

## Chandler Asset Management

Since 1988

Since 1988, Chandler Asset Management has specialized in the management of fixed income portfolios.

Chandler's mission is to provide fully customizable, client-centered portfolio management, which preserves principal, manages risk, and generates income in our clients' portfolios.

## Why a U.S. Treasury Downgrade Shouldn't Matter for Bond Investors

Standard & Poor's decision on April 18, 2011, to place the United States' credit rating on negative outlook served as a shot across the bow for both U.S. policy makers and investors around the globe. The rating agency assigned a one in three probability that the U.S. will lose its pristine "AAA" credit rating, perhaps in the next 18-24 months. At this point, the prospects for a political compromise that would place the country on a path towards fiscal sustainability and forestall a downgrade appear bleak. Republicans are insistent that the deficit must be narrowed without any tax increases, while Democrats are adamant about not cutting entitlement spending.

Despite the seeming intractability of the two sides' respective positions, investors would do well to remember that, as Winston Churchill famously said, "Americans can always be counted on to do the right thing ... after they have exhausted all other possibilities." In other words, despite how poor the odds of compromise currently appear, there is still a very good chance that policymakers will eventually find a solution that will allow the U.S. to retain its "AAA" rating. In fact, S&P actually affirmed the country's current "AAA" rating, as did Moody's. On the other hand, if the U.S. does indeed suffer a ratings downgrade, the event would undoubtedly prove bruising to the psyche of a nation still reeling from the effects of the financial crisis and Great Recession. Furthermore, a downgrade would trigger

an avalanche of negative commentary from market participants, politicians, and media pundits. All of this chatter will simply be background noise, and it is our belief that this article will demonstrate, a U.S. credit downgrade will ultimately have little real impact on investors.

### Are U.S. Treasuries Junk?

A credit rating is ultimately an indication of the likelihood that bondholders will receive full and timely payment of all principal and interest. A higher rating indicates greater certainty of repayment, and a lower rating less certainty. However, even if the United States is downgraded, we believe that it will not materially impact the country's ability to repay its debt. As the world's reserve currency, the U.S. issues debt denominated in dollars, which means that in a worst-case scenario the government could simply print more money to pay back bondholders. Although this is an extremely unattractive option, it is unlikely that the U.S. reaches a point where it even needs to consider rolling the printing presses.

First, even in the event of a downgrade, the United States would likely carry an "AA" credit rating – one of the highest available and still indicative of exceptional credit worthiness. Second of all, the United States remains the world's largest economy and has one of the world's highest standards of living, a well-educated population, reasonably good

demographics, and a well-established legal and political system. Additionally, if investors are to forsake the U.S., they need a viable investment alternative. With Europe and Japan facing their own issues, and the developing markets still developing, the U.S. is likely to remain the world's premier investment destination. Despite what doom-and-gloom pundits might say, this situation is unlikely to change in decades to come.

Finally, and counterintuitive as it might seem, a credit downgrade might actually help the United States. Ultimately, what matters is not the relative credit rating assigned by rating agencies, but rather the country's ability to pay back its debt. Regardless of any ratings action taken, the United States is currently on an unsustainable fiscal path. If a downgrade can help spur more timely action on some of the structural problems the country faces, such an event might actually prove beneficial in the long run.

### **Should You Be Selling Your Treasuries?**

With all of the bad news about the Treasury market, many investors have recently been asking themselves if they should sell their U.S. Treasuries. Before doing so, it might be wise to consider several points. First, ratings agencies and other prognosticators have been wrong before and many large investors are on record as buyers of U.S. Treasury bonds. In fact, ten-year Treasury yields have fallen by around 40 basis points in the past six weeks, indicating that investor interest is strong.

More importantly, although some institutional fixed income investors have wide mandate to invest in nearly any fixed income asset class around the globe, most investors are more constrained and are limited by their investment mandate. For instance, they might be limited to purchase only domestic fixed income or only bonds rated "A" or better. Additionally, many institutions have structural reasons for purchasing Treasuries; for example, bank capital requirements encourage holding a certain percentage of Treasuries. This preference for holding "safe" assets has only been reinforced by the ongoing efforts at financial reform. These structural considerations greatly restrict the

available investment choices for many investors while also ensuring that there will continue to be a built-in investor base that purchases Treasuries.

In the end, an average high-quality fixed income investors' options are primarily limited to government bonds, government agency bonds, high-grade corporate bonds, and certain mortgage and asset-backed securities. For most of these investors, U.S. Treasury bonds should remain the safest possible investment alternative, regardless of what credit rating the U.S. carries. Furthermore, in the event that Treasuries are downgraded, many other instruments that receive implied or explicit rating support from the U.S. government might also be downgraded; including: government agency bonds, mortgage backed securities, and perhaps, the bonds of large banks whose ratings are currently enhanced by implied government support.

Finally, regardless of any ratings actions, the Treasury market will likely remain the most liquid fixed income market in the world. This liquidity is one of the primary reasons that foreign investors such as the Chinese government purchase Treasuries in the first place. Simply stated, not many other markets around the globe are capable of absorbing the huge amounts of money seeking a high-quality, low-risk outlet. This liquidity component is often demonstrated during times of market crisis, when investors generally bid up the price of Treasuries in a flight to quality. The dual characteristics of safety and liquidity are somewhat unique to Treasuries and represent a compelling argument for why they will continue to form an important component of many investment portfolios.

### **Tactics Versus Strategy**

Speculation about a U.S. downgrade, or its actual occurrence, will likely have an impact on Treasury trading over a period of days or perhaps even weeks. However, in the longer term, this impact will be outweighed by market moving events, such as the economic cycle, the level of inflation and inflation expectations, and Federal Reserve monetary policy. The price of Treasuries will rise and fall across market cycles just as they

always have, but any re-pricing that results from a credit downgrade is likely to be both minimal and transitory.

Savvy investors might try to time the market, and selling Treasuries at this point could be the right thing tactically (during the current market cycle) while still being incorrect strategically (over the life of your investment program.) Of course, selling Treasuries now requires the impeccable timing needed to repurchase them at precisely the right moment; some investors may be fortunate enough to have this timing, but it is a rare skill and the opportunity cost is high for those that get this wrong. For that reason, most investors are well advised to maintain their strategic allocation to U.S. Treasuries rather than abandoning them as part of a tactical market call.

### **Conclusion**

A U.S. credit rating downgrade would undoubtedly hurt the nation's pride while unleashing a torrent of negative publicity, both domestically and abroad. Nevertheless, the real impact on investors would most likely be decidedly muted, particularly in the longer run. Treasury securities have a built-in investor base that has few investable alternatives, and those that do exist would likely be downgraded in line with Treasuries. Furthermore, even with an "AA" credit rating, U.S. Treasuries would remain among the safest, most liquid securities in the investment world.

In the end, it is possible that interest rates on Treasuries may rise, but this is far more likely to occur due to stronger economic growth or tighter monetary policy than as a result of any ratings actions S&P or Moody's might take. Regardless of headlines, Treasuries are set to remain the foundation of investment-grade fixed income portfolios for decades to come.

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### **RISKS AND OTHER IMPORTANT CONSIDERATIONS**

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