

# Investor Update: S&P Downgrade

August 8, 2011

The downgrade of the U.S. credit rating by Standard & Poor's on Friday came on the heels of two dismal weeks in the equity markets and has left many investors reeling. We understand the concern and want to take this opportunity to review what has changed over the last several weeks and what it means to portfolios moving forward. While our approach to portfolio construction (detailed below) caused portfolios to lag the equity markets for the first four months of the year, it has served investors quite well in the last three plus months.

## The U.S. Downgrade

In mid-July, Standard & Poor's stated it was considering a downgrade to the U.S. credit rating due to the gridlock surrounding the negotiations on raising the debt ceiling as well as the longer term U.S. fiscal outlook if significant spending cuts were not implemented. In Friday's announcement, S&P commented that the recent agreement in Congress to reduce the deficit by \$2.1 to \$2.4 trillion over the next decade was insufficient, falling short of the \$4 trillion in cuts that S&P believes are necessary to stabilize the U.S. debt problem. The S&P downgrade was not unexpected, but it does add to the uncertainty surrounding the U.S. and world economic outlook.

In addition to poor fiscal conditions, long-term structural issues remain, namely an aging population and ballooning health care costs along with a below average GDP growth outlook. The U.S., like many European countries, is facing long-term fiscal issues, and the impact of a downgrade by one of the three ratings agencies may serve to compound these issues from both behavioral and fundamental standpoints. On the positive side, the recent debt discussions and resulting downgrade may force government officials to take appropriate steps sooner to mitigate any further deterioration. Moody's and Fitch announced earlier in the week they were maintaining their top-notch ratings for the U.S. History has shown that the impact of a downgrade is more significant when multiple agencies have taken action.

What impact might S&P's action have on the economy? Federal regulators announced Friday that the downgrade will not affect capital requirements for banks, and money market funds holding Treasuries will also likely not be impacted. Longer term, some believe the U.S. will be forced to pay higher rates on its debt, perhaps 0.25% to 0.5% higher. If this were to occur, consumers would be directly affected since many types of debt, including mortgages and student loans, are tied directly to the Treasury rates. Agency securities such as Fannie Mae and Freddie Mac issues and municipal bonds will be impacted, with downgrades possible on municipal bonds either secured by the Fed or backed by Federal spending.

While the impact of a downgrade is difficult to predict in the near term, we expect volatility and uncertainty will continue to be high. The stock markets do not like uncertainty, and we are currently faced with uncertainty across a broad spectrum of issues.

What does all of this mean for portfolios?

## Portfolio Construction

At the beginning of the year we highlighted a number of themes we felt would be prevalent and then we constructed portfolios with those in mind. Those themes included:

- Macro driven, high risk environment (one with significant government intervention where fundamentals don't necessarily drive prices)
- Potential for increase in U.S. interest rates
- Second wave of debt crisis
- Corporate cash deployment (many large cap companies are flush with cash and will be pressured to do something with it, such as paying dividends, stock buybacks, or acquisitions)
- U.S. dollar weakness and emerging markets currency strength
- Inflation (we worried about disinflation early on, but felt that inflation could pop up unexpectedly given the amount of liquidity being pumped into the economy)
- Emerging economies GDP to outpace developed economies

How do these themes translate into portfolio construction and, more importantly, have recent events caused us to restate these themes?

- First, we have been broadening our diversification as much as possible, particularly focusing on assets with a low or negative correlation to equities, such as municipal bonds, treasuries, and gold.
- Additionally, we have sought to improve the currency diversification in portfolios by adding non-U.S. developed and emerging markets debt. This shift also reduced the portfolios sensitivity to U.S. interest rates and potential inflation.
- A healthy allocation to commodities was added with two themes in mind: U.S. inflation and growth in emerging markets.
- A shift away from small cap and towards large cap demonstrated our emphasis on strong balance sheets and greater corporate stability in a potentially tumultuous environment.

How has our view on these themes changed in recent times? We believe continued government intervention in the markets is highly likely, though perhaps with less impact. We expect short-term interest rates to remain low for an extended period of time, but still have concerns that longer-term rates could go higher. In the near term, whenever the markets become panic stricken, the U.S. dollar may well rally as a safe-haven, but we believe longer term a weaker dollar is still the most likely outcome. Though it is difficult to predict when, we do believe that at some point fundamentals will again matter and good quality companies will experience superior price appreciation relative to lower quality companies.

## Where Do We Go from Here?

It's worth mentioning that most, if not all, of the recent news regarding the health of the global economy (European and U.S. debt challenges, a slow recovering economy, credit rating downgrade) isn't new news. We have been aware of these issues for quite some time. Therefore, one way to look at what happened in the last two weeks is that equities simply got cheaper and bonds got more expensive. We all know the most basic tenet of investment success—buy low and sell high— but volatile markets like these challenge our fortitude in

sticking with what we know works. Patience is equally important in a time like this as we expect heightened volatility to continue for some time and for better opportunities to come our way. Should these market trends continue, and assuming no meaningful change to underlying corporate/economic fundamentals, you should expect us to start making marginal adjustments in portfolios, starting first with rebalancing—that is, trimming the assets that have run up and adding to assets that have declined—and then adjusting our tactical target allocations. In the coming days and weeks, our Investment Committee and Global Asset Allocation Committee will be focused on identifying areas in the market that may have been excessively impacted by investor sentiment compared to underlying fundamentals and looking for ways to capitalize on those opportunities.

## Disclosure

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