U.S. Debt Ceiling and the Credit Downgrade

- Although I have written about the U.S. debt ceiling and the potential for a ratings downgrade on U.S. Treasuries previously, this article includes the market's reaction to these events.
- I continue to believe that the market has overly discounted a deceleration in economic growth in the U.S. Though I expect continued volatility from a market driven by news, rumors, and fear, I believe the U.S. economy will not "double-dip" into a new recession.
- Of course, frustration with Washington, DC and concern with Europe's debt levels do not instill confidence, which ultimately can impact how the economy and market perform.

The first week of August has seen unsettling domestic news that have all but shattered hopes of a sustained recovery. There is even talk of a new recession. Although the Aug. 5 employment report was positive (117,000 jobs added in July, unemployment rate at 9.1%), it was not enough to balance the effect of all the other disquieting events.

Debt Ceiling: However unthinkable a U.S. debt default may be, national borrowing has reached the $14.3 trillion limit (or debt ceiling) this year. In response, President Obama and leaders of both parties announced (on July 31) and passed (on Aug. 2) a last-minute agreement that would raise the debt ceiling by as much as $2.4 trillion. This measure would enable the government to keep borrowing until 2013, but it requires major spending cuts that may slow down the already-weak economic recovery.

Although expected to restore confidence in the markets, the signing had the opposite effect, mainly because it offered a short-term solution to avert the immediate crisis instead of a long-term plan to reduce future indebtedness. The proposed spending cuts have not been clearly identified or assigned to specific sections of the budget; instead, a bipartisan committee is supposed to make recommendations and submit them to Congress later this year. Markets fell in response to this uncertainty and the political gamesmanship that created it.

Credit Downgrade: On Aug. 5, U.S. debt was downgraded by Standard & Poor's to "AA+" from its coveted "AAA" credit rating for the first time in history. Reasons cited include increased political risk and rising public debt burden as challenges to sustaining an appropriate debt/GDP ratio in the next decade. The first reaction of the market to such news can be observed by looking at Treasuries; surprisingly, Treasury bond yields went down and prices went up. Lower bond yields, despite the downgrade, showed that investors still felt U.S. Treasuries were a safe haven compared to riskier assets. Global equity markets, however, plummeted on Aug. 8, as the downgrade catalyzed a flight to safety because of ongoing concerns with the U.S. and global economy.

Investing Insights: Investors' portfolios may be looking pretty bleak in light of recent market volatility, with falling stock prices and dreadful returns. Panic selling, of course, is not a solution, but neither is sitting patiently and waiting for everything to go up again. In times like these, it is important to have a baseline amount of liquidity to cover near-term expenses, particularly for people who are retired. The next important step is to realign your long-term asset allocation according to your risk tolerance, and then, if you have some money left over and are thinking about putting it to work, an interesting idea would be to look for pockets of the market that appear undervalued right now.

U.S. Market Drops in Reaction to Debt News