STEPPING STONES MANAGEMENT, LLC

Standard & Poors Downgrades the United States

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Fundamental to the world economic system is the risk free interest rate which all risk assets are priced against. The handy reference point for that risk free rate has always been US Treasury debt maturing in a particular time frame. The thinking went that there was no repayment risk in such bonds since the US Treasury could print the dollars to repay them. However, getting paid back in devalued dollars is not as good as stable dollars and Standard & Poors decided that our fiscal imbalances threaten the value of those dollars. They downgraded the rating on long term US Treasury debt from AAA to AA+.

There is no precedent for US Treasury debt being downgraded so nobody knows what happens now. World markets are selling off modestly thus far. When Japan was downgraded in 1998 there was no discernable effect to that country's ability to borrow. US Treasury debt will remain the most liquid asset class in the world and the well telegraphed downgrade threat has not caused rates to rise up to now. Large institutional funds with mandates to invest in only AAA securities have been rewriting their policies to include government debt. It remains to be seen if Treasury debt will have the same collateral value to the banks making loans to hedge funds, if not we could be in for the mother of all "risk off" trades. However, the Credit Default Swap market still shows US debt as among the safest so I don't expect any collateral haircuts. The worst effect of the downgrade may be the blow to confidence among US citizens, further straining our already weak economy. Ironically, the initial reaction looks to be selling of stocks and buying the very debt that was downgraded. Longer term, we could see safe bond money flow into large US companies, some of whom still enjoy an AAA rating, driving down their funding costs. More important drivers of interest rates will continue to be economic growth and inflation expectations.

Last week began with Washington in full congratulatory mood after a deal was reached to raise the debt limit. Although default on US Treasury debt was never a realistic scenario, our politicians claim they averted financial Armageddon. The deal calls for spending to be cut by almost $1 trillion dollars from the baseline over the next decade, but only $6 billion will be cut from spending next year. That amounts to a whopping 0.16% of our budget which is 40% out of balance. Another $1.5 trillion is slated to be cut along lines recommended by a bipartisan Congressional commission which will make the difficult decisions that other congress people have been unable to make. Contrary to what we have all been told, the baseline assumes taxes will go up after 2012 as the Bush/Obama tax rates revert to the Clinton rates. Nobody really expects that $3.5 trillion tax hike to happen though, including S&P.

After a strong rally on Monday morning, the stock market turned negative as investors looked towards weakening economic statistics and sovereign debt trouble in Europe. The sharp drop on Thursday was likely fueled by those with advance word of S&P's coming downgrade. Two other rating agencies passed on a downgrade at this point so S&P's action on Friday night was a bit surprising. We have been holding excessive cash since last year's election expecting these budget struggles, although a downgrade was not an anticipated part of that strategy. We came into this downturn well prepared with a buy list ready and are waiting for some stability to buy into.

This morning also brought news that former New York Governor Hugh Carey passed away at age 92. Governor Carey saw the state through its 1970s financial crisis by getting unions to agree to concessions and cutting the trajectory of government spending. The steps were enough to change President Ford's mind on granting aid to the state. Governor Carey famously said "the days of wine and roses are over". What a difference from today where Washington is overrun by lobbyists out to get as much as they can while the getting's good.

Five countries have gotten their AAA rating back after a downgrade but it has taken a minimum of 9 years, so our leaders have their work cut out for them. It didn't have to be this way. President Obama appointed a bipartisan commission whose ideas could have been enacted into law and this downgrade could have been averted. There is little chance of that happening now in Washington's poisoned atmosphere. Childish accusations and phony budget cuts aren't going to get the job done. Our leaders in Washington think we are too foolish to really know what is going on. The stock market says they are the fools. Let's hope the downgrade serves as a wakeup call.

Yours truly,

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