IdahoTrust

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WealthManagement

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Market Insights

A periodic newsletter from Idaho Trust

In August Standard & Poor's (S&P) sent shock waves through financial markets by downgrading the U.S. Government's credit rating for the first time. This month's Market Insights will discuss the U.S. downgrade and its implications to domestic bond markets.

U.S. Credit Rating Downgrade

On April 18th S&P put the U.S. Government's sovereign credit rating on a negative outlook. Standard & Poor's stated that there was a one-in-three chance that the rating could be cut within two years unless policy makers agree on a plan by 2013 to reduce budget deficits and the national debt.

Late on August 5th, S&P announced that it had downgraded the U.S.'s sovereign rating. The U.S. has held the highest credit rating ('AAA') since 1917. The downgrade occurred merely 5 months after the U.S. was placed on negative outlook, and after Congressional Leaders struggled to raise the debt ceiling until the last minute and implemented budget cuts that were well below S&P's targeted cuts.

Standard & Poor's downgrade was not isolated to the government's credit rating but also affected other bond markets. United States' Agencies like Fannie Mae and Freddie Mac, municipal insurers and municipal bonds were all downgraded. Although a sub-'AAA' rating is a new phenomenon for the U.S., many developed countries have been downgraded before. Canada, Australia, Sweden, Austria, Denmark, Finland, France, Germany, Netherlands, Norway, Singapore,

Idaho Trust Bank offers holistic wealth management services featuring its LifeNeeds™ investing process. Idaho Trust's LifeNeeds™ investment process utilizes proven strategies and techniques delivered by a highly trained staff of wealth management professionals.

LifeNeeds™ wealth management accounts feature optimized asset allocations, robust security screening and Idaho Trust's unique Tactic-Logic™ investment process. All of which are tailored to our client's unique financial needs, insuring LifeNeeds'™ clients the best possible expected return according to their risk tolerances.

Switzerland and the United Kingdom represent the world's top rated sovereign debt issuers. Canada, Australia and Sweden all have had their 'AAA' ratings downgraded in the past, but had their 'AAA' rating re-instated after key budgeting decisions and some tough years of financial reform. Ireland and Iceland are two examples of countries that lost their 'AAA' rating in "near-death experiences" in 2008 and show little hope of regaining them in the foreseeable future. Even more recently, on August 24th Japan, the 3rd largest economy in the world, was downgraded another notch by Moody's, a credit rating agency, from 'Aa2' to 'Aa3'.

Downgrade Implications

Traditionally, a lower credit rating reflects a higher degree of credit risk, risk of a borrower failing to repay contractual obligations. Bond issuers with lower credit ratings typically have to pay higher interest rates to entice potential buyers.

The one notch downgrade from 'AAA' to 'AA+' does not represent a material increase in credit risk, since 'AA+' is still 8 notches above non-investment grade. The downgrade was more reflective of our current economic and political environment. Standard & Poor's explains in their press release:

> *"The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics."* The release continues, *"The outlook on the long-term rating is negative. We could lower the long-term rating to 'AA' within the next two years if we see that less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period result in a higher general government debt trajectory than we currently assume in our base case."*

On August 8th, Moody's reaffirmed its 'Aaa' rating for the U.S. with a negative outlook. On Tuesday, August 16th Fitch Ratings followed suit and reaffirmed the 'AAA' rating of the U.S. with a stable outlook. This leaves a mixed picture of the overall view of the Government's credit rating across the rating agencies.

One fear is that the lower credit rating could cost the U.S. more to issue debt by investors demanding more interest for non-'AAA' government bonds. So far, the opposite has been true. Investors have poured into government bonds since the downgrade viewing them as a safe haven asset effectively causing their rates to fall rather than rise.

Government Bonds

Since the downgrade on the 5th of August and the increase in market volatility, investors have poured into government bonds confirming their perception as risk-free. This has driven treasury yields to historic lows. The

10-year treasury yield is currently at 1.97% (as of 9.6.11) which is far below its 20-year historical average of 5.08%, and even below the lowest level that it reached at the height of the recession in 2008 at 2.06%. In fact, currently lending your money to the Government for a year will only yield you .11% which is startling considering that inflation is currently at 3.60% per year!

These extraordinary low rates reflect the market's overwhelming preference for risk aversion and the scarcity of viable investment alternatives to government bonds. Even at 'AA+' investors feel that government bonds are still safe and liquid investments. With the domestic economy's growth slowing, declining risk appetites and the Federal Reserve's pledge to keep rates near zero until 2013, rates may stay anchored for some time.

Other Bond Markets

Municipal investors have had an enjoyable 2011 thus far. The prevalent fears in late 2010 of widespread defaults have been alleviated. In fact, municipal bonds are on track to have fewer defaults in 2011 than were recorded in 2010. The municipal market, however, did not escape the cascading effects of the U.S.'s credit rating downgrade. Municipal insurers, who provide enhanced credit protection for municipal bonds, have been downgraded along with municipal issuers and pre-refunded municipal bonds that are backed by the Federal Government or Government securities.

Many have worried that corporate bonds, especially bank bonds, could also suffer downgrades by association to Government securities. Fortunately, S&P specifically addressed this concern stating:

> *"The Aug. 5th, 2011, lowering of the United States of America sovereign credit rating to 'AA+' from 'AAA' does not have an immediate or direct impact on our ratings on U.S. Banks. None of the banks we rate in the U.S. has an issuer credit rating higher than the U.S. sovereign rating."*

Although it is good news that no imminent downgrades are present, corporate debt issues may not be out of the woods yet. Corporate bonds, unlike government bonds, are not viewed as safe haven assets and have not benefitted from inflows of investors seeking safe havens as government bonds have.

Conclusion

The recent domestic bond markets have made a strong case for diversification, boasting solid returns and lower volatility than equity markets. Despite the U.S. downgrade, the U.S. government bond market remains the most liquid and relatively risk-free investment readily available to investors. The downgrade is more of a reflection of macroeconomic and political factors and does not necessarily represent a greater degree of risk that the U.S. will not meet its contractual obligations. Hopefully the U.S. can follow suit of other developed countries and regain its 'AAA' rating as well.

Barclays Aggregate Bond Index

3 Month	2.77%
Year-to-Date	5.88%
1 Year	4.62%
3 Year	7.23%
5 Year	6.56%

Barclays Municipal Bond Index

3 Month	3.11%
Year-to-Date	7.29%
1 Year	2.66%
3 Year	6.00%
5 Year	4.94%

Barclays Aggregate Treasury Index

3 Month	4.30%
Year-to-Date	6.98%
1 Year	4.17%
3 Year	6.12%
5 Year	6.60%

As of 8.31.11

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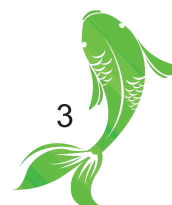

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