



Invesco Insights

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Update: Standard and Poor's Downgrade of U.S. Long-Term Debt

Last week, we reported that while a U.S. default was averted, the work is not over. We also noted that a key outstanding item was the potential for a downgrade of long-term U.S. debt by Standard and Poor's (S&P). On Friday, Aug. 5, 2011, that downgrade occurred.

S&P issued a report¹ that lowered long-term U.S. debt from its AAA rating to AA+. The rating change was accompanied by a "negative outlook," which indicates S&P sees little hope of the U.S. earning back its top rating any time soon. Short-term debt maintained its top rating of A-1+.

Overview from S&P's report

S&P's research report offered the following reasons for the downgrade (access the full report at www.standardandpoors.com):

- S&P believes the recently signed fiscal consolidation plan falls short of what would be necessary to stabilize the government's medium-term debt dynamics.
- S&P also believes "... the effectiveness, stability and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011."
- S&P is pessimistic about the capacity of Congress and the Administration to be able to leverage their agreement last week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon.

S&P also noted its negative outlook means the rating agency could lower the long-term rating to AA within the next two years if it sees evidence that less reduction in spending than agreed to, higher interest rates or new fiscal pressures during the period result in a higher general government debt trajectory than it currently assumes in its base case.

Consequences for investors

As we noted in [previous communications](#), the consequences of such a move cannot be fully anticipated; however, we can offer an updated perspective.

¹ "Research Update: United States of America Long-Term Rating Lowered to 'AA+' on Political Risks and Rising Debt Burden; Outlook Negative"; Aug. 5, 2011; Standard and Poor's; www.standardandpoors.com

Fixed income. Because only one of the three major ratings agencies - Standard and Poor's, Moody's Investors Service and Fitch Ratings - downgraded long-term U.S. debt, the consequences may be muted. U.S. Treasuries have always held a special status as the standard for investing safety, and it appears that banks and other lending institutions will still adhere to that status, irrespective of the S&P downgrade. On Friday, the U.S. Federal Reserve confirmed to banks that the status of U.S. Treasuries remains intact, stating in a press release:

"For risk-based capital purposes, the risk weights for Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities will not change. The treatment of Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities under other federal banking agency regulations ... will also be unaffected."¹

Importantly, the fact that short-term U.S. debt retained the highest possible rating means money market holdings are unaffected by the rating change.

Equities. Stock markets obviously reacted late last week in anticipation of the news, creating volatility not seen since 2008 and suggesting the market was pricing in the downgrade. By close Friday, the market had rallied and regained a good deal of the day's losses. As we noted previously, we believe public reaction is the driver of such activity, rather than any change in fundamentals.

Monitoring the situation

It's important to remember that the U.S. dollar is the world's main reserve currency, and long-term U.S. debt is held in significant amounts in numerous countries. Because U.S. debt is so fundamental to global economies, the short-term effect of a downgrade may ultimately be more psychological than actual, as investors around the globe adjust to the news. On Monday, Aug. 8, S&P will hold a conference call on the downgrade; we will offer an update after we assess their comments.

Managing risk is integral to Invesco's approach to investing. Each portfolio management team continues to operate under a disciplined philosophy and process with strong risk oversight and quality controls. We urge investors to contact your advisor or Invesco representative with any questions.

¹ Board of Governors of the U.S. Federal Reserve System Joint Press Release, Aug. 5, 2011; <http://www.federalreserve.gov/newsevents/press/bcreg/20110805a.htm>

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All data provided by Invesco unless otherwise noted.

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