THE OMNIVEST MARKET VIEW

US Rating Agencies Still Behind the Curve

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While Washington is trying to avoid both a default and a credit rating downgrade by the US-based rating agencies, we remain concerned as to why they have waited this long to consider a potential downgrade. Nearly any other country that watched their deficits increase by over ten-fold over 10 years would have almost assuredly been downgraded early in the process. In 2001, the US sported a budget surplus of $127.3 billion and it is estimated that this year's deficit will reach $1,650 trillion.

To put this increase in perspective, the highest deficit to GDP ratio (post second world war) was 6% in 1983. For the past 3 years, our deficit to GDP ratio has been above 10%. Despite all of the promises to reduce deficits, there appears to be very little willingness to actually take decisive actions by either party.

It is our belief that the US will escape the near term problem posed by the debt ceiling with no more than a "selective" default at worst. However, we believe that a downgrade of US Treasury debt is inevitable, and in some ways, the US has already occurred.

Global investors have used the currency markets to display their displeasure towards the growing deficit problems in the US. Since the US posted a budget surplus in 2001, the US dollar has fallen by 39%. This decline is considerable, especially considering that the two largest holders of US debt behind the Federal Reserve have been Japan and China. As a result, these large holders of US debt have continued to expose themselves to dramatic currency losses.

It is understandable that foreign investors have been losing confidence with the US's ability to deal with its debt issue. China's Dagong Global Credit Company initiated coverage of sovereign debt globally in July of 2010 and downgraded the US to a AA- rating and placed US paper on negative watch. In November of 2010 this same rating agency lowered the credit rating of the US again to A+ and left its credit rating on negative watch for further downgrades.

At some point, the US rating agencies will begin to downgrade the debt of the US government with obvious consequences to global investors. First, Treasury yields will adjust to a lower rating but the degree of adjustment is unknown. After all, we all know that Treasury yields have been held artificially low as a result of QE1 and QE2.

US Government sponsored agencies will lose their implied AAA rating. Municipal debt which has been secured with Treasury securities will also see their values decline. Also, the Treasury yield curve should steepen, as long as the Fed keeps interest rates near zero.

Mortgage rates would be expected to rise but not by the full increase of Treasury yields. The secondary mortgage market would be expected to undergo a significant price adjustment as GNMA securities reset to a lower price.

AAA-rated money market funds would also be downgraded to match the rating for US government debt. The use of the Treasury market as a risk-free benchmark for US investors would likely be unchanged, unless the US suffers a series of downgrades. However, global investors will likely shift from the US to the German or the Swiss market for future benchmarking.

What should investors do?

- First and foremost, all borrowers should lock in long-term fixed loans to secure favorable funding.
- Investors that have been sheltering their liquid investments in the safety of Treasury bills and agency funds should shift out of government only funds.
- Long-term oriented investors should consider the merits of diversifying country risk and currency risk by reducing US exposures.

It is not an accident that developed countries are struggling with excess debt burdens. One common problem shared by these countries is an ageing population with underfunded long term liabilities. Many emerging countries have been able to avoid the impact of spiraling growth in their sovereign debt and have much better demographic characteristics. As such, investors should consider the long-term value of investing in assets of emerging market countries.

Investing in real assets should also benefit as the world grapples with the potential loss of the AAA rating of the world's largest economy. In this instance, gold should continue to appreciate.

Investors in private sector assets (ie: stocks and corporate bonds) may suffer from a temporary negative price reaction but we would expect a full rebound as private sector assets are deemed to be of higher value than the public sector (ie: government debt). In other words, a drop in the value of stocks would be viewed as a buying opportunity. Should investors sell stocks in advance? No, because the current price decline may have been sufficiently steep to satisfy those investors looking for a large market pullback.

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