MILES Capital
Independent Investment Solutions

1.800.343.7084
www.miles-capital.com
1415 28th Street, Suite 200
West Des Moines, IA 50266

David W. Miles
Chief Executive Officer

S&P Downgrade of U.S. Sovereign Debt: The Other Shoes to Drop

August 8, 2011

On Friday, August 5, 2011, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the United States of America to 'AA+' from 'AAA'. The title of the report, "United States of America Long-Term Rating Lowered To 'AA+' On Political Risks And Rising Debt Burden; Outlook Negative," captures the essence of their analysis.

S&P rates sovereign credits using five major rating factors. They are:

- Institutional effectiveness and political risks, reflected in the political score.
- Economic structure and growth prospects, reflected in the economic score.
- External liquidity and international investment position, reflected in the external score.
- Fiscal performance and flexibility, as well as debt burden, reflected in the fiscal score.
- Monetary flexibility, reflected in the monetary score.

The body of the report makes clear that the first and fourth factors were paramount in their re-evaluation of the U.S.'s credit-worthiness. As to the political score, they wrote that ". . . the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges ...."

As to the United States' ability to service its debt, their base case scenario assumes the $2.1 trillion in spending reductions included in the Budget Control Act Amendment of 2011 are implemented, trend real GDP growth of 3% annually and consumer price inflation near 2% annually over the next ten years. Importantly, they have changed their base case scenarios since April to now assume that the tax cuts due to expire by the end of 2012 remain in place, because Congress has shown itself unwilling to enact measures to raise revenues. Based on these and other assumptions, they "now project that net general government debt would rise from an estimated 74% of GDP by the end of 2011 to 79% in 2015 and 85% by 2021," which they ". . . consider to be consistent with a 'AA+' long-term rating and a negative outlook."

Unsurprisingly, U.S. Treasury officials have decried the first ever downgrade of sovereign debt in U.S. history, arguing in a blog post Saturday by John Bellows, Acting Assistant Secretary for Economic Policy, that "there is no justifiable rationale for downgrading the debt of the United States."

Though the controversy over S&P's decision may well continue, we do not believe that they will backtrack, which means that a credit downgrade by one of the three major rating agencies (Moody's and Fitch affirmed their "AAA" rating earlier last week), is a reality.

Given the unprecedented nature of this action, we believe a certain degree of humility is in order in attempting to forecast the effect on U.S. and global markets. We can take some solace perhaps in the minimal impact on interest rates that accompanied other recent sovereign downgrades in Canada and Japan. And even S&P notes that the position of the U.S.

Past performance does not guarantee future results. This does not constitute an asset allocation or investment recommendation. Investors should consider investment objectives, risks and expenses carefully before investing. Investments are not FDIC insured and may lose value.

1.800.343.7084
www.miles-capital.com
1415 28th Street, Suite 200
West Des Moines, IA 50266

David W. Miles
Chief Executive Officer

dollar as the world's reserve currency confers a funding advantage that is likely to change only slowly.

We are focused on five concerns for our clients:

1. Short-Term Turmoil in the Global Stock and Bond Markets. In the near term we see both greater volatility and uncertainty. Equity markets both domestic and abroad have fallen, but the bond market has risen on the flight to quality rather than falling on fears about U.S. credit quality.

2. Spillover Effects Onto Other U.S. Debt Issuers and Bondholders. S&P today downgraded Fannie Mae, Freddie Mac, Federal Home Loan Bank and Federal Farm Credit, given the implied government support. Financial regulators made a joint announcement this weekend that the downgrade will have no impact on risk weights for capital treatment, but some financial entities may still see pressure given portfolio exposures to goverment securities. And some municipal securities may also be affected given their dependence on federal support in various forms.

3. A Further Drag on the U.S. Economy. This is our greatest concern for the United States overall. This recovery has been tepid at best and in recent weeks has shown clear signs of slowing. The impact on consumer confidence of greater uncertainty is certainly going to be negative. Further, we see S&P's actions as fueling demands for near term fiscal restraint which could actually impede the economic recovery and job growth.

4. A Rise in Global Risk Premia. For decades the investment world has operated as though an investment in U.S. government debt was riskless. When the global benchmark risk-free investment is downgraded, investors may re-evaluate long held assumptions on the relative risk of different investments.

5. The Potential for Much Higher Borrowing Cost for the United States Government. Higher rates on U.S. treasuries is by no means certain, but the proportion of U.S. debt that is held by foreign investors has been a growing concern. We certainly don't predict a buyer's strike, but we certainly could see a dampening of demand, requiring higher rates and further hampering our ability to grow out of our deficit.

As has been pointed out by multiple observers – including former Fed Chair Alan Greenspan on Meet the Press Sunday morning – there is no doubt that the United States can repay its debt so long as it chooses to, but there is a price to pay for our ongoing debt problems.

While we could not have predicted the timing of a downgrade, we began repositioning portfolios to reflect the weaker domestic growth outlook earlier this year. Our equity strategies have focused on larger companies with higher dividends and lower volatility, and our active fixed income strategies have reduced credit exposures to protect market value. The priority in today's volatile world is to step back from emotional responses and look for the opportunities. Recent volatility has presented some opportunities and we will continue to take advantage.

Past performance does not guarantee future results. This does not constitute an asset allocation or investment recommendation. Investors should consider investment objectives, risks and expenses carefully before investing. Investments are not FDIC insured and may lose value.