When the Safe Haven is No Longer AAA

How a U.S. Ratings Downgrade May Impact Corporate Treasury Investors.

Abstract

The U.S. debt ceiling situation remains fluid, but we believe that a U.S. default is an extremely remote possibility. A ratings downgrade from AAA may be more likely due to the diminished prospect of a credible deficit reduction path. Market implications of such a downgrade may be greater than merely higher borrowing costs for the government. Investors should cope by focusing on their cash portfolio liquidity and investment policy compliance. Although market adjustments to the U.S. losing its AAA rating may be painful, we believe that Treasuries will continue to have a deep, liquid and functioning market.

Introduction

At the time of this writing, the U.S. debt ceiling situation remains fluid. The market generally agrees that measures will be taken in time to increase the ceiling and avert a technical default of Treasury debt. We think, however, that the Washington brinkmanship has done more long-term damage to the credibility of U.S. government debt than the politicians intended. We believe that a potential downgrade of the AAA U.S. sovereign rating is a more likely threat to the debt markets than a technical default of Treasury debt. And time is running out.

What is the likelihood of the U.S. losing one of its AAA credit ratings? What are the likely market implications of such an occurrence? More importantly, how would such a downgrade affect corporate treasury investors, and what are the steps one may take today to prepare for this potential outcome? Sharing the same concerns as most institutional cash investors, we want to use this opportunity to express our views in hopes of helping investors navigate today's turbulent currents.

Published: July 29, 2011

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

In Our Opinion a U.S. Default is an Extremely Remote Possibility

We should note that the U.S. is not Greece. The U.S. government's ability to service its debt or honor its obligations is not impaired. Nor do near-zero short-term Treasury yields suggest this could occur. The $14.3 trillion debt ceiling, an arbitrary but fiscally responsible constitutional requirement, reflects fundamental significance neither on the U.S. indebtedness nor its fiscal health.

Political leadership is committed to raising the debt ceiling. Treasury Secretary Timothy Geithner sent a letter to Congress on May 16 alerting it that the country had reached its statutory debt limit and that the government has until August 2 to raise the $14.3 trillion debt ceiling or risk not being able to make certain payments on its debt[1]. According to the Congressional Research Service, the debt ceiling has been raised 74 times since March 1962[2]. Political leaders, including President Obama, Congressional Democratic and Republican leadership and the Treasury Secretary, have acknowledged the grave market and economic consequences of a failure to increase the ceiling. The political process relating to lifting the debt limit has the unfortunate timing of happening just before the 2012 election season. Fiscal agreements of the scale being discussed usually come at the last possible moment with twists and turns on the way.

A failure to raise the ceiling does not mean default. Let us assume for a moment that the politicians make the worst policy error imaginable and fail to lift the ceiling by August 2 and the Treasury must decide which payments to make. For August 2011, the Treasury Department is estimated to collect $203 billion in taxes and have $307 billion in expenditures, of which $29 billion are interest payments[3]. There is support for the argument that, in accordance with the 14th Amendment to the U.S. Constitution, the U.S. must service its public debt before making other payments[4]. This means that shrinkage of $104 billion, or 34%, in government spending should not affect debt payments, at least not initially, although the overall economic impact may be devastating. Note that the rollover of existing Treasury debt, estimated at $467 billion in August, does not count toward the debt ceiling.

A technical default may be cured quickly. If a default occurs, then we expect only a temporary disruption of payments. This so-called “technical default” would likely be resolved quickly once the ceiling is lifted and the Treasury resumes issuing new debt. Credit rating agencies allow for this scenario for a short period if a solution is within reach. Taken on its face value, a technical default is a matter of investor inconvenience and government embarrassment, even though the psychological impact may be greater.

A Ratings Downgrade May be a More Credible Threat

We view a U.S. debt default as improbable and mostly political theater, and consider a ratings downgrade from AAA to be more likely. In our opinion, unless Washington demonstrates the resolve to break with the past and set a credible deficit reduction path, the fate of losing the coveted AAA is inevitable.

The U.S.’s fiscal health has deteriorated. We took interest in the U.S.’s credit ratings after the recent financial crisis, and it has been conspicuously absent from the global austerity initiatives among developed nations. The $750 billion bank recapitalizing program in 2008, the $785 billion economic stimulus package in 2009, and sluggish tax receipts since the Great Recession fundamentally changed the federal government's balance sheet, debt burden and fiscal deficits. After many months of making cautious remarks about the U.S.'s deteriorating fiscal health and against the backdrop of the debt ceiling situation, the rating agencies have issued serious warnings that the country's unsustainable fiscal path jeopardizes its AAA ratings.

Rating agencies made good on their earlier warnings. Standard & Poor's was the first agency to formally put the U.S. on notice on April 18, 2011, when it changed its ratings outlook to negative, suggesting a one in three chance of a downgrade in the next two years. Moody's decision came on July 13, when it placed the U.S. "on review for possible downgrade," a more severe warning. It hinted that the rating may fall one to two notches if the ceiling is not raised by August 2. S&P came back on July 14 with an action matching that of Moody's, "CreditWatch negative," meaning a one in two chance of a downgrade within 90 days. Fitch, the third major rating agency, has left its outlook stable while stepping up its verbal warnings in recent weeks[5].

Downgrades may not be tied to the ceiling. We think that the U.S. is at risk of losing its AAA ratings because the agencies are focused more on credible long-term reduction of fiscal burdens than merely an increase in the debt ceiling. If an agreement does not include a credible deficit reduction plan, then S&P and Moody's are expected to affirm the AAA ratings and leave the negative outlook[6]. However, S&P may downgrade the U.S. within 90 days if it feels that a plan is not forthcoming or if it is not credible. In addition, if the ceiling is not raised, but no debt default occurs, then S&P may downgrade the U.S. immediately, while Moody's may wait to take a ratings action. Finally, if a temporary default occurs, then Moody's may lower the U.S.'s rating by one to two notches, while S&P may assign the U.S. rating S.D. (selective default).

Ratings Implications May Be Widespread and Disruptive

Given the great political divide on fiscal issues, we think that, as time runs out, the 'kicking the can down the road' approach will prevail. A failure to conjure up a meaningful deficit reduction plan would probably lead to ratings downgrades in the near future. Market implications would likely be more significant than the potentially higher borrowing costs for the government, which alone would complicate the government's fiscal situation.

Supported entities may be downgraded. Both Moody's and S&P have issued comments that entities whose credit ratings benefit from explicit or implicit government support likely will be downgraded, as well. These entities include government sponsored entities (GSEs), such as Fannie Mae, Freddie Mac and Federal

Home Loan Banks, and some of the 15 states with AAA ratings because of their dependence on federal tax revenue. Foreign debt guaranteed by the U.S. and bank debt guaranteed by the FDIC during the financial crisis would likewise be affected. Other entities on notice include systemically important U.S. banks, insurance groups, clearinghouses, and stock exchanges[7].

A downgrade may create market confusion. Obligations of the U.S. government always have been viewed as "riskless" despite a brief period in 1995 when its AAA ratings carried a negative outlook. Investors tend to buy more Treasuries when there is higher risk in the financial world. Most financial assets, from consumer loans to corporate and mortgage bonds, are priced off of Treasuries of comparable maturities. Also, Treasuries are routinely held as security collateral in secured borrowings such as repurchase agreements and pre-refunded municipal bonds. The reserve currency status of the U.S. dollar (USD) implies that the market perceives U.S. government debt as "riskless." A downgrade of just one notch may have an unwelcome ripple effect on the world financial markets. In fact, experts could not even agree on whether investors will turn to or away from Treasuries if the U.S. is downgraded[8].

The long-term economic impact may be greater. The market's short-term response to a U.S. downgrade may be volatile, but eventually it may accept the somewhat less creditworthy status of government debt. Greater economic impact may be felt from higher bond yields and lower government funding capabilities. The loss of investor confidence globally may further hinder capital flows and cross border investments, as suggested in an International Monetary Fund annual assessment report[9]. A reassessment of the U.S. government's finances "could lead to a rapid deterioration in global financing conditions, capital flows and possibly the value of the dollar," the Fund wrote.

How Corporate Treasury Investors Can Cope with Downgrades

Uncertainty and market volatility resulting from a U.S. ratings downgrade is difficult to predict. However, corporate treasury professionals can take sensible measures to be prepared, even though it may be impossible for a U.S.-based investor to remove oneself from U.S. government risk. We think that investors should focus on the liquidity and investment policy compliance of their cash portfolios.

Portfolio liquidity planning is priority one. In times of uncertainty, liquidity is often the paramount objective. We advise investors to maintain an ample liquidity cushion in the next three months as the market premium for liquidity may be higher. Investors should look to repurchase agreement counter-parties as the source of liquidity rather than the underlying Treasury collateral. Similarly, as CAG does with money market fund investments, investors should study the liquidity buffer and the financial flexibility of a money market fund before investing. Note that even in the unlikely situation of missed debt payments, money market funds may not need to sell their Treasury holdings immediately if the "default" is temporary.

Have a plan of action for downgraded holdings. In the event of a Treasury downgrade, it is highly likely that most cash portfolios will have securities with ratings linked to the government that also are downgraded. These may include GSE debt, agency mortgage-backed securities (MBS) debt, FDIC-guaranteed financial debt, systemically important bank and insurance company debt, and AAA-rated municipal debt. Most of these securities are rated AAA and may move in tandem with the government's ratings. Lower-rated bank names such as Citigroup and Bank of America may lose their Tier 1 short-term debt ratings if downgraded. In these cases, it may be prudent to dispose of at-risk securities ahead of time to comply with portfolio guidelines. In most other cases, we advise investors to continue to hold their highly rated securities. Even in portfolios that require explicit AAA credit ratings, it may be necessary to consider a temporary ratings exemption due to the special nature of events.

Evaluate investment policy statements (IPS) for ratings requirements. We recommend that investors review their investment policy statements to determine the minimum credit ratings for investments. In our experience, U.S. government and agency securities usually are listed as eligible instruments separately from credit investments, for which ratings are required. Investors should decide whether government securities are subject to ratings requirements. In the case of AAA-only investment policies, a decision is needed: exempt U.S. debt from the rating requirement or lower the requirement to AA. In going through the process, one should be aware of the various government-related, financial, municipal and securitized investments that receive ratings uplifts from the government, and should apply a consistent methodology in making any IPS revisions.

Study broader counter-party and enterprise risk implications. A U.S. downgrade would likely impact areas outside of investments. For example, one may want to assess financing transactions or swap contracts that require the backing of government securities or AAA ratings. An entity with debt financing may have its own credit ratings impacted by holdings of below-AAA securities in its cash portfolio. Provider creditworthiness in general liability insurance, pension services, and stock transfers, to name a few, may need to be reassessed. Certain regulated entities may need to re-evaluate their capital or liquidity reserve requirements due to government holdings.

Downgrade May Be Inevitable, but Investors Should Be Open-minded
We believe that the U.S. has a greater probability of losing its AAA credit ratings due to the lack of a credible debt reduction plan than due to the debt ceiling or a temporary default. A U.S. downgrade would likely lead to downgrades of a large number of related entities vital to the stability of the economy. The lack of precedence in determining risk in a previously riskless asset may result in market disruptions with long-term impacts.

We recommend that corporate treasury investors remain calm during this unusual period, maintain sufficient portfolio liquidity, have contingency policies dealing with government downgrades if current policy language specifies AAA, and proactively resolve ratings related issues. In the end, the safe-haven status of U.S. government debt may be somewhat tarnished by the deficit negotiations, but will not be lost forever, in our opinion. Although a U.S. ratings downgrade to AA may have more significance than a corporate downgrade, it nonetheless does not necessarily reflect a massive increase in credit risk. Looking beyond the painful market adjustments in risk perceptions, we believe U.S. Treasuries will continue to have a deep, liquid and functioning market.

---

[1] See the Treasury Secretary's 5/16/2011 letter on the Treasury Department's website: http://www.treasury.gov/connect/blog/Documents/20110516Letter%20to%20Congress.pdf

[2] Jeanne Sahadi, Debt ceiling FAQs: What you need to know, CNNMoney.com, 5/18/2011. http://money.cnn.com/2011/01/03/news/economy/debt_ceiling_faqs/index.htm

[3] Michael D. Tanner, What the debt ceiling really means, the Politico, July 11, 2011. http://www.cato.org/pub_display.php?pub_id=13339

[4] Michael McConnell, The debt ceiling is certainly not "unconstitutional", Advancing a Free Society, July 4, 2011. http://www.advancingafreesociety.org/2011/07/04/the-debt-ceiling-is-certainly-not-unconstitutional/

[5] See the Fitch Ratings commentary Think the unthinkable – What if the debt ceiling was not increased and the U.S. defaulted? June 8, 2011. http://www.fitchratings.cl/Upload/thinking%20the%20unthinkable.pdf

[6] Moody's Investor Service Global Credit Research: Announcement: Moody's Place U.S. Aaa government bond rating and related ratings on review for possible downgrade. July 13, 2011. Standard & Poor's Research Update: United States of America "AAA/A-1+" ratings placed on CreditWatch Negative on rising risk of policy stalemate, July 14, 2011.

[7] See Moody's Special Comment: Implications of a U.S. rating action for other Aaa issuers, June 29, 2011. Moody's Special Comment: Implications of a U.S. rating action on the ratings of U.S. financial institutions, July 13, 2011. Standard & Poor's Special Report: U.S. negative CreditWatch placement and the knock-on effects, July 18, 2011.

[8] Matt Phillips, Seeking a new haven, the Wall Street Journal, July 18, 2011.
http://online.wsj.com/article/SB10001424052702304223804576448541070417826.html?mod=WSJ_Markets_LEFTTopStories

[9] Sudeep Reddy, IMF cites U.S. debt risks. The Wall Street Journal, July 25. 2011.
http://online.wsj.com/article/SB10001424053111903999904576467992755434916.html