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# MARKET UPDATE: U.S. DEBT DOWNGRADE ACCELERATES VOLATILITY

*From the Desk of Our Chief Investment Officer*

After Monday's equity market selloff, the S&P 500 Index has declined almost 17% in the last two weeks. We are providing an update on our market perspectives in light of this volatility.

Two issues have converged simultaneously to dent confidence in the outlook for equities. First, the process of raising the debt ceiling in conjunction with a deficit reduction package was dysfunctional and dealt a blow to the perceived global invulnerability of the U.S. Treasury. Second, economic news took a decidedly negative turn in recent weeks.

Below we address the immediate source of Monday's sell-off, the downgrade by Standard and Poor's (S&P) of the long-term U.S. sovereign debt rating.

## What Happened

On Friday, August 5, S&P downgraded the U.S. long-term sovereign credit rating from AAA to AA+. The AAA rating had been in effect since 1917. S&P has a negative outlook on the AA+ rating, which means that there is a material chance of another rating cut in the next 6–24 months without a change in the trajectory of debt projections. Moody's and Fitch have retained their highest ratings on U.S. long-term debt, but both have qualified the rating with a negative outlook. S&P retained their top 'A-1+' rating on short-term U.S. debt instruments.

## What It Means

S&P's downgrade is disturbing, but it was not a complete surprise. The rating agency placed the U.S. on negative outlook in April, and it was clear that the recent deficit reduction deal fell far short of stabilizing the U.S. debt-to-GDP ratio. There was widespread speculation that the downgrade was forthcoming and that speculation was likely one of the factors in last week's market decline.

S&P rationalized its decision by focusing on the disappointing outcome of the recent debt ceiling debate, pointing to a "contentious and fitful process" that makes meaningful progress on further deficit reduction "less likely than we previously assumed." As a result, there is more pressure on

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the 12-person bipartisan congressional panel to create a credible deficit reduction plan and perhaps go beyond the $1.5 trillion in cuts they are charged with finding per last Tuesday's debt ceiling legislation. The panel will be named by August 16 and has a November 23 deadline to approve specific cuts that would go to the full Congress for approval. This will require a spirit of cooperation and compromise that was missing during the debt ceiling debate. We will be watching to see if S&P's action is the "wake up call" that Washington needs.

## Market Implications

It is unlikely that there will be a forced purging of Treasury holdings due to the loss of the AAA rating. Money market funds should not be impacted, because the rating on short-term paper remains A-1+, S&P's highest rating. Furthermore, regulators have stated that risk-based capital requirements for banks will not be impacted. In a debt-plagued world, U.S. Treasuries remain by far the most liquid market, and no other currency is ready to replace the dollar as the world's reserve currency. The analogy of Treasuries being the "best house in a bad neighborhood" still applies even after the downgrade.

All else being equal, the downgrade should lead to slightly higher long-term interest rates. However, all else is not equal. Over the last two weeks, the yield on the 10-year Treasury note has declined from 2.96% to 2.34% due to weaker economic news—clear evidence that Treasuries remain global safe havens.

A domino effect on other credit markets has begun. On Monday, S&P downgraded the debt of Fannie Mae, Freddie Mac and 10 Federal Home Loan Banks, potentially creating a further challenge for the housing market. They also downgraded municipal bonds that are explicitly backed by U.S. Treasury securities and other forms of federal support. There have been no downgrades yet on state general obligation bonds. The muni market has been calm in recent days, but it has not followed the rally that has occurred in the Treasury market.

Equity markets are now deep into correction territory. A good part of the recent decline was due to the debt ceiling debate, rising expectations of the credit downgrade and weaker economic news. Stocks now appear inexpensive based on most metrics. This has been disregarded in the short term due to rising recession fears and the confidence blow caused by the loss of America's bullet proof credit rating. Interestingly, if we assume a recession scenario and a 15% decline in corporate earnings next year—not our base case—the market is still attractively valued at a P/E multiple of 14x.

Yes, valuations are getting tempting, but it is the sense of the Atlantic Trust Asset Allocation Committee that valuation may not provide short-term support in a highly emotional environment. There are a couple of issues that would need to fall into place to make the risk/reward tradeoff for equities truly compelling:

- We will be following high frequency economic statistics very closely to determine if recession odds grow or recede in the days and weeks ahead.
- We will assess the internal workings of the capital markets to make sure that unforeseen systemic problems are not emerging.

Meanwhile, diversification by asset class and geography remains important in weathering these storms. High credit quality bonds have performed strongly. The vast majority of hedged equity and credit strategies are mitigating downside risk as well. Emerging market stocks have been hit hard but, given the excellent long-term fundamentals, may bounce back more quickly.

**We will be following events very closely in the days ahead, with a balanced approach to averting long-term risk and seeking long-term reward. Please feel free to contact your Atlantic Trust Relationship Manager for further discussion.**

All market performance data is from Bloomberg L.P. as of 08/08/2011.

A credit rating is an assessment provided by a nationally recognized statistical rating organization of the creditworthiness of an issuer with respect to debt obligations. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest) and are subject to change. For more information on rating methodologies, please visit the following NRSRO websites: standardandpoors.com and select "Understanding Ratings" under Ratings Resources on the homepage; moodys.com and select "Rating Methodologies" under Research and Ratings on the homepage; and fitchratings.com and select "Ratings Defintiions" on the homepage.

Fannie Mae and Freddie Mac are government sponsored enterprises chartered by Congress that seek to provide liquidity, stability and affordability for the U.S. housing market.

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