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Should investors fret over a US debt downgrade?

The US Congress may have raised the US debt ceiling, yet the drama is far from over. While Moody's and Fitch have reaffirmed Uncle Sam's AAA credit status, S&P has downgraded US long-term debt from AAA to AA+, because of concerns that the recent deal in Washington does not go far enough to address the nation's fiscal woes.

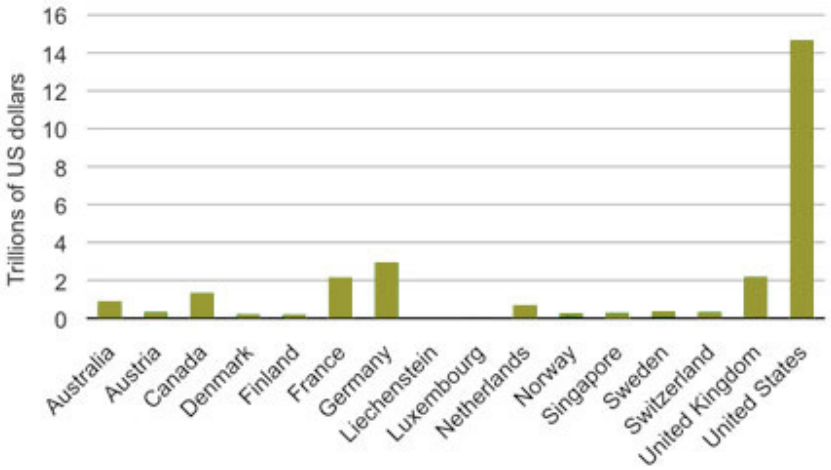
But while that prospect may sound alarming, the short-term impact may be less onerous for bondholders than many predict. In fact, several top-rated countries, including Australia, Canada, Japan and Sweden, have lost their AAA status before; with the exception of Japan, all have eventually recovered it without a severe long-term impact.

With the prospect of a downgrade publicly discussed by the ratings agencies for several months[1], many would argue that this possibility has already been priced into the capital and currency markets.

Consider that demand for US Treasuries has in fact increased in recent weeks; yields have been in decline all year and are back near record lows[2]. In fact, as recently as the 1st of August, Treasury yields averaged 0.72 percentage points less than the world's sovereign debt markets overall[3] – hardly a sign of widespread anxiety.

If not the US.....then who?

The US economy remains larger than all the other AAA-rated nations combined[4]
GDPs in Purchasing Power Parity (PPP) terms



Source: CIA: The World FactBook, as of July 2011. GDP figures are based on the latest data available. PPP estimates the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to each currency's purchasing power. **Past performance is no guarantee of future results**. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

Why the muted response? In part, because the US dollar represents 60.7% of the world's currency reserves, more than double the next biggest currency, the euro[5]. There are at present no serious challengers to its status as the world's main reserve currency – providing a compelling reason to continue buying and holding US debt.

When all's said and done, a rating downgrade could have some positives. The loss of national pride (not to mention the prospect of more expensive borrowing) could be the spark needed to move the country toward better control of its spending. After all, a country's underlying economic strength has a much bigger effect on markets than the opinions of outside rating agencies, whose own reputations remain tarnished after the financial crisis of 2008.

[1] Sources: Bloomberg, 18/4/11.

[2] Source: Bloomberg, August 1, 2011. The benchmark 10-year Treasury yield was 3.3% on 31/12/2010 and 2.77% on 1/8/2011, but still above the low of 2.11% reached on 30/12/2008.

[3] Source: Bloomberg, August 1, 2011.

[4] Source: CIA: The World FactBook, July 2011. US GDP in purchasing power parity terms estimated at $14.66 trillion. The combined GDP of all other nations that currently have a AAA sovereign debt rating equals $12.14 trillion.

[5] Source: International Monetary Fund (IMF) via Bloomberg, August 1, 2011. Being the world's reserve currency means that most global trade transactions occur in US dollars, so there is natural demand that helps reduce the interest rates the US government pays on its debt. Approximately 85% of all foreign exchange transactions in 2010 had the US dollar as one part of the currency transaction, according to the Bank for International Settlements, "Report on Global Foreign Exchange Market Activity in 2010." December 2010.

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