

Standard and Poor's Downgrades U.S. Treasury Debt: What Does it all Mean?

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On Friday, August 5, Standard and Poor's took the unprecedented action of downgrading U.S. Treasury long-term debt one notch from 'AAA' to 'AA+'. It is important to highlight that S&P also placed a negative outlook on the long-term rating, meaning S&P could again lower the rating.

Who are the various rating agencies and what do they do?

Standard and Poor's (S&P), Moody's, and Fitch are the three main rating agencies and are not affiliated with the U.S. government. Their goal is to provide investors with an objective analysis and independent assessment of the credit-worthiness of various countries, municipalities, and companies. Countries are assigned sovereign ratings and take into account various measures including overall economic and political conditions. Note that currently only S&P lowered the U.S. rating, while Moody's and Fitch had retained the 'AAA' rating after the recent debt ceiling compromise.

What does a 'AA+' rating mean and how is it different vs. 'AAA'?

Per S&P, a 'AAA' rating generally signifies an 'extremely strong capacity to meet financial commitments' and is the highest rating available. A 'AA' rating is one notch below and generally signifies a 'very strong capacity to meet financial commitments'. Ratings can also be modified with a '+' or a '-' to show relative standing within the major rating categories.

Why did S&P lower the rating?

S&P's research update¹ announcing the downgrade provided their reasons, both economic and political, for the downgrade. On the economic front, "the downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics." On the political front, "the political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed." In addition, "our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising U.S. public debt burden in a manner consistent with a 'AAA' rating and with 'AAA' sovereign peers."

¹ Standard and Poor's, Research Update: United States of America Long-Term Rating Lowered to 'AA+' on Political Risks and Rising Debt Burden; Outlook Negative, August 5, 2011

Wasn't the debt ceiling increase agreement supposed to prevent this type of action?

Congress and the administration believed (and hoped) the recent compromise would be enough to keep the 'AAA' rating, though it clearly was not in S&P's opinion. Again, it is important to note how S&P's opinion highlights both the economic and political reasons for the downgrade. This downgrade should serve as a strong wakeup call to politicians on both sides of the aisle that serious discussions need to be had to tackle issues such as tax and entitlement reform; otherwise, as S&P has noted, further downgrades are possible.

Does a downgrade mean that the U.S. is going to default on its long-term debt anytime soon?

Most likely, the answer is "no". As stated earlier, a 'AA+' rating still indicates the U.S. currently has the ability to meet its long-term obligations. The downgrade, in essence, highlights how the U.S. needs to get its financial and political house in order so all future obligations can be met.

How are other countries classified in the investment grade universe?

The chart below provides an indication of how some other countries are classified in the S&P investment grade ratings spectrum.

AAA	AA+	AA	AA-	A+	A	BBB+	BB	BBB-
Canada	Belgium	Chile	China	Italy	Mexico	Ireland	Bulgaria	Croatia
U.K.	U.S.	Spain	Japan	Korea	Poland	Russia	Bahrain	India
Germany	New Zealand	Abu Dhabi	Israel	Slovak Republic	South Africa	Brazil	Morocco	Barbados
France		Kuwait	Saudi Arabia	Czech Republic	Estonia	Peru	Lithuania	Iceland

Source: Standard and Poor's, JP Morgan Asset Management, data as of 8/7/11

Can the United States of America regain its 'AAA' status?

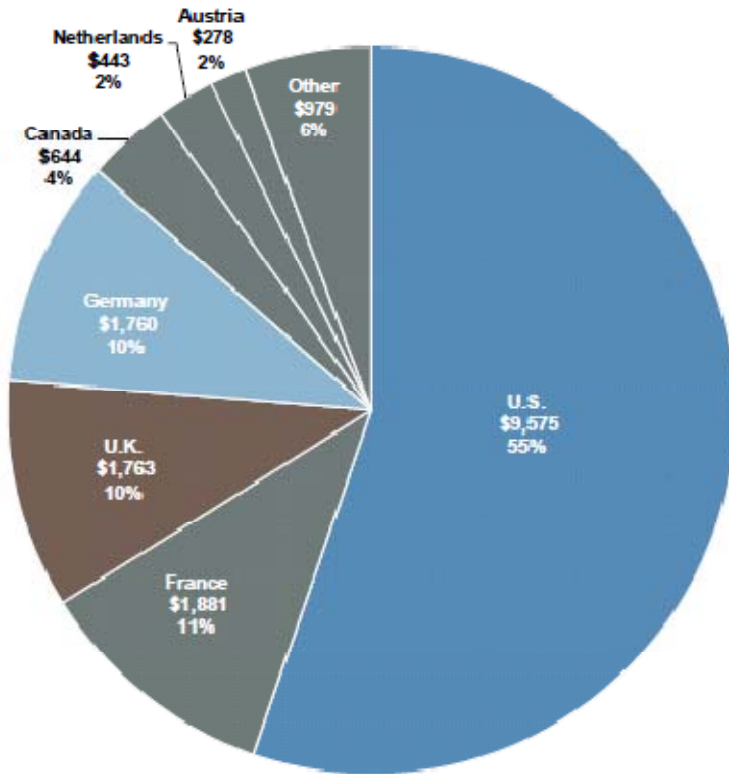
The answer is yes. While there is no set timetable, S&P clearly would need to see the economic and political landscape improve from where it is today. Before the 'AAA' status is regained however, one might expect that the negative outlook S&P placed on the debt would be removed first. To provide some history to past upgrades, S&P officials stated that the earliest a sovereign has returned to 'AAA' status was nine years.

What is the effect the downgrade will have on the markets?

Clearly this event will add additional turmoil and uncertainty into the markets. Confidence in U.S. markets may be eroded, at least in the short term. As a downgrade of U.S. debt has never happened before, no one is exactly sure what will happen. That being said, it is likely that emotion (i.e. nervousness and fear) and reactionary moves will drive the equity markets down further, even though a possible downgrade was at least partially priced in already.

It is also unclear exactly what will happen within the bond markets, though various economists are not expecting major changes. For one, the U.S. Treasury market is still the largest, most liquid bond market

in the world and it is not expected that investors will abruptly leave the market in large quantity. Second, there are not many good alternatives to US. debt (i.e. continued concerns remain in the Eurozone).



The chart to the left shows how, prior to the downgrade, the U.S. accounted for over half of the available amount of 'AAA' debt.

Also, as expected, S&P downgraded the debt of Fannie Mae and Freddie Mac from 'AAA' to 'AA+' as they are reliant on the U.S. government stemming from their being placed under conservatorship in September 2008. We would expect to see a large amount of municipal bonds also downgraded, simply because their credit is scaled to that of the U.S. Treasury.

Source: Standard and Poor's, Bloomberg, J.P. Morgan Asset Management. In the chart, Other includes Australia, Denmark, Sweden, Switzerland, Finland, Hong, Kong, Norway, and New Zealand. Data as of 8/4/11.

What changes, if any, are recommended to be made to your portfolio allocation?

We continue to believe that discipline in investing is important as is being focused on what matters: your goals and objectives, investing in a globally diversified portfolio, and controlling costs (both tax and investment costs). Assuming your current asset allocation is aligned with your individual goals and personal risk tolerance levels, we believe times of market volatility are perfect times to look for rebalancing opportunities and would not suggest making tactical or emotional moves.

As always, please contact your Wealth Management Advisor with any questions or comments.

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