CAPRIN
Asset Management, L.L.C
Capital Preservation & Income

Caprin Asset Management, L.L.C.

1802 BAYBERRY COURT, SUITE 202, RICHMOND, VA 23226
804.648.3333
WWW.CAPRINBONDS.COM

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Caprin Commentary: The S&P Downgrade

Introduction

S&P officially downgraded the United States of America's credit rating one notch from AAA to AA+ Friday evening while leaving its rating outlook "Negative," marking the first time that the United States has held anything less than the highest possible credit rating from any of the three major ratings agencies. S&P's action came as no surprise since, leading up to the debt ceiling deadline, S&P had given strong indications that a downgrade would be imminent if deficit reduction measures were deemed insufficient to reverse projections for America's medium and longer term debt profile. Meanwhile, Moody's and Fitch, the other primary rating agencies, have indicated that they will postpone any ratings action until details of further deficit reduction negotiations emerge later this fall.

The S&P report reads as both a financial and a political document, detailing disappointment with the outcome of the debt ceiling debate and its debt reduction compromise, concluding that the agreement falls short of measures necessary to alter America's mid- and long-term debt metric trajectory. S&P also cites concerns about the political environment that came to light during the debt ceiling negotiations, perhaps reflecting a more broadly felt disappointment: the brinksmanship and rhetoric influenced S&P's opinion of "America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed" (S&P). The agency calls out both political parties for their unwillingness to compromise and address meaningful reform – Republicans for their intractability on taxes and the Democrats for not budging on entitlement spending.

Highlights:

- S&P downgrades U.S. credit rating from AAA to AA+; maintains negative outlook
- Slowing U.S. economic recovery and European debt struggles have overshadowed S&P's threats and action; supporting Treasury market strength, liquidity
- U.S. downgrade could affect some state and local issuer Muni ratings

China Reaction

Initial rhetoric out of China, issued via an editorial from the state-controlled news agency rather than from any specific government official, chastised the United States for its downgrade. As the largest holder of U.S. debt, China, in the same release, called for the United States to get its fiscal house in order and condemned America's "debt addiction" and "short sighted" political gamesmanship. The editorial's most notable shot across the bow was its call for the possibility of a new stable and secured global reserve currency. These types of statements raise concerns that China may seek to diversify its investments away from U.S. Treasuries, a move that would have clear implications for both interest rates and the dollar itself.

Caprin Analysis

This move by S&P had been telegraphed and was largely expected given the failings of the debt reduction measures coming out of the debt ceiling resolution. While a credit downgrade usually suggests that market participants should sell Treasuries until compensated with higher yields that reflect perceived higher risks, we have actually seen a strong Treasury rally and lower interest rates in recent weeks. With continued uncertainty in Europe and the softening of economic growth expectations here in the U.S., the "risk off" trade has dominated recent global and domestic markets with lower equities and higher gold prices. The inability of our political leaders to meaningfully address our longer-term challenges continues to pose a confidence drag on risk assets and business investment.

Despite the downgrade and China's editorializing for a substitute for the U.S. dollar, there seem to be no viable near-term replacements as the reserve currency and flight-to-quality vehicle. However, we may yet see a marginal longer term migration away from U.S. Treasuries as economies and global debt markets evolve. This evolution may well influence U.S. interest rates in the years ahead.

As for the initial comments out of China, we cannot ignore such bold comments from the largest holder of U.S. debt. At the same time, though, we view the likelihood of any kind of immediate mass-dumping by China of U.S. Treasuries as neither likely nor in China's best interest. From such a sale, the likely resulting drop in Treasury prices would impair the value of any remaining Treasuries China held, and the likely concurrent deterioration of the U.S. dollar would endanger U.S. imports of Chinese goods. Finally, as stated above, there don't seem to be any viable risk-free options to replace the dollar and U.S. Treasury.

State and Local Debt Ratings Likely Affected

We will not be surprised to see S&P downgrade state and local governments with significant ties to Federal government spending. If an issuer's credit rating has been linked in any way to support from the U.S. Government, then it would stand to reason that a weaker U.S. Government rating would entail weaker support and warrant at least a change in outlook, if not an actual downgrade. We will be watching in the days and weeks ahead for developments of further and broader ratings actions.

Caprin Strategy

We do not interpret this one-notch downgrade as a surprise, nor do we see a significant change to our portfolios' overall credit profiles. In keeping with our philosophy of capital preservation and income, we have been managing through this environment with a continued priority on quality and liquidity so that we can adapt should unforeseen consequences begin to emerge as a result of this downgrade. We remain vigilant and focused on the fundamentals and will continue to place a premium on avoiding volatility, seeking opportunities and preserving each portfolio's income stream.