



Rational Reaction

DEBT DOWNGRADE

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Background

Late Tuesday afternoon, Fitch Ratings downgraded the credit rating of the US government from AAA to AA+. The US hasn't had a credit downgrade in over a decade, going back to August 2011 when S&P downgraded the US on the back of a politically contentious debt ceiling standoff. In their announcement, Fitch cited the forecasted fiscal situation over the next three years, overall debt levels, and the "erosion of governance...over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions."

The immediate market reaction through the first half of trading on Wednesday was mild, with yields on 10-year government bonds rising about 10 basis points before giving up some of that increase and the S&P 500 falling about 1.4% from the day prior. When S&P downgraded US debt in 2011, equity markets pulled back more significantly in a period of volatility that lasted a few months. However, the debt standoff was much fresher in investors' minds and the economy was still recovering from the Global Financial Crisis with unemployment at 9.0%.

DEBT STANDOFF LED TO US CREDIT RATING DOWNGRADE ON AUGUST 5, 2011

S&P 500 cumulative price changes, December 31, 2010 to December 31 2012



IMMEDIATE IMPACT

The S&P 500 began trending down before the downgrade and was flat on a year-to-date basis two days before. Over the next few days, the S&P 500 fell nearly 11%, and it finally fell by over 12% over the next two months.

MEDIUM-TERM IMPACT

Equity volatility continued throughout the summer and the S&P 500 didn't regain the losses consistently until the end of 2011.

While the bout of volatility was unwelcome, the impacts were relatively short-lived.

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Looking Ahead

As we saw in the market the morning after the announcement, there may be some mild gyrations in capital markets, but we don't anticipate lasting impacts. Rating agencies' assessment alone won't change the direction of the economy or corporate earnings, though they can (not will) have mild and temporary impacts on investor sentiment. Any lasting impact would likely come from a downward turn within hard data, whether that's economic softening or a negative surprise in earnings.

The bottom line is Fitch's announcement is noteworthy and may insert a bit of short-term volatility into markets, but it is unlikely to have a lasting impact. Each issue Fitch raised in their announcement is something the market has been grappling with for some time. For example, the fallout related to the debt ceiling standoff was something markets dealt with during the height of the latest debt ceiling standoff a few months ago and, at least for now, is not a major concern across the economy or market. However, it is nearly certain that more political standoffs around the debt ceiling lie ahead at some point.

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