Compromise or Polarize

"Standard & Poor's ratings express the agency's opinion about the ability and willingness of an issuer, such as a corporation or state or city government, to meet its financial obligations in full and on time."

Standardandpoors.com

After the market's close on Friday, August 5, 2011, Standard and Poor's announced its decision to downgrade its rating on long-term U.S. debt from AAA to AA+, marking the first credit downgrade in U.S. history. This downgrade includes all outstanding U.S. debt with maturities greater than one-year accounting for approximately 72% of the $9.4 trillion in publicly traded U.S. government debt. At this time, the two other primary rating agencies, Fitch and Moody's, have not decreased their ratings on U.S. government debt, yet both firms have published concerns surrounding U.S. debt levels and unsustainable fiscal deficits.

On April 18th, Standard and Poor's warned of the possible downgrade stating "Because the U.S. has, relative to its 'AAA' peers, what we consider to be very large budget deficits and rising government indebtedness and the path to addressing these is not clear to us, we have revised our outlook on the long-term rating to negative from stable." The agency went on to say, "We believe there is a material risk that U.S. policymakers might not reach an agreement on how to address medium and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation is not begun by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer 'AAA' sovereigns."

While most investors focused on the debt ceiling, Standard and Poor's was equally interested in future deficit reductions. As the debt ceiling was raised and the agreed deficit reductions were announced, the proposed reductions were significantly below the $4 - $4.5 trillion level Standard and Poor's viewed, "as the starting point of a process aimed at broader engagement, which could result in substantial and lasting U.S. government fiscal consolidation." At this point, a downgrade was more a question of when, not if.

In most cases, a credit downgrade would be accompanied by an increase in borrowing costs as investors demand higher returns to compensate for higher risk. However, investors' actions over the most recent stock market sell-off do not reflect a heightened concern for Treasury securities, as investors have flocked to the perceived safe haven, sending longer-term Treasury yields down sharply as illustrated:

SHORT-TERM IMPACT OF STANDARD AND POOR'S DECISION

Interest Rates – Interest rates may creep higher and there could be some knee jerk selling causing yields to be more volatile, however, I do not anticipate an immediate broad-base re-pricing of Treasury risk in response to this decision. In fact, if equity investors remain skittish (discussed below), I could envision a scenario where yields actually decline further as risk aversion climbs.

Equity Markets – A more immediate impact will most likely be another hit to an already fragile investor psyche. Following the debt ceiling fiasco and another round of European debt woes, investors exited global stock markets in droves within the past few weeks resulting in double digit declines in most major markets. The decision Friday by Standard and Poor's will most likely result in additional selling pressure and continued heightened volatility, but could provide some very attractive entry points for patient, strong-stomached, long-term investors.

Credit Instruments – Over the next week or two, I anticipate several more downgrade announcements on debt issued by quasi-government entities and entities that hold substantial amounts of government debt (independently or as collateral). We feel liquidity in these instruments may experience some very short-term dislocations as investors digest the changing environment resulting in additional volatility.

Finger Pointing – The final short-term impact will be a seemingly endless amount of finger pointing. People will point at Standard and Poor's and their poor record rating subprime mortgage pools, a major contributor to the 2008 financial meltdown. Republicans will point to Democrats as the cause with their lack of entitlement spending cuts. Democrats will point to Republicans as the cause due to their unwillingness to increase taxes. Standard and Poor's will point to the reaction by Democrats and Republicans as further justification of the credit downgrade.

LONG-TERM IMPACT OF STANDARD AND POOR'S DECISION

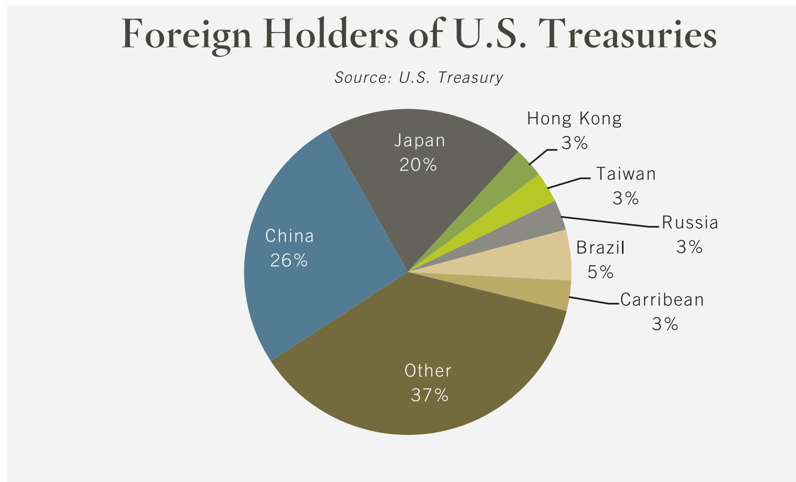
I don't believe the downgrade by Standard and Poor's was truly a reflection of an increased risk in the ability or willingness of the U.S. to pay its debt obligation. As Alan Greenspan stated in response to the downgrade, "This is not an issue of credit rating. The United States can pay any debt it has because we can always print money to do that." He further stated there was, "zero probability of default." I believe the announcement by Standard and Poor's reflected a downgrade on government, which many people would agree with, and the potential longer-term implications on the U.S. dollar.

Steven Leuthold noted several months ago that the U.S. needed a crisis to get politicians to put the interests of everyone ahead of their own interests and hoped it would happen before it was too late. We have a long-term government debt problem that will require very difficult short-term decisions to have any chance for success. These decisions will most likely be unpopular to some, which could be a major obstacle to the career politician.

I am hopeful the decision by Standard and Poor's will be the catalyst/crisis encouraging politicians to go back to the drawing board and craft a reasonable, long-term plan for fiscal responsibility. I am also a realist and understand the odds are equally high (if not higher) that this will polarize each side and gridlock will continue kicking the can further down the road. It will put greater strain on the U.S. dollar and force the voters to make the difficult decisions politicians are incapable of making.

From an investment standpoint, Welch Hornsby's long-term view has not changed at all based on recent events. We continue to stress the following:

Short-Duration/Flexible Fixed Income – Despite anticipating interest rates will not be impacted in the near-term by the recent credit downgrade, we do not feel the 2.5% yield on the 10-year Treasury compensates us for the risk we could be wrong. Over longer periods, we do anticipate yields will climb, especially if the U.S. is unable to adopt a long-term plan. Another factor that could influence yields is demand for Treasuries from foreign holders should the U.S. dollar depreciate in value. We feel this is likely over time. According to the U.S. Treasury's most recent release (data as of 6/30/10), approximately 53% of publicly traded U.S. government debt is held by foreigners. The breakdown of the foreign holders of U.S. Treasuries is:



Despite warnings from China (holds $1.15 trillion) and reassurances from Japan (holds $900 billion), we feel both countries will continue to finance the U.S. economy for the foreseeable future as their economic growth is largely driven by exporting goods/services to the U.S. However, should the dollar experience significant declines and/or the Chinese/Japanese economy becomes less dependent on the U.S. for growth, their demand for Treasuries may decline, putting upward pressure on yields.

Concentrated Stock Pickers – The credit downgrade does not reduce the quality of most corporate balance sheets. We have been very vocal about the attractiveness of high quality companies that have superior capital allocators within management. We feel these companies can add significant value for shareholders, especially those firms that have taken advantage of historically low interest rates and have locked in cheap long-term debt capital. Some very high quality companies may actually benefit from the downgrade when competing for investor capital. Finally, the potential short-term market anxiety may provide some very attractive entry points for the long-term investor who can withstand increased levels of price fluctuations.

Global Flexibility – As we have stated many times, we feel the competing balance sheets of global companies (strong) and global governments (poor) are going to continue to create a financial tug-of-war with investors in the middle. We feel this type of environment will be challenging for many, but there will be pockets of opportunities requiring investors to be flexible in the following ways:

- Blurring the lines of the traditional style box investment framework (relative value)
- Allowing managers to search globally for investment ideas (relative value)
- Broadening out the opportunity set to include both the debt and equity of a company's balance sheet (relative value)
- Enabling the manager to hold cash when markets lack attractive investment opportunities (absolute value)

We feel it is critical for the additional flexibility to be utilized primarily as a tool to manage risk, not maximize return.

U.S. Dollar – With global economies so closely linked together, the primary diversification benefit U.S. investors get when investing outside the U.S. is currency exposure. As mentioned above, we feel the dollar will have some significant headwinds ahead, from both market factors and policy factors (even though officials will probably never acknowledge it). The fact we have control over our currency is the primary reason the U.S. debt problem will not turn out like the European debt crisis (default (s)).

These headwinds will likely put downward pressure on the dollar over time, which will require a more active currency management program within portfolios. We can profit from a declining dollar by investing in a non-dollar denominated asset/company/revenue stream. Based on this analysis, the best currency diversification comes from U.S. based companies that generate a substantial portion of their revenues outside the U.S. and non-U.S. based companies that generate most of their revenue internally (not dependent on exports to the U.S.). Ultimately, we have to balance this long-term negative view on the dollar with the reality that all of our clients' liabilities are denominated in dollars.

In conclusion, while we are certainly concerned about the short-term uncertainty/volatility surrounding Standard and Poor's decision to downgrade U.S. debt, our concerns surrounding the fiscal shape of the U.S. government's balance sheet have been a critical reason behind our nearly continuous search for better ways to manage risk within portfolios (both debt and equity) since 2007. As a result, Friday's decision does not dramatically alter our long-term portfolio positioning/outlook. Hopefully, this will serve as the "crisis" that results in a bi-partisan compromise providing a valid, long-term solution. Hope, however, is not an investment strategy, and we feel we are prepared for a wide range of potential outcomes.

Written by Jim Underwood, CFA, Chief Portfolio Strategist, Welch Hornsby

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