INVESTMENT STRATEGY COMMENTARY

THE U.S. DEBT DOWNGRADE: IT'S THE INDIRECT EFFECTS THAT MATTER

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Late on Friday, August 5, Standard & Poor's lowered its long-term sovereign credit rating on the United States to AA+ from AAA and affirmed its A-1+ short-term rating. S&P cited its view that the fiscal consolidation plan recently agreed to in Washington falls short of stabilizing the government's debt levels over the medium term. Additionally, it cited a deteriorating political process in Washington. The Treasury Department contends the work was flawed as it believes S&P made a $2 trillion error in its calculations, which S&P has apparently acknowledged. We did note in our August 2 commentary, *The Debt Ceiling Deal: Hold the Applause,* that the debt ceiling deal left the United States vulnerable to downgrade, but this has happened sooner than we or the market expected. We believe the direct impact on U.S. Treasury rates will be negligible over the near term (and rates have actually fallen in trading intra-day today), with a longer-term potential rise in long-term borrowing costs of 0.25% - 0.50% due to the downgrade to AA+. Our concerns are more on the indirect effects of the downgrade – if S&P applies this same logic to other sovereign issuers, additional downgrades could follow.

EXHIBIT 1: DOWNGRADES HAVE MIXED IMPACT

HISTORICAL REACTIONS TO TRIPLE-A RATING DOWNGRADE

Country	Bond Rating Agency	Date	Local Stock Market Index Performance (%)			10 Year Government Debt Yield Change (%)		
			1 Week	3 Months	1 Year	1 Week	3 Months	1 Year
Australia	Moody's	9/10/86	+0.8	+18.4	+86.6	-0.10	-0.20	-1.15
Australia	S&P	12/6/86	+1.0	+16.1	-6.8	-0.05	+0.40	-0.45
Canada	CBRS*	4/28/93	+2.4	+6.6	+19.0	-0.30	-0.50	+0.39
Canada	Moody's	6/2/94	-2.0	+1.9	+6.0	-0.16	-0.05	-1.03
Canada	Fitch	8/10/94	+0.5	+0.6	+12.9	-0.13	+0.17	-0.66
Italy	S&P	5/6/98	+2.7	+4.6	+13.6	+0.05	-0.22	-0.80
Italy	Fitch	7/14/98	+5.8	-26.8	+2.3	-0.02	-0.26	+0.07
Japan	Moody's	11/17/98	+5.1	-1.3	+26.8	+0.10	+1.25	+0.93
Japan	Fitch	6/29/00	+0.4	-9.8	-26.6	+0.04	+0.15	-0.60
Japan	S&P	2/22/01	-3.0	+8.2	-20.2	-0.25	-0.17	+0.07
Best Outcome Across Data Set			**+5.8**	**+18.4**	**+86.6**	**-0.30**	**-0.50**	**-1.15**
Worst Outcome Across Data Set			**-3.0**	**-26.8**	**-26.6**	**+0.10**	**+1.25**	**+0.93**

*Canadian Bond Rating Service

Source: Bloomberg, Northern Trust Global Investments.

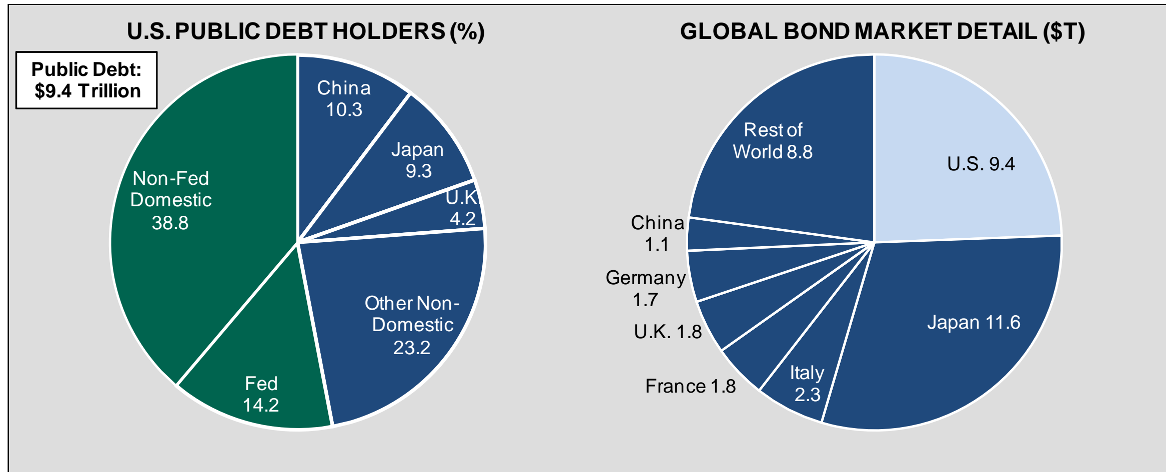
A review of downgrades in Australia, Canada, Italy and Japan as shown in Exhibit 1 shows little consistent reaction (accepting that this is a small sample size and each rating agency action is listed individually). Our belief is that global investors have already been viewing the AAA-rating for the United States as stale, but the psychological impact on equity markets is likely going to be less benign. Additionally, a second downgrade from either Moody's or Fitch (who have recently reaffirmed their AAA ratings but could downgrade with a change in conditions) would put additional pressures on the markets. If the ratings move serves as a catalyst for better policy

action, it could prove constructive. However, as we discuss later in the report, broad application of this same criteria by S&P against other sovereign issuers globally could have continuing negative impacts on risk appetites.

A LOOK AT GLOBAL BOND INVESTING

One of the most frequent worries we hear about the outlook for U.S. Treasuries is our dependence on foreign investors and their potential flight to the exits, a worry we think is exaggerated. As shown below in Exhibit 2, China is the largest foreign holder of U.S. public debt, followed relatively closely by Japan. China's massive buildup in foreign currency reserves has come about as a result of its multi-year trade surpluses, which China can choose to invest as it wishes. However, China's desire to continue to manage the value of the Renminbi (which is managed against the U.S. dollar) has led to significant accumulation of U.S. debt. We believe it is in China's interest for this exchange rate to only change gradually so as to not overly reduce the competitiveness of its exporters.

EXHIBIT 2: A LACK OF QUALITY ALTERNATIVES



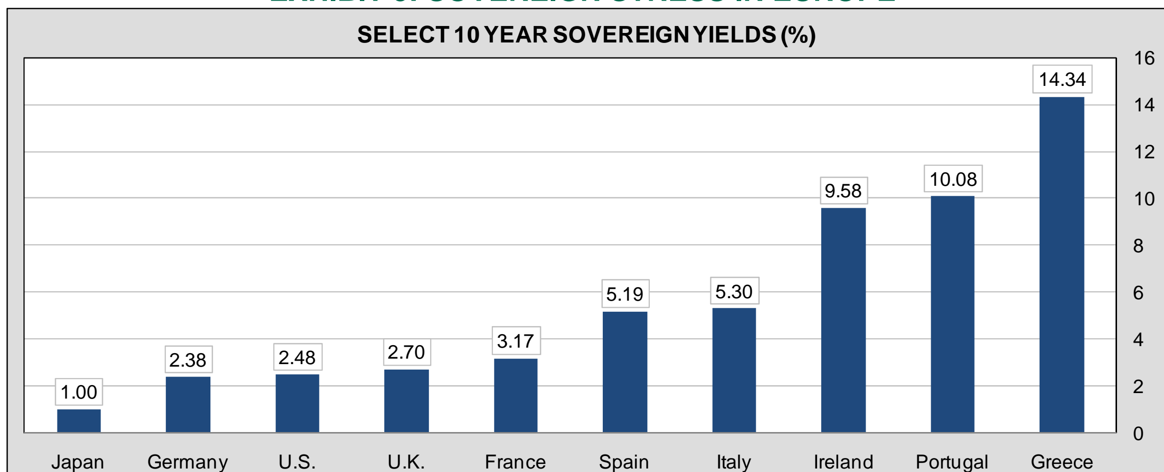
Source: Federal Reserve, U.S. Treasury, Bloomberg, Northern Trust Global Investments. U.S. public debt holders data as of 6/9/11; global bond market detail as of 8/5/11.

At the end of the day, there is no global financial market that matches the features of the U.S. debt markets. Japan, the world's largest bond market, offers yields well below Treasuries, and the fiscal and growth outlook for the world's third largest bond market, Italy, are measurably worse than for the United States. A significant portion of U.S. outstanding debt is financed by foreigners because it is relatively cheap and they find our bond market attractive due to its size and liquidity. The United States currently has $9.4 trillion of public debt outstanding (the remaining $4.7 trillion is inter-governmental debt), of which $4.5 trillion is financed by foreigners. In comparison, total net household wealth at the end of the first quarter was $58.1 trillion, including $8 trillion held in time deposits, checking accounts and money market accounts. If U.S. interest rates were to rise, there is considerable domestic savings that would find the higher interest rates attractive. As highlighted in our research piece, *The Specter of Rising Interest Rates*, we think interest rates will be primarily determined by the outlook for growth and inflation. With our expectation for relatively modest U.S. growth over the next five years and constrained inflation, we do not expect a material upward move in U.S. interest rates during that same five-year period.

A VIEW TOWARD EUROPE

The biggest impact from the S&P downgrade may actually occur outside the United States. If S&P doesn't like the political process in Washington, what about the process in Brussels? We think that much of the recent weakness in equity markets is more a result of the difficulties in European sovereign credit markets than other factors such as the slowing economy or U.S. debt ceiling debate. While our political structure seems pretty fractured right now, this is not uncommon for a democratic legislative process. In contrast, the European Monetary Union has a structural weakness with its common currency without a unified fiscal policy. This has allowed countries such as Greece, Portugal and Ireland to borrow at very low historical rates, over-leverage their economies and then depend on the fiscally stronger countries to back a bail-out.

EXHIBIT 3: SOVEREIGN STRESS IN EUROPE



Source: Bloomberg. Data as of 8/8/2011 (intra-day).

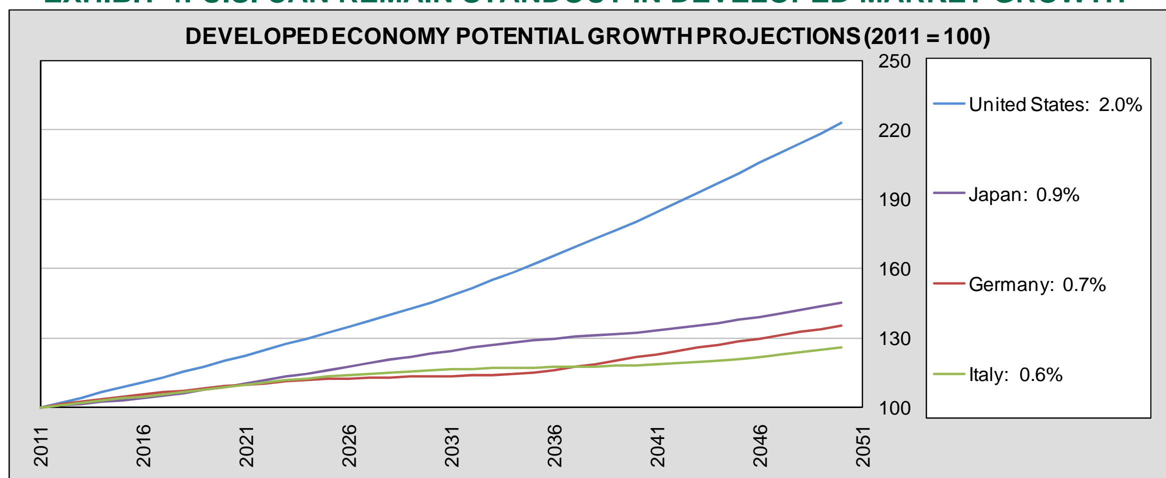
Strains are appearing in select governmental debt markets (primarily the over-indebted Southern European countries). For this debt situation to provide a "Lehman-like" shock to the financial markets, we would likely need a major surprise out of Spain or Italy. We can't rule this out, as the yields on their 10-year notes have recently broached the 6.0% level. But our base case remains that Europe will limp through the crisis by doing the minimum required at the last possible moment. Over the past weekend, the European Central Bank stepped up its efforts to support the bond markets through expanded open-market purchases. In reaction, Italian and Spanish 10-year yields have fallen by more than 0.75% intra-day as of this writing. As a partial hedge against the considerable risk that we feel Europe still faces, we continue to view U.S. equities more favorably than EAFE (Europe, Australasia and the Far East) and we continue to view gold as an attractive hedge.

WHAT IS THE LONGER-TERM OUTLOOK?

The budget issue in the United States is not the current cyclical deficit; rather, it remains the entitlement spending we have promised our populace. We have a couple of choices to consider – simply cut the entitlements and lower the broad standard of living; tax the people who own much of the $58 trillion of household wealth; or some combination of these two. The most likely outcome, as highlighted in the Simpson-Bowles Commission report, is a heavy reliance on

spending cuts in combination with tax code reform, which will end up increasing revenue. However, what is frequently lost in the political debate is the outlook for economic growth – the other half of the scrutinized debt/gross domestic product ratio. At the end of the day, the "assets" that governments control and that investors count on for debt repayment is tax revenue. The United States is not going to sell Alaska, nor is Greece likely to sell Mykonos. Two of the key drivers of economic growth are increases in the working-age population and productivity gains. Additional drivers include the regulatory, legal and political environment. As shown in Exhibit 4, the growth potential of the United States stacks up well against its developed world competitors. These calculations are based on United Nations population forecasts (which exclude immigration, a potential U.S. positive) and historical productivity rates. Our key takeaway is that the United States has the potential to generate much better growth than its developed country peers, enabling it to handle the debt burden if the spending picture can be addressed.

EXHIBIT 4: U.S. CAN REMAIN STANDOUT IN DEVELOPED MARKET GROWTH



Source: United Nations Population Division, Haver Analytics, Northern Trust Global Investments.

In summary, we do not see the downgrade as being problematic near-term for U.S. debt markets. We are, however, focusing on the potential indirect effects on the prospects for other sovereign credits and global economic growth. The developments in the European debt markets, the global economic cycle and the U.S. deficit discussions will be the key focus of our next Investment Policy Committee meeting in mid-August.

This report includes insights from several members of Northern Trust's Tactical Asset Allocation Committee, especially Bob Browne, Peter Flood and Colin Robertson. Special thanks go to Phil Grant and Emmanuel Bernabe for data research.

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