

U.S. Credit Downgrade—How Would It Impact Fixed Income Investors?

By: SEI Investment Management Unit

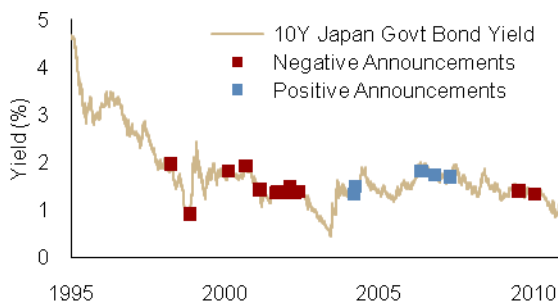


In recent weeks, major credit rating agencies have expressed renewed concern over the fiscal outlook for the U.S. government, even raising the possibility that it could eventually lose its AAA rating. What are the implications for investors? There's both a short- and a long-term dimension to this question. In the near-term, the Treasury estimates that if its statutory borrowing limit is not soon raised by Congress, it could default on interest and debt repayments by August. This risk is still viewed as remote, but if it did occur, it could cause significant dislocation in markets, and a credit rating downgrade would be justified. Additionally, rating agencies worry that the U.S. government is on an unsustainable long-term fiscal path. Does any of this lead us to believe that investors should not own U.S. government debt?

Our View

No, it does not. Judging by current Treasury prices, markets expect the debt ceiling to be raised before a default occurs. If they're proven wrong, it's reasonable to assume that Treasury holders would eventually be made whole for missed interest or principal payments, as occurred following a brief default on maturing bills in late April and early May 1979 (an event caused by administrative and technological problems and by Congress' failure to act on the debt ceiling). As far as the long-term fiscal outlook, most governments in the developed world are in a similar situation as the U.S. Thus, successful active investment in sovereign government debt is now largely a matter of finding relative value, and if investing globally, prudently managing currency risks.

The relevance of fiscally-driven rating downgrades to the securities of sovereign government issuers is also suspect. For example, Japan's government has been put on negative watch or downgraded several times since that country's asset bubble burst, with no discernible impact on its bond prices or yields (which move inversely to each other). As we noted in an earlier paper on this subject, "the consequences of a credit downgrade might not be as disastrous as some fear."



Source: Japan Ministry of Finance, Moody's, Standard & Poor's

In coming decades, many developed countries are likely to end up in situations similar to Japan's, with national government debt at a historically high level relative to the size of their economy. The last time this occurred was at the end of World War II, but the global economy and financial system are very different today, so that history may offer limited guidance. Based on Japan's more recent experience, it's reasonable to expect that a rating downgrade would be a non-event for U.S. government debt, whatever its impact on national pride.

Our Funds

In our funds, we are generally underweight U.S. government securities. Although our managers are attentive to both the short- and long-term risks associated with Treasury debt, this positioning is driven primarily by value considerations, as they believe that other areas of the market offer more attractive risk-adjusted returns.

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