

RIVERPOINT

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STANDARD & POOR'S PUTS WASHINGTON ON NOTICE

Restoring our country's fiscal health will be no easy task for our leaders in Washington.

Standard and Poor's recently placed the credit rating of the US on negative outlook, causing quite a stir in the process. But why? Coming off the "Great Recession" and loaded with debt, it's no secret that our country is slogging a tough path back to financial health.

Technically speaking, what S&P did is completely understandable. Officially, their analysts lowered the outlook on US debt from "stable" to "negative." In the grand scheme of things, an outlook change is like a slap on the wrist. This is like a parent telling their child on Halloween: "if you keep eating this much candy, your teeth will fall out." While true, it's highly unlikely that a child will maintain Halloween-level candy consumption for an extended period of time. If the borrower's situation doesn't improve over the next several quarters, the rating agency changes its negative outlook rating to "negative credit watch." If, over time, the borrower still hasn't taken corrective action or improved its situation, S&P will downgrade the credit rating.

Without question, a downgrade from AAA would put a massive dent in the reputation of the US as the "safe haven" for global investors. The perception that the US will always – ALWAYS – pay back its debts is one of the reasons that our government is able to operate the way it does. The assumption that the US will always pay back its debt allows it to borrow money at rates lower than anyone else in the world, which in turn allows our government more flexibility in pursuing economic growth. Even the slightest downgrade would put our status as a "safe haven" in serious jeopardy, which would lead to broad-based selling of US bonds and dollars. This sell-off would drive interest rates higher.

But higher rates on government bonds may only be the tip of the iceberg. Losing investors' faith that US securities are as good as cash would make it more difficult for our government to raise funds in the capital markets, which in turn would make the job of financing the government budget even more challenging. Borrowing costs for corporations and individuals would also rise, as most lending rates are tied to the rates on Treasury bonds. In simplistic terms, a credit downgrade for the US would make everything more expensive and difficult for everyone – the government, corporations, and individuals alike.

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We don't think that the USA will lose its AAA credit rating.

In our opinion, the US will not lose its AAA credit rating. S&P noted that “some compromise (between the Obama administration and House Republicans) that achieves agreement on a comprehensive budgetary consolidation program – containing deficit reduction measures... combined with meaningful steps toward implementation by 2013 – is our baseline assumption and could lead us to revise the outlook back to stable.” Standard & Poor’s is not breaking any new ground here – everyone that reads the paper or watches the news knows that America’s current fiscal condition is untenable and Washington needs to take steps to correct it. To us, this is a truism that breaches party lines and is a reality that needs to be embraced by our lawmakers. While Democrats and Republicans differ on how to achieve this goal, the goal is the same and that gives us confidence that some agreement will be in place in order to save our country’s AAA credit rating. Recently, the outlook on the United Kingdom’s AAA credit rating was downgraded to “negative;” within months, it was placed back at “stable.” The size and scale advantages that the US economy has over the UK’s give us comfort that the US will achieve a similar reversal in outlook.

Raising taxes won't be enough to solve our country's financial problems – budget cuts will be a necessity.

While the need for fiscal repair is obvious, getting the work done will be difficult. Regarding the budget deficit, tough decisions will have to be made concerning many government programs. We believe that tax hikes alone will not be enough – that budget cuts will also be necessary. According to a recent editorial in the *Wall Street Journal*, the top 1% of earners in America made over \$380,000 each in 2008. Raising the tax rate on this top 1% of earners to 100% – thus handing all of their income to the government – would raise \$938 billion. Such a move would cover a little more than half of the current \$1.7 trillion annual budget deficit. Extending that 100% tax to the top 10% of earners – those making more than \$114,000 – would bring in \$3.4 trillion for the government. While such a tax would theoretically cover our annual deficit, it is not an acceptable solution. Clearly, raising taxes on top earners won’t solve all our ills. Budget cuts are needed, too.

Budget concerns aren’t the only issue our economy faces. The US dollar has been declining since 2002, threatening our status as the “safe haven” currency.

US Dollar Index
March 1996 - April 2011



There are two main reasons for the declining dollar: low interest rates and relatively slow economic growth.

There are two main reasons for the decline in the greenback – low interest rates and relatively slow economic growth. Interest rates in the US have been falling for years, causing investors to sell their dollar-denominated securities in favor of foreign securities. Similarly, investor capital has been flowing from the US (and other developed economies) into faster-growing emerging economies. These two factors have lowered the demand for US dollars, causing a decline in value. While a declining dollar makes US exports more competitive in international markets, it also has driven other nations to consider retaliatory action against the US. China, which is the largest foreign holder of US government debt, has threatened to reduce its holdings should the US continue to allow the dollar to depreciate. Such a move would cause interest rates to rise and potentially slow the US economic recovery.

The potential for inflation is lurking in the shadows, with rising oil prices taking a toll on both corporations and consumers. The Federal Reserve, on the other hand, has indicated its belief that long-term inflation expectations are under control. In its most recent policy meeting, the Fed announced that it will allow “QE2” (its rate-lowering government bond purchasing program) to expire in June. This signals that: a) the Fed is comfortable that the economic recovery is on fairly solid footing and the labor market is improving, and b) inflationary pressures are relatively tame and less likely to send long-term interest rates shooting higher. We agree with the Fed that long-term inflation pressures remain at bay – the recent rise in energy prices is due to uncertainty in the Middle East and not supply / demand imbalances; the job market is still weak enough that wage inflation is not a threat; and there is enough capacity in the economy to keep manufacturers from having to raise prices.

At this point, political bickering is the biggest risk to our nation’s economic recovery. Corporations are reporting solid profits for the first quarter, an indication of continued recovery and expansion. The issues that face our nation are clear – debt reduction, a more balanced budget – but these can only be solved through genuine collaboration. As Warren Buffett says, “It’s never paid to bet against America.” We remain conservative in our asset allocation because of all of this and are unlikely to change this position in the coming months. As always, feel free to call a RiverPoint professional if you have any questions.

“It’s never paid to bet against America” – Warren Buffett
