Fears of a Downgrade

As an client, you probably noticed today, that the Standard & Poors bond rating division has threatened to downgrade the credit rating of U.S. Treasury bonds. This announcement was typically covered in breathless fashion by the media. The U.S. markets dropped 1% almost immediately after the news broke, and the S&P 500 index of large cap stocks finished the day down 1.1%.

What was not always emphasized in the news coverage is that this is far from an actual downgrade. The announcement actually said that Treasury securities would be given a AA rating (the credit rating of Japan) rather than the current AAA (the highest credit rating, which is also enjoyed by France and Germany) if the federal budget deficit is not addressed within two years. (Coincidentally, Moody's had something to say about this as well and came out saying that it felt that the US would get the deficit managed so it was not putting our Debt on a credit watch, precisely the opposite of S&P.)

Coming from the same organization which, in 2008 and before, gave AAA ratings to subprime mortgage debt instruments, this credit evaluation by S&P might be dismissed--except that other parties seem to be equally worried. In February, PIMCO--the world's largest bond fund investor--announced that it had sold all U.S. Treasury securities in its $236 billion Total Return Fund. The company is worried that rising inflation and interest rates will cause bond values to drop. But it also noted that sustained deficits in the U.S.--like the much greater debts in Greece, Ireland, Iceland and other debtor nations--would cause global investors to demand higher interest rates on government debt. Higher rates on new issues would cause the value of existing bonds to fall.

But why are stocks falling when the conversation seems to be all about bonds? Investors may be worried that any rise in interest rates would raise the borrowing costs across Corporate America as the U.S. economy is still rebuilding from the Great Recession. But there may also be some concern that stocks haven't fully factored in the flock of black swans that are swimming around various corners of the global economy. An article in the April 17 issue of the Wall Street Journal lays out the case: Japan, the world's third-largest economy, has gotten clocked by an earthquake, tsunami and nuclear disaster--plus continuing aftershocks and more nuclear problems. North Africa and the Middle East--where much of the world's oil comes from--are seething with unrest and uncertainty. Portugal has joined Greece and Ireland in requiring a Eurozone bailout for its sovereign debt. Closer to home, the article tells us, many economists have dropped their first-quarter estimates of U.S. economic (GDP) growth to below 2%. Six months ago, the more bullish estimates were coming in around 4%.

Looking at all this uncertainty, one might think that getting out of stocks altogether is the wisest, safest thing to do until things settle back down again. The problem, of course, is finding a good place redeploy the money. Should you buy the Treasury bonds that PIMCO is unloading? Global stocks? The global economic uncertainty has actually caused inflows into the U.S. market, which seems to be an island of relative calm, and has always benefited from investor fear and a flight to quality. Plus, as the Wall Street Journal article points out, the jobs picture in the U.S. is starting to improve. About 230,000 private sector jobs were added in March, and U.S. retail sales rose for the ninth straight month.

Any hint that the U.S. government will lose its best-in-the-world credit rating is likely to be sensationalized, even if the event won't take place for another two years, even if it is conditional on no action being taken between now and then. If the government's cost of borrowing does go up from the current 3.40% on 10-year Treasuries, it would unhelpfully raise the cost of financing our nation's debts. But the news media never seems to provide a full perspective on these banner headlines. Japan's sovereign debt is, proportionately, higher than America's, and Japan received the dreaded credit downgrade to AA status earlier this year. That caused Japan's borrowing costs, on its 10-year securities, to go up incrementally--to, currently, 1.29%.

Japanese 10-year yields: http://www.tradingeconomics.com/Economics/Government-Bond-Yield.aspx?Symbol=JPY

U.S. government 10-year yields: http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

Announcement of S&P's downgrade warning: http://news.yahoo.com/s/nm/us_ratings_usa_sp

Wall Street Journal article: http://online.wsj.com/article/SB10001424052748704487904576267490353062226.html?mod=WSJ_topics_obama#articleTabs_tab_quotes