LMCG Update: U.S. Downgrade | 8/8/11
What Does it Mean?

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Late on Friday, S&P lowered the long-term rating of the debt of US government and federal agencies from AAA to AA+. The short and long-term ratings were removed from CreditWatch negative, but the outlook on the long-term rating remained negative and S&P warned of further action. Bill Gross from PIMCO said the move from S&P showed "spine", while Treasury Secretary Timothy Geithner said the move showed "really terrible judgment". Debate around the validity of the move will certainly continue for some time, but it's now left to investors to deal with the consequences.

We want clients and investors to keep a few key points in mind when discussing the recent downgrade:

- S&P left the outlook on the US government negative because of political risks and a rising debt burden, in that order. The ability of the US to meet its obligations has not changed, but the willingness to pay its obligations has been muddied by the political process.
- Moody's and Fitch have maintained the US's triple-A credit rating.
- The US is still the largest and most liquid market in the world. With the growing sense of panic in European credit markets, the US bond market continues to be a safe haven for international capital flows.
- China, the largest holder of US debt, reacted as one would expect by declaring that the US needs to cut spending and cure its debt addiction. However, US yields are lower than practically at any time in history and China continues purchasing US debt to manipulate their currency.
- Since the credit crisis, rating agencies have lost a great deal of credibility with investors. Many see them as enablers of the financial meltdown.
- Looking back through history, sovereign downgrades from AAA to AA+ or AA have typically resulted in falling yields. In our opinion, the stock market is more likely to sell off than the bond market.

At LMCG, our fixed income strategy has changed very little as a result of the downgrade. Since the credit crisis in 2008, we have consistently recommended investing in corporate balance sheets versus government balance sheets. We have been underweight government securities relative to the benchmark and will remain so following the US downgrade. We will likely move further underweight should this latest sharp drop in government yields continue. We have also favored domestic credit versus international, due to the problems in the Euro Zone. Recently, we have adjusted our allocation away from ETF's that contained exposure to European sovereigns in favor of a more domestic bias. Some municipal bonds will be affected by the downgrade. Those states with greater federal backing, as well as housing and pre-refunded bonds, will likely face downgrades from S&P. We have limited exposure to these sectors and don't anticipate a significant change in our strategy or allocations. Although our bias for higher quality municipal credits has cost us a few basis points in performance during recent "risk on" periods in the market, we are comfortable with our current position.

We believe that investors will adjust to the new realities in the US Treasury market over time, and that the US dollar and treasuries will not be displaced as global benchmarks. There will certainly be unintended consequences of S&P's latest move, but we at LMCG are very confident in our current fixed income portfolio positioning.

Update on Trading – Monday, August 8, 2011 at 4pm:

Jeffrey P. Davis, CFA
Chief Investment Officer

By late afternoon today, a sharp selloff in equities has driven the broad markets significantly lower, sinking financial services, energy, materials, and some of the more aggressive growth stocks (biotechnology stocks, in particular). The S&P 500 closed down just over 6.6%. Many professional investors are being instructed to sell equities by clients who have no tolerance for losses of the magnitude experienced in October, 2007. Very little news is driving this market action, outside of the S&P credit downgrade. Spreads of European sovereign debt have held fairly steady as the ECB has been actively supporting their markets. While equity shares in European and Asian markets were down less at their close this morning than in the US, selloffs in ADRs and foreign index ETFs created losses as deep as US equities, indicating that markets overnight will likely be very weak. Bond markets rose with little change in spreads.

The magnitude of issues facing the US and global economies is substantially less today than in September and October, 2008 (yet more than in October, 1987). Balance sheets in banks and in most corporations are healthy, and much of the unstable leverage has been flushed out of the financial system. We are monitoring market and economic developments very closely, but everything we see right now indicates that an unwarranted panic is creating a highly oversold equity market.

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