MV Capital Management Thought Leadership

Treasuries and the Rating Agencies: Newsworthy or Non-Event?

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In the profession of journalism there is a time-honored saying: Does a story qualify as "dog bites man" or "man bites dog"? The idea being, of course, that the former happens all the time and is not worthy of a second glance, while the latter is most unusual and probably deserves coverage in the nightly news. Sometimes, though, it's not entirely clear which category a story falls into. We had that feeling earlier this week while digesting the news that credit rating agency Standard & Poors had issued a "negative" outlook for US Treasury securities, the first time in history the outlook had fallen from its customary "stable" level to negative. It was the kind of headline that certainly makes you sit up in your seat and pay attention. US Treasuries – the ultimate safe harbor in the tempestuous seas of the capital markets – teetering on the brink of a downgrade? That would certainly seem to fall into the category of "man bites dog".

The stock market on Monday also seemed to see this as Real News, with major market indexes plummeting by more than 1%. Or did it? It seems like the S&P 500 goes up or down by 1% on just about a daily basis. If the index had fallen 3% - maybe. But 1% - well, yawn. Besides, the performance of the stock market was only of secondary interest in terms of a read on how the market was taking in this news – what about actual Treasury yields and the US dollar? If investors were really freaking out over a possible loss of triple-A status for Uncle Sam then we would expect to see precisely two things play out at the same time: higher yields on Treasury bonds and a fall in the US dollar. As it turned out, neither of these things happened. Treasury yields actually fell on Monday, the day of the S&P announcement, and the dollar also enjoyed a brief rally. The 10-year Treasury note yield fell about 10 basis points on Monday – meaning that at the end of the day Uncle Sam could borrow on *cheaper* terms than at the beginning of the day. Think about that – it's like your personal credit score went down and your credit card company phoned you up to tell you they were going to *lower* the interest rate on your card!

So the collective response to this news from the market seems to be: No Big Deal. Dog bites man. Is this right? We think the story is a bit more complicated than that. In the near term the conventional wisdom is probably right – markets have been incredibly resilient to just about everything from faltering European sovereigns to nuclear disasters in the past couple months. Right now we seem to be embarking on another happy-talk earnings season, with equities indexes reaching new highs for the year and the dollar's weakness stemming more from its role in carry trade games among hedge fund managers than from anything related to the US economy. It is highly unlikely that we will see actual downgrades of Treasuries in the near term – the official statement from S&P was that there was a "1 in 3 chance" of a downgrade in the next twelve months – high by normal standards, certainly, but certainly not Code Red.

Not to mention, as some cynical observers have, that this is Standard & Poors we are talking about. As in – the rating agency that slapped AAA ratings on all of those wonderful collateralized mortgage obligations that nearly brought an end to finance as we know it a couple years ago. The reaction among some in the chattering classes this week has been less about the US government's solvency than about S&P's own business acumen – what, these guys are still in business?

All well and good, but here is why we believe that what happened this week really is newsworthy – a Man Bites Dog with potentially far-reaching effects. This is not just about the potential solvency problems of the world's largest economy – important as that is. It is about how we value any asset in the capital markets. Bear with us for a moment while we explain. The whole idea of valuing any financial asset is to assess the amount of risk inherent in the asset, and bake that risk assessment into a formula that comes back with an evaluation of how much return investors would demand for holding that amount of risk. That risk assessment needs a benchmark for comparison, and the benchmark is known as the *risk-free rate*. To express this in non-mathematical terms, the hypothetical value of Asset X is going to be based on how risky Asset X is compared to the risk-free rate. Let's say the risk-free rate is 3%. Depending on any number of risk factors deemed relevant for Asset X (and by "risk factors" we mostly mean things that can affect the magnitude, timing and predictability of cash flows from Asset X) we arrive at a *risk premium* for Asset X relative to the risk-free rate and employ a valuation method suitable to the asset's inherent characteristics – for example whether it is a bond, a share of common stock, an option or some other instrument.

Here is why we took you through this discussion. For all practical purposes, when investors actually put the concept of the risk-free rate into practice, they invariably – and we mean literally 100% of the time – use the US Treasury rate as the proxy. The financial valuation tools that we use today – the Capital Asset Pricing Model, the Black-Scholes Model and others – have been around for a handful of decades, and over this entire time period the one universally accepted given truth on which all investors could hang their hats was that US government securities are the safest, most predictable, most risk-free assets available in the market. So these valuation tools, which all depend on the existence of a risk-free rate to work, routinely plug in the prevailing Treasury rate in order to tell you how much the shares of XYZ Company or the options of ABC Inc. are worth in theory. Investors use these calculations to then decide whether the actual price of XYZ stock in the market is overvalued or not.

So what do we do when the rug is pulled from under this edifice of valuation methodology? Let's be honest – it's not like there is some readily available substitute for Treasuries to serve as the new risk-free rate. Chinese government bonds? Please. The truth is that there are no substitutes. In one sense the formulas still work – we can still say that Asset X should carry a risk premium relative to the Treasury yield. But in another sense it doesn't work – the relationship becomes more blurred, and the overall level of risk in the market is going to necessarily be higher if the least risky asset available is now on putatively shakier ground than it has been since well before Harry Markowitz, William Sharpe, Myron Scholes and others pioneered the great advances in financial valuation that are in the toolkit of every investment analyst everywhere in the world.

And that, in short, is why what happened this week matters for anyone invested in the market, and why we will be dealing with the implications of this new world for quite some time to come. It is indeed newsworthy, and rest assured, we take it very seriously.

With warm regards,

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