



Downgrade of U.S. Treasury Debt

After the close of the markets on Friday, August 5, 2011, Standard & Poor's (S&P) announced they were downgrading the credit rating of U.S. Treasury debt to AA+ from AAA. This marks the first time since before World War II the U.S. has not had a AAA rating.

S&P is considered one of the three primary credit rating agencies in the country. The other two are Moody's and Fitch. Moody's has already reaffirmed their highest rating for U.S. Treasury debt, while Fitch has stated that they will complete their evaluation by the end of August. Therefore, at this time Treasury debt is considered split-rated, having different ratings from the rating agencies.

In the short-run, investors will view this split rating as a technical device to maintain compliance with policy guidelines, but it is probable that one or both of the other rating agencies could follow S&P's move in the near future if significant progress is not made regarding the level of spending and reduction in debt levels.

S&P's Rationale

In explaining their decision, S&P emphasized their concern regarding the ineffectiveness of Congress to deal with the debt issue on a forward looking basis, as opposed to concerns with regard to being able to service the debt in the near term. Further indication of this position is that they did not downgrade the rating of short-term Treasury Bills, which remain at A-1+.

Initial Ramifications

The way Treasury securities will be viewed as part of bank reserves, the reaction of investors within money market funds, international investor behavior and the effect on the dollar, and the response by institutional investors based on in-place management guidelines may have impacts to varying degrees and directions on the pricing of U.S. Treasury debt after the downgrade. Once these forces have time to find an equilibrium level, it will be easier to assess the long-term cost of the downgrade.

The Federal Reserve issued a statement almost immediately after the downgrade that "the risk weights for Treasury securities and other securities guaranteed by the U.S. government, government agencies, and GSE's will not change" as related to the required reserves held by banks. This position by the Fed will mitigate the short-term impact on banks' ability to extend credit, which is necessary given the economy's current weak status.

Money markets should be less negatively affected since the short-term rating was maintained. Longer-term government bond yields may increase relative to short-term treasury yields (the 5-year yield has dropped from 2.4–1.2% over the past six months) as investors shorten the maturity of their government debt exposure.

Foreign holders of our government debt may diversify to other investments, driving yields up on U.S. debt and putting downward pressure on the dollar, if not immediately, then systematically over time. China, our largest creditor, has already

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signaled this will be their stance. Offsetting this influence in the short-run is the very real pragmatic problem of where else to invest such large sums of capital. With similar or worse economic conditions elsewhere in the world and less capacity to absorb the significant level of capital flow, this movement should take place over time as opposed to immediately. Nevertheless, this flow of capital to other investments around the world may drive our cost of capital upward, which would result in a larger deficit problem and slower economic growth. It is this impact to our economic growth potential that is the real long-term cost of the downgrade.

Institutional investors will need to reassess their investment manager guidelines with regard to the limit of holdings of U.S. Treasury debt and the average credit quality of their portfolio. As an example, if an investor has a guideline that the average credit quality of their bond portfolio must be AA or better, then the downgrade of U.S. Treasury debt may force the manager to actually hold more Treasury bonds than desired to meet this average quality constraint. In order to do this, they would need to sell other credits within the portfolio, potentially taking unnecessary losses to meet the requirement.

Practical Considerations

The M Wealth Model portfolios have exposure to five mutual funds, the PIMCO Real Return Fund, Vanguard Limited Term Tax-Exempt Fund, Vanguard Intermediate Term Tax-Exempt Fund, PIMCO Low Duration Fund, and the PIMCO Foreign Bond Fund. The quality guidelines for the PIMCO funds are broad enough in scope that the manager can continue to manage these funds effectively without changes to the guidelines related to the credit quality within each fund.

Both of the Vanguard tax-exempt funds have the same credit quality constraints: “At least 75 percent of the securities held by the Fund are municipal bonds in the top three credit-rating categories as determined by a nationally recognized statistical rating organization (NRSRO) (e.g., Aaa, Aa, and A by Moody’s Investors Service, Inc.). No more than 20 percent of the Fund’s assets may be invested in bonds in a medium-grade category as determined by an NRSRO (e.g., Baa by Moody’s). The remaining five percent may be invested in securities with lower credit ratings or in securities that are unrated.” Vanguard should be able to manage these constraints in light of the current downgrade without revision to the guidelines.

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