



Invesco Insights

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After the Downgrade

Evaluating S&P's decision and possible opportunities for investors

The world watched on Monday to see the reaction that followed Friday night's downgrade of U.S. long-term debt by Standard & Poor's (S&P). In a nutshell: Stocks fell. Treasuries and gold rose. S&P elaborated on why it downgraded the U.S. and Moody's Investors Service explained why it didn't.

It's a lot for investors to absorb. So in the next few pages, I want to highlight a few points that we believe give some much-needed context to this unprecedented situation. And I want to share some thoughts from my colleagues around Invesco, who are carefully monitoring both the risks and the opportunities presented by this downgrade.

Market reaction

U.S. stocks were hit hard on Monday, with the Dow Jones Industrial Average closing down 5.6% and the S & P 500 Index falling 6.7%. Investors fled to U.S. Treasuries and gold. Monday, yields on the 10-year Treasuries fell to 2.3% as prices rose. And gold futures soared to new levels.

Tuesday morning, U.S. stocks opened higher, Treasuries lost some ground and gold stayed strong.

S&P elaborates

S&P held an open conference call Monday morning to give some insight into its reasons for downgrading the U.S. long-term debt from AAA to AA+ and assigning it a negative outlook.

There are five key risks that S&P considers in its sovereign ratings: Political, economic, external, fiscal and monetary. Two of these factors - fiscal and political - came into play during S&P's decision. On the political side, S&P again noted the fractured nature of the dialogue concerning deficit reductions.

On the fiscal side, S&P noted that the ratio of net government debt to gross domestic product (GDP) is currently 74%, and that number is set to rise under almost any conceivable scenario. The question is by how much.

- **The "base case."** This scenario estimates that figure would rise to 79% by 2015 and 85% by 2021.

- **The “upside.”** This scenario, which could warrant a change in outlook to “stable” on the long-term rating, assumes that in addition to the deficit cuts outlined in the recent debt ceiling agreement, the country would realize about \$950 billion in new revenues from the scheduled expiration of certain tax cuts for high earners. That would result in a much flatter growth trajectory for the debt, S&P estimates, with a 77% debt-to-GDP ratio in 2015 and 78% in 2021.
- **The “downside.”** This scenario, which could warrant further downgrade from AA+ to AA, assumes a slower path of economic growth, a higher path of interest rates on U.S. government bonds and incomplete adoption of deficit reduction measures. That would result in a 90% debt-to-GDP ratio in 2015 and 101% in 2021, S & P said.

How does this compare with the debt levels of AAA-rated countries? Currently, S&P has AAA sovereign ratings on 18 countries, and there are four of them that it views as relevant peers to the U.S. – Canada, France, Germany and the U.K. Among these peers, 2011 net general government debt to GDP ratios will range from 34% in Canada to 80% in the U.K., compared with the U.S. at 74%.¹ By 2015, S&P’s base case scenario projects those figures will range between 30% for Canada and 83% for France, with the U.S. at 79%.¹

According to S&P, the difference between the U.S. and those four peers is that their debt burdens are eventually expected to decrease. But we believe the markets will be the ultimate judge of the creditworthiness of the U.S. as compared to the 18 AAA-rated nations.

What about a scenario that moves the U.S. back to AAA status? Perhaps that could happen over time, but it would require broader consensus on a fiscal stabilization package, S&P said on Monday’s call. Given the polarization of views around fiscal policy right now, S&P does not believe this is likely anytime soon.

S&P highlighted five countries that have lost and regained AAA status: Canada, Australia, Finland, Sweden and Denmark. All of them achieved substantial fiscal consolidation over time, and all but Australia also implemented economic reforms. The quickest path back to AAA took nine years. The longest, 18 years. S&P noted that each situation is unique, however, and it would not suggest any particular scenario for the U.S.

Concerning the role of the U.S. dollar, S&P believes the dollar will remain the key international reserve currency under any plausible scenario. The only other option is the euro, and it has experienced its own issues.

Overall, S&P stressed that there are many levels between AAA and D, its lowest rating, and that defaults among AAA, AA and A-rated sovereigns are very rare. On its Monday call, the firm described its downgrade as a matter of degrees, and said that moving from the highest rating to the second-highest rating was “like going from indigo to navy blue.”

Moody’s weighs in

Also on Monday, Moody’s gave more details on its decision to confirm its Aaa rating on the U.S.² According to the agency, characteristics that support the rating include:

- **The economy.** Moody’s cited, “The unparalleled diversity and size of the U.S. economy and its long record of relatively solid economic growth, based on both demographics and productivity.” Moody’s noted that despite weakness in the short-term economic outlook, the long term remains favorable relative to many other advanced economies.

1 Source: Standard & Poor’s, “United States of America Long-Term Rating Lowered to ‘AA+’ on Political Risks and Rising Debt Burden; Outlook Negative,” Aug. 5, 2011

2 Source: Moody’s Investors Service, “The Key Drivers Behind Moody’s Confirmation of the U.S. Aaa Rating,” Aug. 8, 2011

- **The dollar.** The unique global role of the dollar means the U.S. government can support higher debt levels than other governments, Moody's reported. "Thus, while comparisons of government debt ratios form an important part of our rating analysis, the status of the dollar and the U.S. government debt market need to be taken into account when making such comparisons. Over time, the dollar's role may be eroded, but we see no immediate threat."
- **The relative debt.** While the U.S. debt position is somewhat high compared with other large Aaa-rated governments, it's not out of line with the positions of these countries. "While the projected trend of U.S. government debt is less favorable without further deficit reduction measures, we believe that eventually such measures will be adopted. The less favorable debt ratio trend now in place is reflected in the negative outlook assigned to the rating."
- **The process.** Moody's called the debt ceiling agreement a step in the right direction toward deficit reduction. "Although the political process has been considerably more contentious than usual in the past few months, it finally did produce an agreement. We expect further fiscal measures over time, albeit with vigorous debate over the particulars."

Fitch continues its review

Fitch Ratings previously noted¹ that the agreement reached on the debt ceiling increase was "commensurate with its AAA rating" for the U.S., but it was concerned over the medium-term outlook for the U.S. debt trajectory. Fitch has said it will complete its scheduled review by the end of August.

Risks and opportunities

My colleagues around Invesco are carefully monitoring both the risks and the opportunities presented by this downgrade.

Equities. Juliet Ellis, Invesco's chief investment officer for U.S. growth equities, believes that at this point in time, the markets are oversold. "There is an opportunity to upgrade one's portfolio," she said. "Fundamentals are being disregarded. Everything is not equal." Specifically, opportunities may lie in companies with strong balance sheets and strong growth prospects. Ellis notes a statistic from J.P. Morgan: From 1993, there have been seven sovereign downgrades from AAA status. On average, stock markets in those countries have gained 12% six months following their downgrade.²

On the risk side, Ellis notes that a lack of confidence could make recession a self-fulfilling prophecy. With that in mind, pressure is building for another round of monetary stimulus, or QE3, which could help provide a floor for the market.

Jim Gilligan, Invesco's chief investment officer for U.S. value equities, also cites a lack of confidence. "People are losing confidence in the ability of the central bank to stimulate the economy. That's long been the backstop for the markets. That doesn't exist anymore and people are coming to that conclusion."

Gilligan notes that when the markets experience a sell-off, the tendency of investors is to search for buying opportunities. "Since the backstop does not exist anymore, we have to very careful about using the 'old playbook,' which has been to buy high-beta names." He says strong companies that have healthy balance sheets and offer dividends may be particularly attractive now, and he expects performance will be concentrated in that area and, on the other end of the barbell, companies with true revenue growth.

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

2 Source: J.P. Morgan via Reuters Knowledge. "U.S. Equity Strategy FLASH." Lee and McElligott. Aug. 7, 2011

On the risk side, Gilligan notes the overall economic weakness across the globe. "I keep looking to see where we're going to get the growth."

Fixed income.Importantly, while S&P downgraded U.S. long-term debt, short-term U.S. debt retained the highest possible rating from all three rating agencies, meaning that money market holdings are unaffected.

As a result of the long-term downgrade, S&P on Monday also lowered the long-term issuer credit ratings and related issue ratings to AA+ from AAA on several government-related entities (GREs), including Fannie Mae and Freddie Mac, as well as the rating of five large insurance companies.¹ The agency noted that the sovereign downgrade would not have an immediate or direct impact on its ratings on U.S. banks.

As we noted on Sunday, U.S. Treasuries have always held a special status as the standard for investing safety, and the U.S. Federal Reserve confirmed to banks on Friday that the status of U.S. Treasuries remains intact.

Real estate.Invesco Real Estate believes the U.S. will continue to experience very modest GDP expansion in the 1% to 2% range. Such sluggish growth will continue to affect commercial real estate construction, and the team believes the resulting occupancy rates will remain stable to slightly better over the next several years. Any change in the team's outlook would result from a change in the space demand by tenants. Invesco Real Estate also notes that apartments are a particular bright spot in the real estate market, given the anemic housing markets.

Managing risk

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 Sources: Standard & Poor's, "Rating Actions Taken on 10 U.S.-Based Insurance Groups Following Sovereign Downgrade," Aug. 8, 2011. Standard & Poor's, "Ratings on Select GREs and FDIC- and NCUA-Guaranteed Debt Lowered After Sovereign Downgrade," Aug. 8, 2011.

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