

Why We Plan

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Introduction

As you probably know by now, Standard and Poor's (S&P) lowered the credit rating of the United States by one notch from the highest rating, AAA, to the next highest, AA+. Over the weekend and in the coming days, you have heard and will likely continue to hear various analysis of this move with some urging you to panic and others, perhaps, a little more measured in their response. The purpose of this issue of Why We Plan is to give you some perspective, both short and long-term, on what caused this downgrade, what it likely means, and how should you really react to the news.

What Caused the Downgrade

A few months ago, the various credit ratings agencies warned the United States government that if it didn't get its financial affairs in order, it would be at risk of losing its coveted AAA credit rating. The agencies realized that the debt ceiling debate was forthcoming and they were doing their part to exercise some political muscle and become relevant once again (they lost tremendous credibility for their complicity in the sub-prime crisis, but more on that later).

Essentially, the ratings agencies signaled that if the U.S. did not take a significant, balanced step towards righting the ship, there would likely be a downgrade. Importantly, as they saw the risk of the process devolving, they put the U.S. on negative watch – a real shot across the bow.

As we all know, our politicians did not acknowledge that shot. Rather than working together to create a plan that would truly put the country back on track, the process was politicized and we ended up with a compromise that effectively kicked the can down the road – again.

While the two other major ratings agencies, Moody's and Fitch, have initially decided that the compromise was a good start, S&P determined that it was too little too late and downgraded the U.S. When it did so, it issued the following statement:

“We lowered our long-term rating on the U.S. 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.

Our lowering of the rating was prompted by our view on the rising public debt burden and our perception of greater policymaking uncertainty, consistent with our criteria. Nevertheless, we view the U.S. federal government's other economic, external, and monetary credit attributes, which form the basis for the sovereign rating, as broadly unchanged.”

As you can see, the statement says nothing about the country's ability to repay its debts. This appears to be based simply on a lack of faith in the ability of our politicians to actually govern and manage the financial affairs of our country.

So, What Does It Mean?

The foregoing comment was very important, so we'll repeat it: The statement says nothing about the country's ability to repay its debts. This appears to be based simply on a lack of faith in our politicians.

Usually a downgrade is based on a risk that a debt will not be paid. There is absolutely no chance that the U.S. will not pay back its debts. As aptly put by Warren Buffett:

“Think about it. The U.S., to my knowledge, owes no money in currency other than the U.S. dollar, which it can print at will. Now, if you are talking about inflation, that's a different question.”

So, there is not a concern about us repaying our debts. That doesn't mean there are not concerns. Since we are entering “uncharted waters”, trying to forecast all the potential ramifications of the downgrade is a difficult endeavor, but let's start with a few:

- The impact on banks should be limited, if there is any impact at all. There was a concern that the banks might be impacted since the credit quality of a bank's holdings has an impact on how you calculate that bank's reserves. The Fed has said that this change in rating will have no impact on how government issued securities are evaluated for reserve purposes – so, no change.
- Interest rates will likely not change much initially. The bond market has known of this possibility for months, and it votes with its money. Lately, that vote has been in favor of the U.S. as funds have moved out of foreign countries into U.S. treasuries. The reality is that **rates have been coming down in recent weeks**, despite the debt ceiling debacle. In fact, ironically, after S&P put the U.S. on credit watch, the fear seemed to cause people to buy even more U.S. Treasury bonds, notes, and bills. As of now, the interest rate on the 10 year U.S. Treasury Note, for example, stands at about 2.5%, **very close to its all time low**. In fact, many countries who still have a AAA rating on their debt - Canada, Australia, United Kingdom, France, New Zealand, and Norway – all pay higher interest rates on their 10 year debt than the United States. Of course,

over time, the downgrade may result in higher rates across the board – or it might not. Only time will tell.

- Countries that do not like us will up the rhetoric. This is a perfect time for countries like China, Russia, Venezuela, etc. to try to force a conversation about replacing the U.S. dollar as the world's reserve currency. Their stated desire is to use a basket of currencies. The problem is that there are very few currencies in the world that have the depth, transparency and stability of the U.S. dollar, and that will probably not change for quite some time. Progress to make such a change, if any, would likely be very drawn out and would probably still result in the dollar being a significant component of the “basket” given the size and importance of the U.S. economy.
- Companies may have increased costs. This would be a function of interest rates. Once again, those rates have been stable with the prospect of a downgrade known by all market participants, so it is likely that any increased costs would be negligible in the immediate future. More importantly, companies are sitting on record levels of cash, so their need to access the credit markets at this point is negligible.
- The wildcard, in our opinion, is really consumer and business sentiment, which will be the crux of our focus. Since the downgrade was largely telegraphed, most businesses have prepared for the eventuality. Consumers will likely take their cue from the government and business. This is an area that we will need to monitor.
- Hopefully a positive outcome will be that our politicians will put country before party or self. Both parties have been complicit in getting us into this position, and it will take both parties *working together* to get us out of it.

For what it is worth, Mr. Buffett also noted:

“In Omaha, the U.S. is still triple A. In fact, if there were a quadruple-A rating, I’d give the U.S. that.”

In other words, he isn't going to do anything different with his money as a result of this downgrade. It is likely that for all intents, it will be business as usual, but that is something we will have to wait and see.

Your Reaction

So, how should you react to this news?

First, if you are like me, you should be upset with your elected representatives. If you are, I would encourage you to send a note expressing your displeasure. It is amazing how receptive politicians can be to public outrage.

Next, you should understand that despite the fact that the “market” has known about this likelihood for quite some time, there might be a **temporary** market reaction. There is already some degree of skittishness in the market, and this may simply add to the concern. My counsel would be for you not to get caught up in it for a few reasons:

- 1) The market was attractively valued coming into last week. Given the losses last week, it was even more attractively valued at the end of the week. Any additional weakness will simply make valuations that much more attractive. In fact, as noted by First Trust's Brian Wesbury, *"the S&P downgrade alters nothing about the economy or corporate profitability in the short, medium or even long- term"*.
- 2) Economic news, while not reflective of a fast growing economy, is reflective of a growing economy. Downgrades to GDP growth in the first and second quarters reflect the past and are, in part, a function of the disaster in Japan, tornadoes in the U.S., and other events that caused *temporary* dislocations in supply chains, manufacturing, etc. Those events are largely behind us, and the data suggests the second half of the year will be more robust than the first. Moreover, all data from services and manufacturing continue to indicate growth despite what you might be hearing from the media.
- 3) Some 75% of companies reporting second quarter earnings beat analyst estimates, and some 72% beat revenue (sales) expectations. Earnings are up by some 18% over last year's earnings. Since most people were focused on the debt ceiling debate, this fact has been largely ignored. By many measures, the stock market is cheaper now than it has been in many decades. Based on trailing earnings, the S&P 500 market is currently trading at a P/E of about 12, a level not seen in decades (and when it was seen, short-term interest rates were at 8%). Moreover, one can receive more income from the average dividend-paying company of the S&P 500 than they can from a U.S. 10 year treasury note.
- 4) This is not 2008 all over again. 2008 was effectively a run on our banks (hence, the need for TARP and other programs). Today, the banks have liquidity and companies are sitting on lots of cash. The backdrop is significantly different.
- 5) S&P (and the other ratings agencies) failed to understand the risks associated with the products Wall Street created that were tied to sub-prime loans. They assigned AAA ratings to securities that should have rightly been rated as junk (if you'd like a detailed explanation, you can call). Needless to say, people invested based on the AAA rating and got burned – badly. To say that the ratings agencies were complicit in the financial crisis we experienced would understate their role. To some extent, S&P is trying to become relevant once again. Once again, the basis of this downgrade from S&P's own statement is "political".
- 6) Other countries have lost their AAA rating and eventually regained it. During the interim, there were no major negative ramifications. In fact, Canadian stocks gained more than 15% in the year following its downgrade in 1993, and the Tokyo stock market gained some 25% in the year following its downgrade. We are not predicting the same thing will happen in the U.S., but it is instructive to see that a downgrade, in and of itself, is not necessarily a bad thing for the economy or the market. Importantly, it is likely that tremendous efforts will be put in place to have our AAA rating reinstated sooner rather than later.

Like everything else, this will likely prove to be a rallying cry for the media and the pundits that pay to be on air. The usual suspects will be on air 24/7 providing you with forecasts of depression, deflation, failure, blah, blah, blah. Ignore it.

We spend quite a bit of time studying the economy, the markets, valuations, etc. It is that effort that gives us the confidence to create **long-term** portfolios for our clients. Moreover, those portfolios are designed to weather storms such as this, which is why spending needs for an extended period of time are maintained in cash or bonds. Additionally, your long-term growth focused portfolios are not invested only in companies based in the U.S. Further still, it has been estimated that most large U.S. based corporations get a substantial portion of their profits from non-U.S. operations. This will likely prove to be a short term phenomenon. Remember, the Canadian stock market was up over 15% and the Tokyo stock market was up some 25% in the 12 months following their respective downgrades. We are not predicting this will happen in the U.S., but it is important to realize that a downgrade such as this is not necessarily a negative across the board.

The only reason you should make a change is if your personal situation has changed. In other words, for the time being, ***you should not react.***

Wrapping It Up

Although we may agree with S&P in their sentiment that the U.S. needs to get its spending under control, we believe they are too pessimistic about the long term future of the U.S. History has shown repeatedly that when faced with challenges, we have altered our course, and there is no reason to think this time will be different. In fact, the entire debt ceiling/government spending debate ultimately should prove to be a positive by focusing our elected ~~clowns~~ officials on and ultimately reducing our government's spending as a share of our economy. We were in worse shape in the late 1970's and early 1980's, and the media was rife with stories of the demise of the U.S. and the rise of a great Asian superpower (back then it was Japan). But the debate changed in Washington and we embarked on a period of tremendous growth.

It's the media's job to tell you that it is different this time, just as they did then. History has shown, time and again, not to bet against the best companies in the U.S. and the world. So as we stated above, unless something has changed in your personal financial circumstances, ***you should not react.*** This too, shall pass.