U.S. Credit Outlook Downgrade: Another Reason to Consider Foreign Sovereign Debt or Currencies from Stronger Regional Blocs

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On Monday, April 18, 2011, Standard & Poor's placed a "negative" outlook on the United States' AAA credit rating,[1] citing the United States government's failure to address growing short-term deficits, burgeoning entitlements and external borrowing. The announcement intensified pressure on Washington policymakers to enact and implement constructive fiscal reform. Failure to do so jeopardizes the rating; S&P places a 33% likelihood on a downgrade in the rating within a two-year window.[1]

Specifically, Standard & Poor's is worried about the following:

+ **Short-Term Deficits:** S&P reports that U.S. government deficits fluctuated between 2% and 5% between 2003 and 2008. During the financial crisis, the deficit ballooned to over 11% and has yet to come down.
+ **Large and Growing Entitlements:** Social Security, Medicare and Medicaid currently comprise approximately 42% of fiscal 2011 government spending. These numbers are forecast to rise with the aging of the U.S. population.
+ **Weight of External Borrowing:** S&P calculates that the net external debt level of the U.S., a measure of how much foreign borrowing the United States must undertake, is approaching 300% of current account receipts in 2011. As the S&P report notes, this "external indebtedness by this measure is one of the highest of all the sovereigns [Standard & Poor's] rates."[2]

And above all:

+ **Lack of Any Progress on Fiscal Consolidation:** While other developed market nations—the United Kingdom, France and Germany—have enacted fiscal austerity programs, the United States has actually increased fiscal deficits through the extension of tax cuts that aren't matched with a decrease in expenditures.

Market reaction to the announcement was limited. While S&P's two-year window was a surprise, the issuance of a negative outlook by a rating agency seemed inevitable, given the deterioration in fiscal balances and the reticence of political parties to address it. Remember that squabbling over the debt ceiling and a threatened government shutdown prompted Moody's to take similar action in early 1996.

The announcement provides a warning with a long horizon. The clock is now ticking, and Washington needs to develop a substantive plan. Over the near term, the July 8 deadline for raising the debt ceiling looms as an important checkpoint. Lack of progress in advance of this date could trigger further anxiety, with higher yields needed to clear upcoming debt auctions. In the longer term, failure to address the problem in a decisive manner will weigh on both the dollar and the U.S. Treasury market and could prompt investors to look to alternative solutions for investing their reserve assets.

Given the current state of political gridlock in Washington and the relative unattractiveness of U.S. Treasuries on a long-term fundamental basis, investors may want to consider options to diversify their fixed income exposure away from dollar-denominated assets.

[1] S&P AAA Credit Rating is the highest level of Investment Grade as defined by Standard and Poor's. The issuer has an extremely strong capacity to meet financial commitments.
[2] Source: "United States of America 'AAA/A-1+' Rating Affirmed; Outlook Revised To Negative." April 18, 2011.

But not all foreign fixed income investments should be considered equal. We believe there's a growing disparity between the prospects for developed world and emerging market currencies and fixed income exposure. A primary driver: in contrast to the developed world (e.g., the U.S., Japan and Western Europe), which is plagued by entitlements and fiscal obligations granted to an aging and elderly population, the demographics of the emerging markets are young, with faster-growing economies.

Additional factors motivating these prospects:

+ **Emerging market countries' share of global reserves (the assets that help cover liabilities) has been consistently rising over the past decade.**
+ **Emerging market debt-to-GDP (gross domestic product) ratios have been declining over the past decade, as economic growth has outstripped debt issuance. In contrast, Japan, Western Europe and the United States face rising debt levels with lower potential GDP growth.**
+ **Unlike the United States, which has seen rising foreign borrowing, the external debt-to-GDP ratios for emerging markets have been shrinking over the past decade. Emerging market countries in Latin America have seen external debt-to-GDP ratios collapse from above 43% in 2002 to just above 21% in 2010, while emerging Asia has seen external debt-to-GDP ratios collapse from 23.8% in 2002 to levels forecast to be below 13% for 2011.[3]**
+ **Relatively high nominal interest rates in emerging market countries potentially compensate investors for additional inflation and currency risks.**

In this environment, the following investment strategies intended to address concerns about a falling U.S. dollar may be appropriate for income-oriented investments:

+ **ELD:** WisdomTree Emerging Markets Local Debt Fund seeks a high level of total returns consisting of both income and capital appreciation. The Fund attempts to achieve its investment objective through investment in local debt denominated in the currencies of emerging market countries. ELD employs a structured investment approach designed with an active risk management overlay to help monitor the credit profiles of the countries included: Brazil, Chile, Colombia, Indonesia, Malaysia, Mexico, Peru, the Philippines, Poland, Russia, South Africa, South Korea, Thailand and Turkey.
+ **ALD:** WisdomTree Asia Local Debt Fund seeks a high level of total returns consisting of both income and capital appreciation. The Fund attempts to achieve its investment objective through investment in local debt denominated in the currencies of Asia Pacific ex-Japan countries. ALD employs a structured investment approach designed with an active risk management overlay to help monitor the credit profiles of the countries included: China, India, South Korea, Indonesia, Thailand, Malaysia, Australia, Hong Kong, Singapore, New Zealand, the Philippines and Taiwan.
+ **CEW:** WisdomTree Dreyfus Emerging Currency Fund seeks to achieve total returns reflective of both money market rates in selected emerging market countries available to foreign investors and changes to the value of these currencies relative to the U.S. dollar. Constituent currencies include: Mexican peso, Brazilian real, Chilean peso, South African rand, Polish zloty, Israeli shekel, Turkish new lira, Chinese yuan, South Korean won, Taiwanese dollar, Malaysian ringgit and Indian rupee. Although this Fund invests in very short-term, investment grade instruments, the Fund is not a "money market" fund and it is not the objective of the Fund to maintain a constant share price.

[3] Source: JPMorgan, 2011