

Well thank goodness we had the weekend to get ready for Monday's market opening. We had several days to examine and think about the downgrading of US debt by S&P from AAA to AA+ a single step down. Although it has never happened in our history, many had expected something like this to happen. At the beginning of the week, Moody's and Fitch, a non-American rating agency, kept the US at its AAA status. That S&P chose to do its down rating after the close of the market before a weekend only illustrates and acknowledges that such action would in fact roil the markets. On Sunday here in America (which because of the international dateline) is Monday in Asia, the market did react. Most Asian markets dropped between 2% and 3.5% on the news. As I write this the Dow is down more than 5.5% and the S&P is down 6.9% even after President Obama spoke in an attempt to calm the markets. Over the weekend most of the major national creditors spoke about not selling their holdings of US Treasuries and about the need for the US to get its house in order. China was most vocal in expressing the need for the US to do so. One could not find anyone willing to sell Treasuries and buy something else. In the world's view there is no "something else" to buy at least in the near to intermediate term. So, in a strange twist of fate, in the face of the downgrade, people and nations bought US Treasuries in a flight to safety. Go figure!

Looking at this sequence of events, there are several observations that should be made:

1. The credibility of all of the rating agencies is suspect. After handing out AAA ratings to subprime mortgage investments in the run up to the financial crisis in 2008 and Enron several years before that, many market participants feel inclined to "downgrade" the credit agencies themselves. In fact, there has been a push back against S&P over the weekend and continuing today from all quarters.
2. Only S&P exercised its inclination to downgrade US debt. Moody's and Fitch did not; although, they did warn that they may do so if the US does not address fiscal matters effectively over the next several months (read that they will be looking at the congressional super committee's recommendations and the implementation of those recommendations in a timely manner.)
3. Some minor clerk at the Treasury immediately noted that S&P made a \$2 Trillion error in calculating the amount of US debt. \$2Trillion! As the Treasury said, after finding this error and bringing it to S&P's attention (which did not acknowledge this error), The error speaks for itself in casting doubt on the conclusion of the rating agency.
4. As has been noted all weekend, the US is not in any danger of not being "able" to pay its bills either now or at any time in the future.
5. S&P noted as a major factor in its conclusion to down rate US debt that Washington demonstrated a remarkable willingness to cause a self-inflicted wound through our political process that would have resulted in a US default for the first time in history. S&P feels that our government is dysfunctional and unable to address the serious issue of reducing our ongoing annual deficits and reigning in the growth of our national debt. S&P went further and indicated that it is precisely the lack of political will and the depth of the partisan divide which led S&P to indicate that it may further downgrade our debt over the next two years as Congress and the President battle over entitlements, defense spending and revenue increases to address the problem.
6. In fact, it has been noted by many economists and commentators that the downgrade was more about the lack of political will and dysfunction than about US economics.
7. That most of the world has fled to the safety of US Treasuries even though the proximate cause of the last two day's turmoil has been these same instruments, also illustrates the there is no market deeper, with more transparency or liquidity than the US. And so for at least a while there is no other place to invest for safety other than the US. Even the Swiss Franc which has exploded in valuation cannot be the world's reserve currency nor can gold.
8. On May 13th I sent you an email about the place of the US Dollar in world affairs. Please go to my website and reread this message because it will help you to understand some of the reasons people are fleeing to Treasuries.
9. Although technically many investment instruments and banks are required to have risk free investments as the mainstay of their holdings, it is not expected that there will be any move to dump treasuries to meet these requirements.
10. Finally, there are some knock on effects we should expect. Already, today S&P downgraded Fannie Mae and Freddie Mac which are dependent on US debt for their ratings. We should expect a few more of these actions from S&P. We should also expect some added pressure on the remaining AAA rated countries to also experience a down grade from S&P.

I don't know where this will all end up but please know that each of you has a portfolio which is much more defensive than it was in 2008 and that each of you is experiencing much less of this market downturn than the market itself. Call if you wish to further discuss this with me.