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## When “Risk-Free” Isn’t Risk Free: The Impact of a US Treasury Downgrade

Many investors are on edge about the market’s reaction to a possible downgrade in US Treasury bond ratings. We think the impact is likely to be modest—we’re more concerned with long-term structural issues in the US fiscal situation.

Rating agencies’ recent threat to downgrade US Treasury debt from its current AAA status, if a resolution on the debt ceiling isn’t reached quickly, has intensified the ongoing political struggle in Washington, DC. Our view is that a deal will eventually be struck to keep the US from defaulting on its obligations—politicians fear being blamed for what could be catastrophic market fallout from an actual default.

But while the US political system is reacting aggressively to the near-term fiscal crisis, it seems unable to address the long-term structural issues behind it. Rating agencies have put the US on notice that those issues could lead to a Treasury downgrade, regardless of whether the debt ceiling is raised.

What would happen if US Treasury ratings were downgraded?

### Looking at Past Downgrades

We researched the potential market impact by studying previous downgrades of sovereign debt. We found that US Treasuries are not likely to see a large increase in yields simply due to a ratings downgrade. This is consistent with the market’s reaction so far to saber rattling by rating agencies—despite the concerns over US finances, Treasury yields have been *falling* rather than rising, which would be expected if investors were demanding higher risk premiums. That’s not to say that market conditions couldn’t change rapidly, causing Treasury yields to spike, but if the only change between today and tomorrow is a

credit-rating downgrade, history suggests that the market won’t react severely.

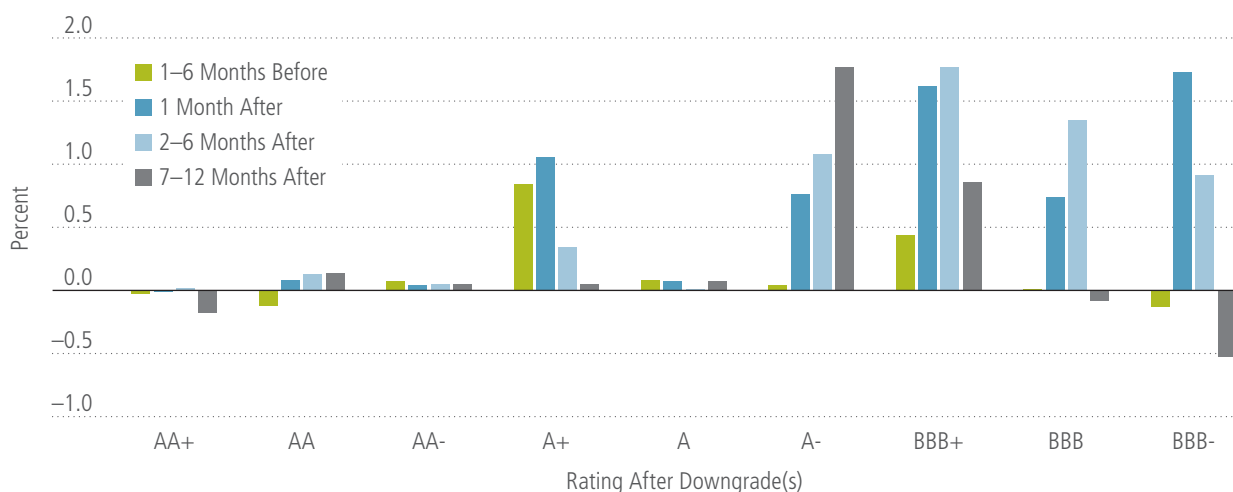
To assess the impact of other sovereign downgrades, we analyzed the change in interest-rate spreads of countries that suffered ratings downgrades of one to three notches since 1990 (*Display, next page*). We looked at a variety of time periods, including the six months before the downgrade (to capture market reactions leading up to the downgrade) and periods after the downgrade. (For a more complete explanation of our methodology, see “About Our Analysis,” page 3.)

The spread change for highly rated countries tended to be very modest. For countries downgraded to AA+, the average spread barely changed—in fact, on average it narrowed about three basis points in the six months before the downgrade. In the two to six months after the downgrade, spreads were only two basis points higher than they were six to 12 months before the downgrade.

Generally, the lower the new rating, the more spreads reacted. History shows that ratings downgrades into the BBB category or lower (ratings below BBB-

## Downgrades Have Historically Had Little Impact on High-Quality Sovereign Spreads

Impact of Ratings Downgrades on Spreads



**Historical analysis is not a guarantee of future results.**

Based on data from January 1, 1990, through April 30, 2011

Source: Bloomberg, International Monetary Fund, Moody's, S&P and AllianceBernstein

not shown on the chart) have had significant impacts on financing in terms of higher yields. However, we don't think this is a likely scenario for the US.

### Impact Varied with Investor Confidence

In the majority of downgrades, spreads didn't widen significantly either before or after the downgrade. Generally, these downgrades occurred in more stable market conditions and included downgrades on some of the larger developed economies. These included Sweden in 1991; Canada in 1994 and 1995; New Zealand, Finland, Italy, Belgium and Ireland in 1998; Japan in 2000, 2001 and 2002; Italy in 2004; Portugal in 2005; and Japan in 2009.

When Moody's downgraded Canada from Aaa to Aa1 in June 1994, there was a short-term yield increase in the month immediately following the downgrade: 10-year yields rose from 8.80% to 9.29%. However, spreads then moved back toward their normal range relative to US Treasuries by August, approaching

levels seen before the downgrade. Even when the global environment was weakening, such as when Japan was downgraded from AAA to AA+ in June 2000 by S&P, yields actually declined in the following months because of Japan's standing as a safe-haven investment.

In all these cases, we don't believe that investors sensed any less of a commitment by governments to meet their future obligations after the ratings downgrade from AAA to AA—or even from AA to single A. As a result, financing spreads barely budged.

It was a different story for downgrades that took place in the context of a broader economic or financial crisis—in those cases, yields rose significantly. These situations included Italy's 1991 downgrade during the early 1990s recession, Finland's and Sweden's downgrade in 1992 in the wake of the Soviet banking crisis, and Italy's downgrade in 1992 during the European Exchange Rate Mechanism crisis. Also included were Iceland in 2006, Spain and

Ireland in 2009 during the global financial crisis, and Spain again in 2010 during the peripheral-debt crisis. In each of these cases, the downgrade only compounded issues that were already reducing risk appetites in the market.

### Safe-Haven Status Should Mitigate Impact

Our analysis suggests only a limited impact on US market yields if Treasuries were downgraded from AAA to AA, thanks to the combination of America's status as a safe haven in times of crisis and the fact that the world is several years into an economic rebound. Broadly, we'd expect something similar to what was seen in Canada in 1994 or Japan in 2000. The US dollar's special place as the world's reserve currency reinforces this perception.

Obviously, the sheer size and presence of the US market could cause a downgrade to provoke a bout of risk aversion across markets, pushing up yields on risk assets both in the US and other countries. But if the market perceives that the claims-paying status of the US government

hasn't actually changed, such a risk-averse environment may in fact help support Treasury bond prices and lower yields, as investors continue to consider the US a safe-haven destination.

In our view, the most likely scenario is that the market will continue to view the US government's creditworthiness as risk-free—whether the rating agencies act or not. We'd hope, though, that the threat of agency action might spur

Congress and the president to work together to prevent any changes to America's credit standing.

The longer-term question is whether the market will decide that the US is simply incapable of addressing its underlying structural issues with Social Security, Medicare and other entitlement programs. The current assumption is that the threat of a potential crisis will spur

the US government to act. But if inflationary expectations take hold and yields start to rise, higher financing costs will start to cause a dramatic deterioration in US fiscal projections. At that point, our analysis would change significantly: The US might fall into the category of sovereign downgrades that accelerate an already-worsening fiscal situation. Based on Treasury yield movements, we're not there yet. ■

## About Our Analysis

To assess the impact of downgrades on a country's risk premium, we analyzed the interest-rate spreads of countries that had suffered ratings downgrades of one to three notches over the past two decades. We defined the spread as the difference between a country's sovereign yield and the yield on either US Treasuries or German bunds.

In developed economies, we focused on changes in long-term local-currency ratings by Moody's and S&P, evaluating spreads on local government debt to US Treasuries or German bunds. Because emerging markets were historically more dependent on foreign currency borrowing, for these countries we instead used long-term foreign currency ratings and the spread to Treasuries on dollar-denominated debt in the JPMorgan EMBI Global.

We evaluated periods both before and after ratings downgrades. All changes are cumulative relative to a country's average spread during the six to 12 months before the downgrade (we defined this as our "pre-downgrade" yield benchmark). The bars in the display show changes against this benchmark over subsequent time periods.

The first bar in the display represents the spread change in the period one to six months before the ratings change. For instance, if a country was downgraded at the end of December of a given year, the first bar would represent the difference in the country's average spread during the July–December period of that year relative to its January–June spread of the same year (the "pre-downgrade" period). So the first bar represents the difference during the run-up to a ratings change: a positive number means that the financing cost increased as the market

became concerned over a country's credit rating and anticipated the future downgrade.

The second bar looks at the cumulative change in financing cost one month after the downgrade compared with the pre-downgrade period (six to 12 months prior). This bar inherently incorporates any change captured by the first bar.

The display excludes data from countries suffering the most severe downgrades—more than three notches in less than six months. These situations are less relevant to the question of what may happen to the US if it's downgraded from AAA. However, it's worth noting that those severe downgrades have historically had a much larger impact on financing costs than the situations examined here, with spreads increasing 500 to 850 basis points in the seven to 12 months after the downgrade.

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