

Market Update

U.S. Downgrade

Background

Standard & Poor's (S&P) downgraded the credit rating of long-term U.S. government debt to AA+, one notch below the highest rating of AAA. The country had proudly held the "risk-free" designation from all major rating agencies since 1917. The S&P announcement came after months of warnings about persistent U.S. budget deficits and a few days after a deal in Washington raised the government debt ceiling.

S&P's Report

Political risks figured heavily in the downgrade. In its report, S&P pointed to the latest round of political brinksmanship as spotlighting "America's governance and policymaking becoming less stable, less effective, and less predictable." While other countries with the top-notch rating have debt levels as high or higher than the U.S., S&P believes U.S. policymakers are not "tackling the structural issues" in a way that is "consistent with a AAA rating and with AAA-rated sovereign peers."

Our Perspective

The downgrade is a serious psychological blow. It's an embarrassment for the country to no longer be in the same league as Australia, Canada, France, Germany, the Netherlands, Switzerland, and the U.K., among others. Even though it is a subjective call by an agency eager to rebuild its credibility following its role in the housing bubble — competitors Moody's and Fitch recently reiterated their AAA ratings for the U.S. — the downgrade is a bitter pill. It is yet another development bound to shake the world's confidence in trusted institutions that not long ago appeared impregnable.

Nevertheless, the lasting fallout will likely be manageable. U.S. Treasury bonds remain safe, with continuing timely payments of interest and principal. As described by S&P, a rating of AA+ reflects "very strong capacity to meet financial commitments." In the current environment, we expect investors' hearty appetite for Treasury bonds to persist:

- Few investors are required to hold only AAA-rated securities, and regulators will still apply full value for Treasury holdings on banks' balance sheets.
- Even as S&P lowered the U.S.' long-term rating, it retained the country's top rating for short-term paper so we don't expect pressure on money-market funds to exit Treasuries.
- Credit ratings aren't the sole determinant of market yields, as evidenced by Australian bonds (rated AAA) currently yielding far more than Japanese bonds (rated AA).
- Investors looking for safety have few attractive alternatives. After the U.S., the next largest bond markets are Japan and Italy, and we don't foresee a stampede into either. Even the remaining AAA-rated countries have issues of their own, precluding full comfort for investors.

All told, we are convinced that yields on Treasury bonds are unlikely to move sustainably higher until global economic news improves and investor fear subsides. Although we anticipate S&P will shortly announce some ancillary downgrades of government agencies and municipalities, we do not expect a rash of damaging consequences.

History suggests that a downgrade can create added urgency among a country's policymakers. If so, the difficult news from S&P may produce a silver lining over time, including reconsideration of proposals

made by the deficit commission last December. While a prompt restoration of the U.S.' AAA rating isn't feasible given the amount of work needed to rebuild its fiscal credibility, we note that Australia and Canada are among the countries that at one point lost their AAA rating but regained it after improving their fiscal positions.

Outlook and Strategies

Although the downgrade was not entirely unexpected, it will likely lead to additional near-term market turmoil. Yet we don't see it reshaping the near-term bond yield environment or causing serious economic difficulties.

The downgrade reinforces the strategic moves made in our client portfolios over the past several months, including the following:

- Cutting government bond weightings;
- Shortening the duration of bond portfolios;
- Increasing the emphasis on real assets; and
- Diversifying currency exposure away from countries with higher debt.

Other strategies in our portfolios enhancing protectiveness include holding elevated cash levels in stock and commodity portfolios as well as maintaining significant exposure to less-volatile corporate credit.

Yet we are not inclined to overreact to the recent spate of discouraging news. Although challenges exist in all corners of the world, signs of progress are also evident, such as rising world trade and strong corporate earnings. We are convinced that a balance of defensive and growth-oriented strategies is most appropriate in the current environment. In the period ahead, we will monitor developments closely, with a keen eye on policymakers' ability to make needed adjustments in difficult times.

This material reflects the views of Bessemer Trust and is for your general information. It is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Opinions expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation.

Atlanta • Boston • Chicago • Dallas • Denver • Los Angeles • Miami • Naples
New York • Palm Beach • San Francisco • Washington, D.C. • Wilmington • Woodbridge
Cayman Islands • New Zealand • United Kingdom

Visit us at www.bessemer.com.