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The Impact of U.S. Credit Rating Downgrade

S&P, which has given the U.S. a top AAA ranking since 1941, said on July 14 that the chance of a downgrade is 50% in the next three months and may cut the rating as soon as August if there isn't a "credible" plan to reduce the nation's deficit. S&P has "set out a very clear timetable" that may lead to a U.S. downgrade and "will be accountable whether it sticks to that or not." Pacific Investment Management Co.'s Mohamed El-Eraï said. It seems that U.S. can avoid a default, but downgrading of the credit rating is inevitable. So, what will happen when it comes true?

According to the Alliance Bernstein's report released on June, U.S Treasuries are not likely to see a large increase in yields simply due to a rating downgrade. To assess the impact of downgrades on a country's risk premium, they analyzed the interest-rate spreads of countries that had suffered ratings downgrades of one to three notches over the past two decades. They defined the spread as the difference between a country's sovereign yield and the yield on either U.S. Treasuries or German bunds and they looked a variety of time periods, including the six months before the downgrade.

It was found that the spread change for highly rated countries tended to be very modest. For countries downgraded to AA+, the average spread barely changed – in fact, on average it narrowed about three basis points in the six months before the downgrade. In the two to six months after the grade, spreads were six to twelve months before the downgrade. For example, when Moody's downgraded Canada from Aaa to Aa1 in June 1994, there was a short-term yield increase in the month immediately following the downgrade. The 10-years yields rose from 8.8% to 9.29%. However, the spreads then moved back toward their normal range by August, approaching levels seen before the down grade.

JPMorgan Chase & Co.'s Terry Belton expect a U.S. credit-rating cut would likely raise the nation's borrowing costs by increasing Treasury yields by 60 to 70 points over the medium term while the short term effect would be about 5 to 10 basis points because few asset managers would be forced to sell Treasuries. He also forecast that the downgrade may cost \$100 billion a year.

To see what will happen in the bond market, we need to consider the diverse pool of investors who own Treasury securities. Foreign holdings make up the largest share of outstanding Treasury security holdings (about 46% as at Q1, 2011) and more than three quarters of it is held by foreign official institutions. This would include foreign sovereign wealth funds and central banks.

Will they dump Treasury securities shortly? We don't think so. There are no viable alternatives for official foreign institutions that offer the liquidity and stability of U.S. dollar-denominated Treasury securities – Japan's debt market is huge, but its fiscal outlook is much poor than U.S., it would take time for the European sovereign bonds (or E-bond) to grow and earn a respectable reputation among international investors, the size of bond markets in other AAA-rated countries like Germany, Canada, Norway, Australia, Singapore, etc are too small as well.

We expect the second largest buyer - the Fed (keep 14% holdings), would take measures to stabilize the bond markets when necessary. They would also keep the status of the collaterals (i.e. Treasury securities) unchanged for the loans to prevent the surge in borrowing costs.

How about the retirement funds? Wells Fargo Securities said investment policies of the funds vary on a case-by-case basis, but not all of them required by law to hold AAA-rated securities. Money market funds, which invest only in short-term, highly liquid securities that present minimal credit risk, will be most affected by the downgrade. According to U.S. Investment Company Institute, a money market fund's ability to purchase or hold a

a rated security depends on the issuer’s short-term credit rating (Table 1)

Credit rating agencies would have to cut their ratings on short-term U.S. government securities steeply – by an amount roughly equivalent to eight steps on the long-term rating scale – to force the money market funds to dispose of their holdings in U.S. government debt. A downgrade of U.S government short-term debt from First Tier to Second Tier would not preclude money market funds from purchasing or holding U.S. government securities. Nor would it require money market funds to sell their current holdings of Treasury and other government securities.

In addition, SEC Rule 2a-7 requires a money market fund to dispose a security that is no long eligible (i.e. First Tier or Second Tier) or has defaulted as soon as practicable consistent with achieving an orderly disposition,” unless the board finds that disposal of the security would not be in the best interests of the fund. (Fund manager might stop selling the securities if the prices are too low or market is too volatile)

If the downgrade is caused by default or temporary-default, market would slump. However, if the credit rating agencies do it because they don’t satisfy with the budget-cutting plan, the negative impact would be much lower. We think the second case is more likely.

Money market fund category	Moody’s		Standard & Poor’s		Fitch		
	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Eligible securities	First Tier	Aaa		AAA		AAA	
		Aa1		AA+	A-1+	AA+	F-1+
Eligible securities	Second Tier	Aa2		AA		AA	
		Aa3	P-1	AA-		AA-	
Eligible securities	Third Tier	A1				A+*	
		A2*		A+	A-1	A	F-1
Eligible securities	Third Tier	A3*		A*		A-*	
		A2*		A-	A-2	BBB+	F-2
Ineligible securities	Third Tier	Baa1		BBB+		BBB	
		Baa2*	P-2	BBB*		BBB*	
Ineligible securities	Non-investment grade	Baa3	P-3	BBB-	A-3	BBB-	F-3
		Baa3		BB-		BB-	
Ineligible securities	In default	Ba1 to B3		BB+* to		BB+ to B-	B
		Caa1 to Ca	Not Prime	CCC*	B	CCC to C	C
Ineligible securities	In default	C	Not Prime	B* to CC	C		
				SD, D	SD, D	RD, D	RD, D

**Due to the inherent complexities in comparing long-term risks with short-term risks, all three agencies allow some overlap in rating categories.
Sources: Moody’s Investor Services, Standard & Poor’s Global Credit Portal, Fitch Ratings, Bank for International Settlements*

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