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Self-Inflicted

The stock market continues to reflect the fears of investors worldwide to the debt pressures of the developed economies. Today the Dow Jones fell 635 points, and the S&P 500 fell 6.7%. These sobering declines are on top of a series of losses registered in 9 of the past 10 business days. The drop in equities has been rapid, persistent and painful - we all feel the pain.

By now, you have likely heard the news that the Standard & Poor's debt rating agency downgraded all U.S. government debt with more than a year of maturity, from the top AAA rating down to AA+. This is remarkable, and some (Warren Buffet among them) would argue unjustified. To put this downgrade in perspective, there are now only 17 countries that enjoy a AAA rating on their government bonds. This generally means that they are considered the safest havens for cash, and therefore are able to pay the lowest interests rates on their borrowing.

The AAA list includes Australia, France, Austria, Norway, Denmark and Great Britain, all of which pay higher, not lower, rates than the U.S. Only Hong Kong and Switzerland have lower rates. Ironically, U.S. Treasury rates have actually gotten lower during the weeks of angry debate in Washington and even today (after the credit downgrade), as investors continued to lend money cheaply to our government. Why? The weakness in the stock market has made bond investors nervous, which usually causes them to buy the safest paper they can find. As an Associated Press report notes, the U.S. still offers the deepest and most liquid bond market in the world.

The second thing to understand is that, despite the high levels of government debt, there is not an immediate crisis in our government's finances or in the economy. S&P officials made it clear that they were more influenced by the recent messy debate in Congress than the fundamentals of government finance. They may have been particularly rattled by public statements by key members of Congress that it might not be a bad thing if the U.S. government defaulted on its sovereign obligations to its global lenders--sort of like one of us telling the bank that we're thinking seriously about not making any more mortgage payments. David Beers, global head of ratings at S&P, said in a supporting statement that the agency was concerned about "the degree of uncertainty around the political policy process." A separate statement by the rating agency said that policymaking and political institutional control had weakened "to a degree more than we envisioned."

Long-term, our government faces difficult choices. The question now is whether we'll get action from Congress or more political posturing. Perhaps we'll have a better understanding when we see how the new Congressional "super-committee" operates. Made up of an equal number of Democrats and Republicans, they will be looking for $1.5 trillion in deficit cuts that have not yet been specified through the debt ceiling compromise. (A total of $917 billion in cost reductions has already been earmarked). This may not create a "fix" for our many economic challenges, but it would be a meaningful step in the right direction. Our fragile economic recovery hangs in the balance.

What does all this mean for investors? The investment markets have clearly been rattled by the tone and uncertainty of the debt ceiling debate, along with the downgrade of our country's debt obligations. The market's precipitous losses are evidence of that. But it's also worth noting that when a country loses its AAA rating, the nation's stock market does not

always fall into a long-term decline. Canada, for example, was downgraded from AAA status in April of 1993, but the country's stocks gained more than 15% the following year. The Japanese government's bonds were downgraded in 1998, and the Tokyo stock market climbed more than 25% in the following 12 months.

The discomforting nature of the debt ceiling debate, plus the downgrade, has added fear and uncertainty to an already sluggish economic recovery. The Treasury debt downgrade is a blow to U.S. pride, and it is a warning to Congress--particularly those representatives who think the U.S. can simply walk away from its obligations without consequences.

However, as the decline in Treasury rates made clear, the downgrade has limited economic effect in the bond markets. The U.S. can still borrow very cheaply, for now. You may remember that last summer there were rampant concerns about a double-dip recession. Mild panic sent the S&P 500 down a long unhappy slide to a low of 1022 on July 2 (we are at 1,120 now), with a few additional bounces along the bottom until a September rally. Investors who sold out of the markets at that time missed significant--and largely unexpected--gains through the Fall, Winter and Spring, as people gradually realized that the world was not coming to an end.

In the short term, emotions rule the market, and they are visibly tilting toward panic. Longer-term, we know that market prices reflect company fundamentals, and it's reassuring to remember that corporate profits have been, and continue to be, strong. Throughout these volatile times, Lodestar has been pro-active in addressing the risk in client portfolios, using a range of tools to reduce the negative impact of painful market shifts. We will continue to do our best to keep you on a sustainable long-term path, and we are available should you need a confidence boost. If you feel the need, call us.

Sources:

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