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S&P downgrade of US to AA+. What now?

12 August 2011

With the Standard and Poor's rating downgrade for US government debt now almost a week on, what might this signify going forward?

In an article in Monday's Financial Times (6 August) Mohamed El-Erian, Pimco's chief executive, referred to this "potential Sputnik moment" as a shock that might serve to unite Americans under a common vision. It is certainly true that the announcement of the downgrade to AA+ galvanised the media and led to a sharp retort from the US Treasury; yet it should not have come as a total surprise to observers.

Sovereign credit ratings focus on both the ability and the willingness to repay debt. The US shares the same advantage as Japan and the UK, that it issues debt in its own currency and that it could, if required, repay this debt by printing more currency – thus risking both domestic inflation and devaluation of the currency. However, there is also the issue of political will to make tough decisions and the markets demonstrated significant volatility in the run-up to the downgrade due to concerns about the ability of politicians to resolve the questions of extension of borrowing capacity, tax and expenditure.

S&P's statement indicated that their outlook on US debt remains negative and that they could lower the rating another notch to AA within the next two years if the government's debt requirements increase more than assumed in the rating agency's base case modelling.

To put this into context, there is no real imperative that government debt must be rated AAA: for instance Japan's credit rating has been lower for some time, most recently reduced to AA-. The assumed change in annual probability of default for downgrades from AAA to AA+ or perhaps lower is relatively modest, though there is a presumption that the borrower would have to grant investors a little more in yield to compensate. There are also obvious implications for servicing costs and on Capitol Hill.

Investors have relatively few alternatives should they wish to substitute an alternative "risk-free" asset for Treasuries. The key large AAA rated sovereign issuers: France, Germany, Canada and the UK, do not issue in sufficient volume to replace and currency immunisation products would not be sufficiently liquid to translate the flows of those bonds through into dollars in any case. Individual investors may make this change but the market will not be able to accomplish this en-masse. Substitution pressure on yields is therefore likely to be modest.

Market developments since the downgrade may have seemed a little counter-intuitive. US government credit default swap prices, which had been volatile and elevated in the previous week, fell back and Treasury bill bond yields have actually declined since the downgrade. The reality is that the narrow credit effect of the downgrade has been swamped by the broad rates effect of the ongoing flight to quality by investors in response to a general increase in risk aversion. The perception is that the focus is currently on European government borrowing and on uncertain American growth prospects next year. Consequently, investors holding US Treasuries have not yet been adversely impacted.

There are a few operational and behavioural questions that investors may wish to bear in mind:

- Historically, some investment products have tended to treat US Treasuries and AAA-ratings almost interchangeably. Given this partial disconnect – though other rating agencies maintain their equivalent highest rating – it maybe worth checking that no concerns regarding inadvertent forced sale of assets exist. This might be particularly relevant in money market funds and specialist products, such as agency mortgage-backed products

- Investors pledging US Treasuries as collateral – obviously not so common in the UK – might wish to check that agreements don't include binding constraints as to minimum credit rating. This would not currently be usual but requests from counterparties to tighten eligibility provisions are not unknown

- In times of market volatility, patient institutional investors are sometimes more at risk from the actions of shorter-timeframe co-investors than their own actions. This was seen in the effect of multiple redemption requests on some money market funds in 2008. It is always worth investors keeping in touch with the managers of pooled vehicles, even low risk ones, to check liquidity profile and volumes of redemption requests.

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