Print Close

# A Year Later, S&P's Wake-Up Call Still Unanswered

By Matt Egan

Published August 06, 2012 | FOXBusiness

Standard & Poor's historic decision last summer to downgrade the U.S. credit rating for the first time ever was painted as a potential wake-up call to both Washington and Wall Street.

But exactly a year later it's clear neither was true. Washington is still scrambling to prevent the country from falling over the so-called fiscal cliff, while investors continue to scoop up U.S. debt, pushing borrowing costs to record lows.

All of this underscores apprehension to take risk amid threats to the global economy from the likes of Europe and China, as well as questions regarding the continued role of the U.S. as the world's safest and deepest bond market.

McGraw-Hill's (MHP) Standard & Poor's created international news by wiping out America's pristine "AAA" credit rating on August 5.

**U.S. Still a Safe Haven**

Somewhat ironically, interest rates have tumbled since then, with the yield on the benchmark 10-year Treasury note plunging from 2.6% to 1.556% on Monday. Likewise, stock prices have rallied; the S&P 500 has jumped 24.5% to 1394 over the past year.

"I don't think the downgrade really matters all that much," said Josh Feinman, chief global economist at Deutsche Bank's (DB) DB Advisors. "I think [investors] see the U.S. still as a safe haven. I don't think people question the U.S government's willingness and ability to meet its obligations."

All of this means that, despite S&P's warning, the financial markets are saying the U.S. is still the safest house in the developed markets, especially as the eurozone debt crisis has intensified significantly over the past year.

"If the safest large country, the U.S., got downgraded, it means the whole group's risk has increased," Cam Harvey, a finance professor at Duke University, wrote in an email. "Hence, you get the seemingly paradoxical implications that yields actually decreased after a downgrade as investors flocked to the U.S. as a safe haven."

The fact that interest rates have descended since the S&P move has kept the cost of credit relatively cheap, especially in the housing market. According to Freddie Mac, the average rate on a 30-year fixed mortgage stood at just 3.55% last week, compared with 4.39% a year earlier, and rates have fallen to or matched record-low levels in 13 of the past 14 weeks.

But this phenomenon also highlights concerns about global growth as investors prefer to stash their money in Treasurys where it will earn virtually nothing rather than risk losing capital in riskier assets.

**Fiscal Cliff Looms**

The lack of a bond-market revolt in the wake of the S&P downgrade also helps explain why Washington has failed to reach a comprehensive deal on its fiscal mess.

Despite low Treasury yields, "I don't think Congress should be at all comfortable with where we are," said Douglas Holtz-Eakin, former director of the Congressional Budget Office. "In a different world Europe doesn't melt down and our rates go up. That's the message they need."

Unless Congress acts, a slew of painful changes, dubbed the fiscal cliff, will take place in 2013, including $1.2 trillion in automatic government spending cuts, the expiration of the Bush tax cuts and the payroll tax cuts.

"If they were to fail to deal with the fiscal cliff, I think it would be a recipe for another downgrade," said Holtz-Eakin.

The CBO has warned that if these changes go into place, the U.S. is likely to fall into a recession.

**Washington Doesn't Feel the Heat**

The lack of pressure from the bond markets in the U.S. stands in stark contrast to the situation in Europe, which has seemingly only contemplated credible solutions when yields on Italian and Spanish bonds have surged near unsustainable levels.

In the U.S., "interest rates keep moving lower. There's no pressure being brought to bear on the U.S.," said Feinman.

Harvey notes the current U.S. borrowing rate of 2.6% is half of 2007's 5.04% rate -- even though the country's debt load has doubled since then to $15.9 trillion, the interest cost to service the debt has remained the same.

"It seems like the politicians mainly care about the service cost -- not the absolute level of debt," said Harvey. "Of course, that is short-sighted and the level of debt will come back and bite them when rates start to climb again."