S&P U.S. Credit Rating Downgrade

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Highlights

- We don't agree with the S&P downgrade rating and the criteria that was used to assess the U.S.
- The credit downgrade is based on a 2 Trillion calculation error which would add 2% in projected GDP-Debt Ratio
- U.S. has a strong record and ability to meet financial obligations worldwide as it has done so in the past
- U.S. Treasury bonds are still perceived as the safest assets in the world

Sovereign Credit Rating Explained

A sovereign debt rating measures the creditworthiness of a nation. It also provides insight to the economic and political stability of the country. The three largest issuers of these ratings include the S&P, Moody's, and Fitch which are classified as credit rating agencies (CRA). There are other CRA's out there but these three are the most influential in markets. A sovereign credit rating is important because it allows countries to access international bond markets for financing public debt. It also affects the rate of interest the government is able to borrow as well. Sovereign Credit Risk is the measure in which a country is unable to pay or meet its debt obligation in the future. This **credit risk** is one of the factors that played in the S&P's role to downgrade the U.S. Credit rating. Before diving deep into the S&P analysis, it would warrant merit to look at the US Debt to GDP Ratio around this time frame (2005 - 2012).

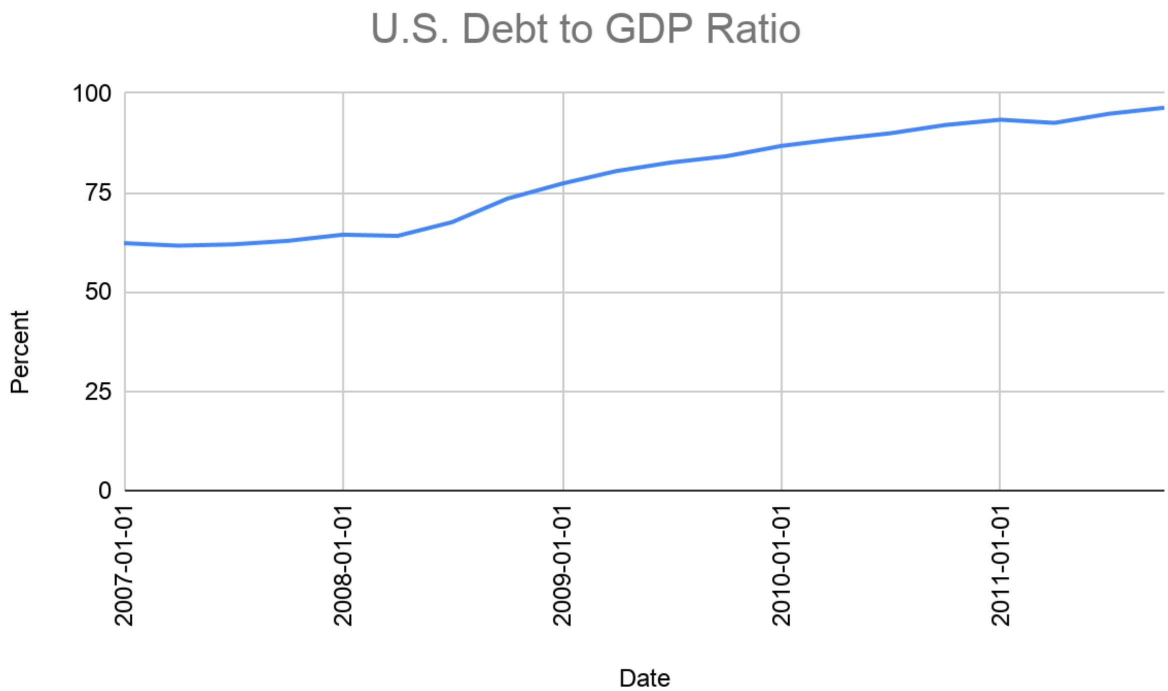
Credit Rating Considerations

Issue credit ratings are based, in varying degrees, on S&P Global Ratings' analysis of the following considerations:

1. The likelihood of payment--the capacity and willingness of the obligor to meet its financial commitments on an obligation in accordance with the terms of the obligation;
2. The nature and provisions of the financial obligation, and the promise we impute; and
3. The protection afforded by, and relative position of, the financial obligation in the event of a bankruptcy, reorganization, or other arrangement under the laws of bankruptcy and other laws affecting creditors' rights

U.S. Debt to GDP Ratio

The debt to GDP ratio simply put is the Total Debt of a Country divided by the Total GDP of a country. The higher the ratio, the higher the probability the country is to default. This can spook investors and cause higher interest rates on borrowing costs. However, this isn't to say that a country will automatically default if it's debt exceeds its GDP. Investors will deem countries "stable" if it continues to make payments while growing its economy. Large economies usually do run with budget deficits and this is no different from the US.



Source: Federal Reserve Bank of St. Louis

Seen above, around the start of the financial crisis, there was an approximately >25% overall jump in the US Debt to GDP Ratio.

S&P Rating Downgrade

The S&P downgraded the US from a triple AAA+ to a double AA+ for the first time in seventy years.“The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government’s medium-term debt dynamics,” S&P said in a statement.(Brandimarte, 2011) The rating came on the heels of recent legislation that was signed by President Barack Obama. “President Barack Obama signed legislation designed to reduce the fiscal deficit by $2.1 trillion over 10 years. (Harwood, 2011). The S&P’s view was that the reduction was not enough, it needed to be cut even further, a view that S&P thought “fell short of the $4 trillion in savings S&P had called for as a good "down payment" on fixing America's finances” (Harwood, 2011). S&P also cites increasing political gridlock as one of the reasons why the US Credit rating was downgraded. Overall, the rising level of government debt and ineffectual policy making was the main reason S&P believed that the US no longer hold the it’s AAA Sovereign Credit Rating.

From a qualitative perspective, S&P had a negative outlook of the U.S. political climate, observing that the stability, predictability, and effectiveness of the nation’s policymaking has weakened, as demonstrated in the recent debate around the debt ceiling. S&P also criticized the nation’s lawmakers for failing to cut spending and raise revenue to reduce record budget deficits.

S&P Ratings Downgrade Impact

The triple A-debt club in 2011 (consisted of 17 countries, Australia, Austria, Canada, Denmark, Finland, France, Germany, Isle of Man, Luxembourg, Netherlands, New Zealand, Norway, Singapore, Sweden, Switzerland, United Kingdom and the USA) allowed these countries to borrow funds at low cost because their respective bonds were deemed stable and safe. This should be no different for the US. The US. dollar in the past and, still currently, is revered as the world's number one reserve currency due in part to investors holding this in high regard since it's backed by the "full faith and credit of the U.S. government" -- which until now, has never seriously been called into question." (Censky, 2020).

After the downgrade, S&P basically put the US on par in the same category in more than a dozen governments that ranked below the US in 2011. The "U.S...soon joined the ranks of the lower-level, double-A rated countries like China, Spain, Japan, Saudi Arabia and even Kuwait" (Censky, 2020). To apply the same rating that these countries currently hold doesn't make much sense given the stability of the US financial system.

And a ratings downgrade like this usually has large impacts on borrowing costs and degrades the confidence of investors. The cost of borrowing goes dramatically up. Though even a slight downgrade, "the U.S. will be forced to pay higher interest rates, say about 0.5 percentage point higher, simply because they are seen as being slightly riskier than before. While only a slight gain, such a jump would increase the cost of a wide array of debt, from a home mortgage to the trillions of dollars in debt carried by the U.S. government itself." (Paletta, 2011). This also increases the possibility of a double dip recession due to a larger fiscal deficit. And this impact isn't limited to the US alone, it affects the global financial system and countries such as Russia, China who currently hold large reserves of US Treasury bonds.

Said that, S&P downgrade has a small or no impact on US borrowing cost since two of the major three rating agencies still have a AAA rating. Also the debt ceiling agreement reached between Congress and Administration showed that a political solution can be reached and US monetary and exchange flexibility enhance its capacity to absorb and adjust shocks. Diminishing impact of rating downgrade can also be seen in 1994 when Canada was downgraded to AA. Its interest rate went up slightly for 4 months but rebounded back.

Bond Market Reaction

Ironically, interest rates on US bonds fell on the day after the S&P downgrade. "On the first day of trading, rather than going up, rates on our government debt fell to near record lows as money poured out of riskier assets (equities) in a flight for safety." (Philips, 2011) Bonds have an inverse relationship between rates and price meaning if the interest rate has increased, the price of the bond has fallen and vice versa. "When the markets closed last Friday, and the U.S. still had a AAA rating from S&P, the yield on the 10-year Treasury was 2.55%. It ended Monday down to 2.34%." (Philips, 2011) The ratings drop did little to change the value of US treasuries, it actually had the opposite effect by reinforcing its strength. "The market proved on Monday, U.S. treasuries are still the least risky place to put your money in the whole world. (Philips, 2011) This is problematic in the sense that investment is pouring out of equities and into safe haven investment such as bonds. The economy thrives when the stock market holds its ground.

S&P Miscalculation “The 2 Trillion Calculation Error”

On the day that the downgrade, the Treasury department noticed a large numerical mistake in the analysis. “After two hours of analysis, Treasury officials discovered that S&P officials had miscalculated future deficit projections by close to $2 trillion. It immediately notified the company of the mistakes.” (Palmetta, 2011) A ratio calculation was to blame on the part of the S&P. “The error was in the calculation of the U.S. debt-to-GDP ratio over time and was based on a misreading of what the correct congressional baseline was.” (Harwood, 2011). The $2tn error translates to a 2% increase in projected debt to GDP ratio.

The quick turnaround time of Washington showed how much was at stake for the government amongst the tussle back and forth with the S&P. “This came after a confusing day of reports: Standard & Poor’s told the U.S. government early Friday afternoon that it was preparing to downgrade the U.S.’s triple-A credit rating but U.S. officials notified S&P that it had made a $2 trillion mathematical error.” This confusion alone shows how at odds the government and S&P were and the ineptitude on the part of the S&P.

Despite the government finding the error and notifying S&P, it did little to delay the decision. “S&P confirmed it changed its economic assumptions after discussion with the Treasury Department but said it did not affect its decision to downgrade.” (Reuters, 2011) After the rating was issued, the Obama administration and S&P expressed polar views. “A judgment flawed by a $2tn error speaks for itself," a US treasury department spokesman said of the S&P analysis. (BBC, 2011). The S&P stated that this could have been avoided altogether. “John Chambers, chairman of S&P's sovereign ratings committee, ...stated... the US could have averted a downgrade if it had resolved its congressional stalemate earlier.” (BBC, 2011).

Financial crisis

The financial crisis of 2008 was one of the worst catastrophes the global financial system has ever seen. Credit agencies were stamping products that were junk with top tier ratings. “A lot of worthless mortgage-related securities were given AAA ratings” (Zaidi, 2016) S&P was among the agencies that had supplied ratings to Mortgage back securities that contributed to the financial crisis. S&P willingly knew what it was doing and “aimed for increasing profits and market share by giving inaccurately strong ratings to underperforming assets.” (Zaidi, 2016) Columnist Paul Krugman for The New York Times wrote, “The skewed assessments, in turn, helped the financial system take on far more risk than it could safely handle.” In 2011, the Financial Crisis Inquiry Commission found that these ratings agencies “were key enablers of the financial meltdown.” (Zaidi, 2016) This is the same agency that is downgrading the sovereign debt rating of the United States.

CRA Ratings Table For S&P, Moody's & Fitch

Grade	S&P*	Moody's*	Fitch*	Credit Worthiness
Investment Grade	**AAA**	**Aaa**	**AAA**	An obligor has a VERY STRONG capacity to meet its financial commitments. It differs from the highest rated obligors only to a small degree.
Investment Grade	**AA+** AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-	An obligor has STRONG capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.

*Source S&P, Moody's & Fitch

Moody's & Fitch Affirm AAA Rating

Above is a table that consists of ratings from the S&P, Moody's & Fitch. Based on the rating system that S&P currently uses, "S&P defines an AAA credit rating as "Extremely strong capacity to meet financial commitments. Highest Rating." The AA rating is merely a "Very strong capacity to meet financial commitments." (Reeve, 2011). Rating Agencies Fitch and Moody did not agree with the assessment that the US falls into the very strong category but remain as is (the equivalent of extremely strong based on their respective ratings system) and kept their rating at AAA but held a discernible negative outlook even after the debt ceiling fight that took place earlier in 2011. "Fitch and Moody's...reaffirmed their versions of AAA ratings ...But Fitch also said it was keeping its US rating under review until the end of August (2011)." (Adams, 2011) S&P isn't the only rater in town, there are obviously two others that have equal impact on the markets. Already, we can start to question the validity of the S&P downgrade rating.

Conclusion

In the wake of the financial crisis of 2007–2010, the rating agencies came under criticism. The Financial Crisis Inquiry Commission (FCIC) & the Financial Crisis Inquiry Report (FCIR), concluded that the "failures" of the Big Three rating agencies were "essential cogs in the wheel of financial destruction" and "key enablers of the financial meltdown". The SEC president commented that ratings were "catastrophically misleading", yet the agencies "enjoyed the most profitable years". Combined this criticism with the $2trillion miscalculation that was pointed out by the Treasury department within 2 hours of review showcases the ineptitude of the S&P. The downgrade didn't carry much weight either. Moodys and Fitch affirmed the AAA rating status. The debt limit agreement which was reached by Congress showed that despite political differences, a solution can still be reached on both sides (Democrats & Republicans). Also, almost all financial institutions treat AA+ ratings in the same category as a AAA as they conduct their own research as well. The S&P downgrade also didn't have a major impact on borrowing cost as bond interest rates fell at the day of downgrades, US monetary and exchange rate flexibility proved its capacity to absorb and adjust to shocks and most institutions did not react or sell based on S&P rating.

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