DiNuzzo Investment Advisors, Inc.

FEE-ONLY WEALTH MANAGERS

Interim Market Correspondence
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America's Tarnished Credit Rating

Is our country going to start getting calls from debt collection agencies, or have to check its credit reports periodically? Here's a funny video of how the rest of us have to handle debt problems: http://www.youtube.com/watch?v=fujTIOeM2SI

By now, you've probably heard that the Standard & Poor's debt rating agency has downgraded all U.S. government debt with more than a year of maturity, from the top AAA rating down to AA+. To put that in perspective, now only 17 countries enjoy the AAA rating on their government bonds. Typically, that means that they are considered the safest havens for cash, and therefore are able to pay the lowest interests rates on their borrowing.

Here's the list, and we've included the current yields on each country's 10-year government bonds in parentheses. This lets you see what the top-rated countries pay on their debt, compared with the 2.34% interest our government has to pay on its 10-year U.S. Treasuries:

France (3.41%), Germany (2.83%), Canada (2.93%), Australia (5.75%), Finland (3.19%), Norway (3.29%), Sweden (2.82%), Denmark (3.06%), Austria (3.30%), Switzerland (1.53%), Luxembourg (NA), Guernsey (NA), Hong Kong (2.29%), the Isle of Man (NA), Liechtenstein (NA), the Netherlands (3.17%), and Great Britain (3.11%).

The first thing to notice is that our U.S. government is still borrowing at very attractive rates compared with the triple-A nations, and Treasury rates actually got better during the angry debate in Washington, as investors continued to beat down our doors to lend money to our government. Why? The downgrade and recent weakness in the stock market have made bond investors nervous, which usually causes them to buy the safest paper they can find. As an Associated Press report notes, the U.S. still offers the deepest and most liquid bond market in the world.

The second thing to understand is that, despite the high levels of government debt, there is really no crisis in the government finances or in the economy. S&P officials made it clear that they were more influenced by the recent messy debate in Congress than the fundamentals of government finance. They may have been particularly rattled by public statements by key members of Congress that it might not be a bad thing if the U.S. government defaulted on its sovereign obligations to its global lenders--sort of like one of us telling the bank that we're thinking seriously about not making any more mortgage payments. David Beers, global head of ratings at S&P, said in a supporting statement that the agency was concerned about "the degree of uncertainty around the political policy process." A separate statement by the rating agency said that policymaking and political institutional control had weakened "to a degree more than we envisioned."

Long-term, our government faces some difficult choices. The question now is whether we'll get action from Congress or more political posturing. We'll get an early look between now and Tuesday, as a new

Congressional committee, made up of Democrats and Republicans, will be looking for $1.5 trillion in deficit cuts that have not yet been specified through the debt ceiling compromise. (A total of $917 billion in cost reductions has already been earmarked).

What does all this mean for investors? The investment markets were clearly rattled by the tone and uncertainty of the debt ceiling debate, with the S&P 500 losing 10.8% of its value over the ten trading days of the Congressional standoff. But a Money magazine report points out that when a country loses its AAA rating, that is not always terrible news for the nation's stock market. Canada, for example, was downgraded from AAA status in April of 1993, but the country's stocks gained more than 15% the following year. The Japanese government's bonds were downgraded in 1998, and the Tokyo stock market climbed more than 25% in the next 12 months.

The awful nature of the debt ceiling debate, plus the downgrade, has clearly added fear and uncertainty to an already sluggish economic recovery. The Treasury debt downgrade is a blow to U.S. pride, and a warning to Congress--particularly those representatives who think the U.S. can simply walk away from its obligations without consequences.

However, as the decline in Treasury rates made clear, the downgrade is largely symbolic. Congressional gridlock and partisan posturing could leave us with a long 15 months until the next time we have a chance to vote on their job security. But it might be helpful to think back to last Summer, when concerns about a double-dip recession and mild panic sent the S&P 500 down a long unhappy slide to a low of 1022.58 on July 2, with a few additional bounces along the bottom until a September rally. Investors who sold out of the markets at that time missed significant--and largely unexpected--gains through the Fall, Winter and Spring, as people gradually realized that the world was not coming to an end.

In the short term, emotions rule the market, and they are visibly tilting toward panic right now. Longer-term, the market prices always tend to return to fundamentals, and it's helpful to remember that corporate profits remain strong, new jobs are being added and the economy is still growing. The U.S. markets weathered much worse than this in 2008, in 2000, during the first and second world wars and a lot of panic-stricken times in between. Without the ability to see the future, our best prediction is that the Sun will continue to rise each morning and the U.S. will emerge from this crisis like it has all the others--and reward those who managed not to succumb to the panic like so many did last Summer and so many other inevitable periods of anxiety when things don't go exactly as we'd hoped.

Sincerely,

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