

# Bond Market Perspectives

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### Highlights

U.S. Treasuries may still lose their AAA rating in coming weeks and months even if politicians agree to raising the debt limit.

A Treasury downgrade poses risks to the broader taxable bond market as well as the municipal bond market.

In our view, a downgrade of U.S. Treasuries is not fully priced into the bond market, but we believe such an event may have only a modest impact on the U.S. bond market.

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## Life Without a AAA Rating

The bond market is beginning to ponder just what life would be like without a AAA rating on Treasuries. In July 2011, all three of the major ratings agencies—Moody's, S&P, and Fitch—placed the AAA rating of Treasuries on watch for a downgrade due to the risk that the debt limit may not be increased before the August 2 deadline. If an agreement is not reached in time, which we view as highly unlikely, we still believe the Treasury will be able to service its debt obligations (see last week's *Bond Market Perspectives*) but will likely result in a ratings downgrade even if temporary. Although President Obama and Congress remain at odds over how to resolve the debt ceiling impasse, we continue to believe that a deal will be struck before the August 2 deadline.

However, even if politicians come to an agreement over raising the debt limit (as we expect), Treasury bonds may still be downgraded in coming weeks and months. The rating agencies have been critical of the rising debt burden of the United States for some time now and the need for budget deficit reduction in order to maintain the top AAA rating. Of the three major ratings agencies, S&P has taken a harsher tone stating that it would like to see meaningful steps to reduce the long-term deficit in order to avoid a ratings downgrade. With the August 2 deadline merely one week away, time is running out, and the odds of more substantial budget reductions being implemented in time are dimming. S&P may therefore downgrade Treasuries in coming weeks or months after it reviews any debt deal.

In the event of a downgrade, bond market reaction may be muted. Prior sovereign downgrades have elicited a minor market reaction [Chart 1] but context is very important. The rise in Japanese government yields in November 1998 was in response to the fading of risks following peak of the Asian crisis which led to investor outflows from all Asian government bond markets. Following the 2001 downgrade of Japanese government debt, Japanese government bond yields declined along with other government bond yields in response to recession and reduced inflation risks—the classic drivers of bond yields.

Spanish government yields did increase following the initial downgrade and resumed rising several weeks after Moody's downgrade. We view Spain differently and context is important here as well. The United States is not as debt burdened (debt relative to the size of the economy as measured by GDP) as Spain. In addition, the monetary flexibility of the Federal Reserve compared to the European Central Bank (ECB) and European



Union (EU) nations is a positive, as is the stronger growth trajectory of the U.S. economy in 2011. Therefore, a downgrade would not necessarily spark a sharp, quick sell-off in Treasuries and, in fact, market reaction may be limited. Over time, however, we expect modest upward pressure in yields until investors see improvement in underlying credit quality conditions but this impact may be more than offset by bond market reaction to changes in economic growth and inflation.

### 1 Prior Bond Market Reaction to Sovereign Downgrades from Triple-A to Double-A

Date	Country	Ratings Agency	1 Week 10-Yr Government Yield Change (%)
Jun-94	Canada	Moody's	- 0.14
May-98	Italy	S&P	+ 0.03
May-98	Spain	S&P	+ 0.03
Nov-98	Japan	Moody's	+0.14
Feb-01	Japan	S&P	- 0.03
Jan-09	Spain	S&P	+ 0.33
Sep-10	Spain	Moody's	- 0.09
<b>Average 10-Yr Government Yield Change</b>			<b>+ 0.03</b>

Source: LPL Financial, Moody's, S&P 07/26/11

In the event of downgrade, Fannie Mae, Freddie Mac, and Ginnie Mae Mortgage-Backed Securities (MBS) and agency debt would likely also be downgraded. So far neither the MBS nor agency market is showing concerns with a potential downgrade as yield differentials to Treasuries have remained relatively stable.

We do not foresee forced liquidation of Treasuries or other government debt as a result of a downgrade. Based upon a sample review of mutual fund prospectuses and a few institutional client surveys, many large investors are stipulated to hold "government debt" without specification to rating. Many are required to maintain a bond portfolio with a minimum average rating. Should Treasuries get downgraded, investors' forced to sell holdings in order to meet minimum rating criteria for their portfolios could sell any bond not necessarily government bonds in order to achieve a target average rating.

There are certainly risks posed by a potential downgrade of Treasuries. A downgrade could impact roughly \$18 trillion in bonds including affected Treasuries, agency debt, and government related MBS. The downgrade of Treasuries alone could impact liquidity in the Treasury market, which in turn could reverberate to other sectors of the bond market. Moody's has also warned that the municipal bond market may be impacted. The 15 AAA-rated states could be subject to a modest downgrade if Treasuries were downgraded, as may other municipal debt more directly tied to the Federal government. In sum, investors may demand higher yields, which would exert modest downward pressure on prices, as compensation if they deemed the credit quality change long lasting.

We certainly hope a downgrade is avoided given the potential risks noted earlier but ultimately do not view a downgrade as overly problematic for



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the bond market. Our base case is for a limited reaction over the near term based upon historical precedent and the differences between the U.S. and smaller indebted peripheral European countries currently under market scrutiny. In addition, for many global investors, a downgrade may not come as a surprise. Ratings agencies are politically influenced and this perhaps explains why China's rating agency, Dagong, downgraded Treasuries to AA one year ago and Germany's Feri EuroRatings service downgraded Treasuries to AA in June. Furthermore, Moody's has taken a softer tone to Treasuries and provided an 18- to 24-month time frame to evaluate potential long-term deficit reduction plans. Therefore, any downgrade may result in a "split-rating" where ratings agencies may rate the same bonds differently. Such an outcome would likely soften the potential impact and help the market transition to a new rating.

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#### IMPORTANT DISCLOSURES

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Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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