Commentary: Responding to S&P Downgrade of US Treasuries

What happened?

Standard & Poor's (S&P) downgraded the long-term rating for US Treasury debt one level from AAA to AA+ on Friday, August 5, 2011.

What about the other rating agencies?

S&P was the only rating agency to take this action. Fitch Ratings and Moody's Investors Services affirmed their AAA rating for US Treasury debt on August 2, 2011.

Why did this happen?

In the report, S&P stated, "the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011."

What does that mean?

The official report states, "We lowered our long-term rating on the US because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process. We also believe that the fiscal consolidation plan that Congress and the Administration agreed to this week falls short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade."

In a nutshell, in S&P's opinion, the budget agreement was not enough to show progress toward sustainable deficit reduction.

You mentioned 'long-term rating'. Is there a short-term rating?

The US has two ratings. While the long-term rating was reduced by one level, S&P affirmed the short-term rating of A-1+ which is the rating for all US T-Bills and the highest rating available.

Does this impact the investment guidelines-restrictions of any of our Fixed Income portfolios?

No.

For Bernstein mutual funds, there is no impact to the investment guidelines-restrictions.

For separately managed accounts, we typically apply the 'higher of' when applying a credit rating. Since Moody's and Fitch affirmed their AAA rating for US Treasuries, they will continue to be viewed as AAA.

Does this announcement change the portfolio strategy for our Fixed Income portfolios?

No. This announcement does not change our views in the portfolios.

How might this impact US Treasury yields?

As we state in our research article "When 'Risk-Free' Isn't Risk Free: The Impact of a US Treasury Downgrade," "We researched the potential market impact by studying previous downgrades of sovereign debt. We found that US Treasuries are not likely to see a large increase in yields simply due to a ratings downgrade." The article goes on to observe that a significant change in yield occurs when the rating declines to BBB+.

US banks are large holders of US Treasuries. Could this pose any problems for US banks?

This should not be a problem, as the Federal Reserve has already announced there will be no changes for banks from a capital perspective.

US insurance companies are also large holders of US Treasuries are there any issues for them?

This news should not impact US insurance companies. US insurance companies adhere to NAIC ratings (NAIC stands for the National Association of Insurance Commissioners). The NAIC has established various bands that indicate the capital requirement for each investment, with the highest band (least risk) named the Class 1 band. The NAIC Class 1 band is quite wide (including securities rated from AAA to A-), as a result US Treasuries will remain in the Class 1 band.

How might this affect other corporations who issue in US dollars?

The impact is expected to be limited as there are very few corporations with AAA ratings since the credit crisis. Of the 3,872 bonds in the Barclays Aggregate Corporate Bond Index, 46 of those bonds have AAA ratings. Collectively, these bonds currently represent 1.2% of the Corporate Bond Index and 0.24% of the Barclays US Aggregate Bond Index. Of the 11 current issuers, there are 5 corporations, 1 medical institute and 5 higher education institutions:

AAA Corporations
Johnson & Johnson (16 bonds)
Microsoft (10 bonds)
Rabobank (4 bonds)
SeaRiver Maritime—a division of ExxonMobil (1 bond)
XTO Energy—a division of ExxonMobil (5 bonds)

AAA Medical Institute
Howard Hughes Medical Institute (1 bond)

AAA Higher Education Institutions
Massachusetts Institute of Technology (1 bond)
Harvard University (2 bonds)
Princeton University (2 bonds)
Stanford University (3 bonds)
Yale University (1 bond)

In addition, there is precedent in some emerging market countries where corporations have had higher credit ratings than the government.

Does AllianceBernstein think large central banks, such as China, will be compelled to sell US Treasuries on this news?

No. While there have been some comments by China recently with regard to the US deficit, we do not believe that the downgrade will result in significant short-term sales of US Treasuries by China. China has been diversifying its investments for some time and will continue to do so. We expect this diversification will likely continue through the investment of newly accumulated foreign exchange reserves rather than selling US Treasuries to purchase securities in other government bond markets. ■

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1345 Avenue of the Americas, New York, NY 10105, 1.212. 486.5800

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