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No Default, But Worries Over Credit Downgrade, Stalled Economy Persist

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The long, hot summer of deficit debate is over, as the White House and Congress struck a last-minute deal to raise the debt ceiling and cut government spending.

The agreement allows the U.S. government to narrowly avoid its first-ever credit default but leaves many of the hardest questions about the future of entitlement programs and tax reform unanswered. It also opens the door to many more months - if not years - of partisan debate as key members of both parties hammer out the details of the deal.

The Plan at a Glance

The basics of the plan include the following:[1]

- **The debt ceiling:** The debt ceiling will increase by as much as $2.4 trillion, giving the government borrowing power into 2013. This includes $400 billion in immediate increases, with the remainder coming later this year and in early 2012. The future increases would be assured unless disapproved by two-thirds of Congress.
- **Spending cuts:** The plan includes $1 trillion in cuts to discretionary spending over the next 10 years. A special bipartisan congressional committee will be charged with finding an additional $1.5 trillion in cuts by late 2011.
- **Enforcement measures:** Failure to find at least $1.2 trillion in savings will trigger automatic across-the-board cuts of $1.2 trillion that will be split 50%/50% between defense and domestic programs. Programs for low-income households, as well as Medicaid and Social Security, would be exempted; but Medicare payments to providers could be cut. Cuts would not become effective until December 2013.
- **Tax increases:** None in the immediate deal, but President Obama has threatened to veto any extension of the Bush-era tax cuts unless Congress acts on an overhaul of the federal tax code.

With Default Averted, Is a Downgrade Imminent?

With the 11th-hour deal in hand, the nation can breathe a collective sigh of relief knowing that the United States will not default on its financial obligations. The deal also takes a tentative first step toward addressing the formidable challenge of reducing the potentially crushing federal debt load. But have lawmakers done enough to avoid a downgrade of the country's 'AAA' credit rating?

Standard & Poor's, one of the three credit rating agencies in the country, has placed the United States on CreditWatch with negative implications. Its rationale was that simply raising the debt ceiling would not be enough. In a press release dated July 14, 2011, S&P stated, "We may lower the long-term rating on the U.S. by one or more notches into the 'AA' category in the next three months if we conclude that Congress and the Administration have not achieved a credible solution to the rising U.S. government debt burden."[2] S&P believes that solution should include budget savings of $4 trillion - significantly more than the $2.4 trillion in savings agreed to in the lawmakers' plan.

How might a downgrade affect consumers, businesses, and the economy? At the very least, a downgrade could result in increased borrowing costs for the federal government, as well as for states and municipalities, corporations, and consumers holding mortgages, credit cards, and student or auto loans. There is wide concern that such increases could inflict further damage on the nation's faltering economic recovery.

The Economic Impact

Aside from the implications of a credit downgrade, many economists say that the legislation itself could endanger the economic recovery - both because of the spending cuts that it mandates as well as its failure to renew measures such as the reduction in payroll taxes that have put money in Americans' wallets.

In addition, the timing of the deal coincided with a slew of bad economic news. For example, reports out this week indicated that the manufacturing sector grew at a slower rate in July than in June and consumers cut their spending in June for the first time in two years. In addition, the latest gross domestic product (GDP) figures released last week indicated that the economy grew at an annual rate of less that 1% in the first half of 2011, much slower than previously thought.

Commenting on the news, Standard & Poor's Senior Economist Beth Ann Bovino stated that S&P would "shave off several basis points from our already soft 2.4% estimate for 2011 GDP. With the real GDP growth trajectory for this cycle lowered, it makes the outlook for the economy a lot weaker going forward. It also increases chances that the Fed will keep interest rates at near zero levels until 2013, and possibly open the books for another round of quantitative easing this year."[3]

With many of the cuts delayed until 2013, some see the short-term drag on the economy as minimal. Still others see the economic implications of the bill quite differently. Some leaders in the business community, such as Thomas J. Donohue, chief executive of the U.S. Chamber of Commerce, said the agreement would help "restore economic growth, reduce spending, and create millions of new jobs."[4]

Takeaways for Investors

While markets have been choppy as the debate in Washington has played out, many Wall Street observers believe that any fallout from the debt deal has already been priced into the market. Still, it is likely to take weeks or months for the full impact to be realized. That said, there are some "baseline" strategies for investors to consider in the short-term:

Your portfolio: While the deal itself should not require you to make radical changes to your asset mix, it reinforces the need to diversify with international stocks and bonds. Whatever percentage you choose to put in international holdings, the majority should probably be directed toward developed markets.

The dollar: Although the debt deal spurred an immediate, temporary rally for the dollar, the longer-term outlook remains weak. That may be bad news for summer travelers, but it presents another argument for owning stocks or funds that are denominated in other currencies.

Municipal bonds: For retirement investors who count on income from municipal bonds, the current debt situation is cause for concern. Federal spending cuts may mean less aid to states and local governments, making already strapped states more vulnerable to budget deficits and downgrades. One strategy may be to diversify within a muni portfolio. For example, you could shift some focus from general obligation bonds, which may be more dependent on federal funds, to revenue bonds, which may be supported by dedicated revenue streams such as water, sewer, electricity, or highway toll fees.

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[1]Source: Adapted from *washingtonpost.com*, August 1, 2011.

[2]Source: Standard & Poor's Ratings Direct, "United States of America 'AAA/A-1+' Ratings Placed on CreditWatch Negative on Rising Risk of Policy Stalemate," July 14, 2011.

[3]Source: Standard & Poor's, *U.S. Financial Notes Weekly Market Analysis*, July 29, 2011.

[4]Source: *The Washington Post*, "Debt-ceiling deal risks compromising fragile economic growth," August 1, 2011.

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