



Invesco Insights

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Deficits and the Debt Ceiling

A U.S. default is averted, but the work is not over

The Budget Control Act of 2011 has been signed into law, raising the U.S. debt ceiling and forging a path for long-term deficit reductions. We applaud Congress and the White House for avoiding a default, which we believe could have triggered enormous unintended consequences.

We also recognize that the work is not over.

About the legislation

The legislation outlines \$917 billion in deficit reduction between 2012 and 2021, to be achieved through caps on domestic and defense spending. It also creates a bipartisan committee to identify another \$1.2 trillion to \$1.5 trillion in deficit reduction, potentially including spending cuts, entitlement reform and tax reform. The committee must recommend its deficit reduction proposal by Nov. 23, and Congress is required to vote on it by Dec. 23. If a reduction is not agreed upon by the deadline, automatic procedures will be triggered that reduce spending by as much as \$1.2 trillion, starting Jan. 15, 2012. Half of the cuts would come from national security and defense. Medicare would receive limited cuts, but Social Security and Medicaid would be exempt.

Bottom line: Deficit reduction should total between \$2.1 trillion and \$2.4 trillion over 10 years.

Waiting for the ratings

Once the deal was signed, the question turned to the reaction of the three ratings agencies – Standard & Poor's, Moody's Investors Service and Fitch Ratings – and whether they would maintain the country's AAA credit rating, the highest rating possible.

At the end of the day Tuesday, Moody's issued a press release confirming the country's Aaa government bond rating, with a negative outlook. Moody's noted that the debt deal has "virtually eliminated" the risk of default. In assigning its negative outlook, Moody's said there would be a risk of downgrade if any of the following occur:

- There is a weakening in fiscal discipline in the coming year.
- Further fiscal consolidation measures are not adopted in 2013.
- The economic outlook deteriorates significantly.
- There is an appreciable rise in the U.S. government's funding costs over and above what is currently expected.

Fitch Ratings also weighed in on Tuesday, noting that the agreement reached on the debt ceiling increase was “commensurate with its AAA rating” for the U.S., and it will complete its scheduled review by the end of August. However, Fitch reiterated its concerns over the medium-term outlook for the U.S. debt trajectory and AAA rating.¹

As of Tuesday evening, there was not yet an update by Standard & Poor’s. On July 14, S&P placed the U.S.’s AAA long-term and A-1+ short-term sovereign credit ratings on CreditWatch with negative implications. Many people interpreted S&P’s comments as advocating for at least \$4 trillion in long-term deficit reduction – almost double what’s outlined in this legislation. But since then, S&P’s president has clarified that the firm was not advocating a specific target and was waiting to analyze the final proposal before making a judgment.²

The possibility of a rating downgrade by one or more of the agencies, along with a weak manufacturing report,³ a weak consumer spending report⁴ and concerns over U.S. economic growth, appear to have tempered any enthusiasm the markets may have had over the debt deal. Monday started with a rally, but U.S. stocks finished lower. On Tuesday, stocks finished lower again with the Dow Jones Industrial Average recording its eighth straight daily loss.⁵

Prices of U.S. Treasuries rose on Tuesday when the agreement was signed, which lowered the yield on 10-year Treasuries to 2.61% from 2.75%.⁶

Assessing the effects

A downgrade situation is without precedent and implications are difficult to assess. I’ve talked with portfolio managers across Invesco to get a sense of potential downgrade effects on their asset class.

- **Fixed income.** If a multi-notch downgrade in the U.S.’s short-term credit ratings were to occur, money market funds (particularly government-only funds) would be most directly affected. However, given Tuesday’s announcements by Moody’s and Fitch, that near-term risk has been substantially reduced. Given the potential longer-term downgrade risks, Invesco Global Cash Management continues to actively manage its maturities and portfolio positions to reflect the safety and liquidity objectives of our funds, and we are continuously stress-testing the net asset values (NAVs) of our portfolios. Other fixed income teams have been performing a portfolio-by-portfolio review of guidelines to identify required actions under various downgrade scenarios.
- **Equities.** Equities are not expected to be directly affected by a downgrade, although they may be affected by public reaction. In the longer term, high-quality large-cap corporations – those with predictable earnings streams, manageable debt levels and plenty of cash – may be more attractive than riskier, lower-quality companies.

1 Source: Fitch Ratings press release, “Fitch Comments on U.S. Debt Ceiling, Deficit Reduction Agreement & Sovereign Rating,” Aug. 2, 2011

2 Source: Bloomberg, “U.S. Rating Hinges on Long-Term Fix: S&P’s Sharma,” July 27, 2011

3 The Institute for Supply Management’s manufacturing index fell to 50.9 in July, down 4.4 points from June, marking the sector’s slowest growth since July 2009. Source: CNNMoney, “Manufacturing recovery slows,” Aug. 1, 2011

4 The U.S. Commerce Department reported that consumer spending fell 0.2% in June – the first spending decrease in 20 months. Source: CNNMoney, “Stocks drop as economic worries resurface,” Aug. 2, 2011

5 From July 22, 2011, to Aug. 2, 2011

6 Source: Bloomberg

Monitoring the situation

Across the globe, Invesco's investment professionals are actively monitoring the potential for a U.S. ratings downgrade, the underlying economic data and market reactions. Managing risk is a key function for all of our investment teams – and each one operates under a disciplined philosophy and process with strong risk oversight and quality controls.

We believe investors should approach their financial plans in the same way – with purpose, prudence and diligence. We urge investors to contact their financial advisors with any questions or concerns about their financial plans, rather than relying on speculation. Having a solid plan that's focused on an investor's goals is one of the best ways to combat uncertainty.

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All data provided by Invesco unless otherwise noted.

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This does not constitute a recommendation of the suitability of any investment strategy for a particular investor. A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated, and should not be interpreted as indicating low quality.

For more information on rating methodologies, please visit the following NRSRO websites: www.standardandpoors.com and select "Understanding Ratings" under Rating Resources on the homepage; www.moodys.com and select "Rating Methodologies" under Research and Ratings on the homepage and www.fitchratings.com and select "Ratings Definitions" on the homepage.

The Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.