Manulife Asset Management™

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U.S. Debt Downgraded. Business as Usual in Canada

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Friday evening, Standard & Poor's took the unprecedented step of downgrading the long-term US debt rating from AAA to AA+. This is the first time in history that the benchmark security has been downgraded below AAA. North American stocks were volatile last week prior to the downgrade; stocks in Asia and other parts of the world are under pressure this morning. That said, the bond market seems to be taking the downgrade in stride and bonds are actually up this morning (i.e. yields are lower).

The downgrade does not necessarily mean yields on US treasuries will sky-rocket in the near term. There is precedence for yields actually falling after a downgrade. Previously, when Canada had their debt rating downgraded in the 1990's, yields on Canadian bonds fell. The US bond market remains the largest and most liquid in the world, backed by the largest economy in the world. Replacing it won't be easy, so it is highly unlikely in the near term, to foresee a significant negative impact in bond markets.

In Canada, it should be closer to business as usual. Only a few weeks ago, Moody's reaffirmed our AAA rating and Canada continues to be rated AAA by S&P. On a relative basis, the Canadian economy is in an enviable position – the Federal government has pledged to balance the budget by 2015 or earlier and many provinces are on the same or better track. Finance minister Flaherty has recently noted that Canada's budgetary position is among the strongest in the world. However, the bad news is the US and global economies appear to be slowing. This will likely mean, less demand for our goods, which would put pressure on our economy. Weakness in our currency due to lower demand, and weaker commodity prices will likely prove to be a mixed blessing for Canada, benefitting central Canada while hurting the oil patch and some parts of the Maritimes.

In closing, the downgrade in the US debt rating in no way can be viewed as a positive event though in time, it may be the catalyst to initiate progress and fiscal discipline in Washington. Further, we expect US Treasury markets to remain highly liquid and active, though volatile. Markets will likely see lower yields in the near-term while risks grow that longer-term rates may rise should further rating downgrades occur.

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