, there is a risk of debt defaults that would materially impact the European banking system and the global financial system.

In the United States, all political actions must be seen through the lens of this being part of the 2012 presidential election. The next concern is whether the Joint Select

Committee (JSC) can agree on the requisite 10-year plan of \$1.5 trillion in fiscal consolidation by the December 23rd deadline. If not, which is a distinct possibility, the deficit ceiling agreement triggers \$1.2 trillion of spending cuts in 2013. This would be a very negative outcome. S&P has suggested that failure of the JSC could warrant a further credit rating downgrade in late 2012. The triggered government spending cuts would likely stall the U.S. economy and runs the risk of creating a renewed contraction. Even if the JSC does find the required fiscal measures, further progress on U.S. fiscal balances are unlikely until after the November 2012 presidential election. One can expect the election to be focused on jobs and proposals to address the fiscal deficit, and then new actions aimed at fiscal rebalancing will come in 2013.

The bottom line is that the S&P downgrade does not fundamentally change the economic and financial environment. Quite the reverse, the decision is simply a reflection of the prevailing environment. There is enormous political risk to the economy and financial markets. This risk is likely to persist over the coming year, and it is likely to create periodic bouts of financial market volatility. Regrettably, it comes at a time when the U.S. economy is fragile. The fiscal problems and political risk could weigh on consumer and business confidence. To the extent it does, there are downside risks to the economic outlook. Our base case remains for modest economic growth in the second half of this year and in 2012, but we acknowledge that there is at least a 1-in-3 chance of a renewed U.S. downturn.

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