Russell's view:
And now this – Can the market's psyche handle the downgrade?

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By: Erik Ristuben, Chief Investment Officer – Client Investment Strategies

A message to financial advisors and their clients

As investors watch Monday's open in both the bond and equity markets following the S&P downgrade of the United States' credit rating, Russell believes that bond-market response will be muted while the equity market is likely to see a measured, but not panicked, response to another blow to its psyche. As news continues to unfold about the global markets, Russell Investments' experts will continue to share their insights with you.

As markets open for Monday trading on August 8, 2011, investors' eyes will alternate focus between global bond and equity markets to gauge the reaction to Friday's announcement by S&P that U.S. Treasury debt is no longer among the safest investments in the world. The drop to an AA+ rating marks the first time in 70 years that the U.S. hasn't held the triple-A rating among the major rating agencies.

But is this the harbinger of economic apocalypse? Is it the signal of the beginning of the end of America's global economic leadership? We don't think so.

Our view is that recent negative market volatility reflects a drop in confidence in response to a spate of negative headlines – not a global economic collapse. Confidence of all shapes and sizes was tested last week by a sensational buffet of dire reports asserting the possibility that a weakened global economic recovery could slide off the cliff.

As confidence declined, speculation barreled ahead: But our analysis of the facts leads us to believe that although the economy has been weakened, a "double-dip" recession remains unlikely. The astounding volume of intraday trading activity on August 4 and 5 was a perfect mirror of rattled investors' collapsed confidence. Add Friday's downgrade announcement to the mix, and it's understandable that investors are wondering how much more the markets can handle.

Eyes fixed on fixed income

We've been watching reactions to the downgrade through the weekend, and we don't think the bond market is looking to S&P to determine what U.S. Treasuries are worth. In fact, last week's drop in Treasury yield – which reflected a flight to safety – gives us a good indication that there is no significant concern about America's ability to service and repay its debt. Our current thinking is that the bond market reaction to S&P will likely be muted.

The downgrade does raise technical concerns regarding capital requirements for banking, insurance, derivatives and money funds, but the Fed, other regulators and governments in Europe and Asia have strongly stated that the risk weighting for U.S. Treasuries in capital structures "remains unchanged."

Although it's impossible to be completely certain how yields will react (panicky investors could choose to park their money outside of risk assets), there is reason to believe, based on recent history, that Friday's downgrade will not necessarily prolong the current weak patch in the U.S. economy. Russell still forecasts roughly 2.5% in U.S. GDP growth in the back half of this year.

What's in the cards for equities?

The wildcard is the equity market, which has been dealing with blows to its psyche for months in the form of the eurozone sovereign debt crisis, lackluster economic data, the U.S. debt-ceiling issue and now the downgrade. As of this writing on Sunday, August 7, the announcement is two days old and many nations have come out in support of the value and safety of U.S. Treasuries.

We've also seen a measured response in the U.S. futures market. Both of these events are potentially good news. Russell is cautiously optimistic that we will not see an emotional reaction in the equity markets on Monday, and although we do not expect it to be a good day in the market, we're also not expecting panic. The early futures activity in the Asia Pacific market indicates a negative open to the markets, but not full-out panic.

Certainly the S&P downgrade won't do anything to help speed the economic recovery in the U.S., which has been weaker and slower than we would have hoped, and we also anticipate that traumas such as those experienced last week will be a regular "companion" of the recovery. However, a double-dip recession does not look probable unless a negative spiral of sentiment makes it a self-fulfilling inevitability.

If you have any questions about this article, please contact your Russell representative or financial advisor.

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