

Manning & Napier Response: U.S. Credit Rating Downgrade and Recent Market Volatility

In the response below, Manning & Napier Advisors, Inc. (“Manning & Napier”) provides our perspective on Standard & Poor’s (S&P) credit rating downgrade and the recent market volatility. Overall, we believe the credit downgrade is the starkest warning yet that the U.S. needs to address its long-term fiscal problems. That said, we believe the state of the economy is likely to matter more than a credit rating agency’s ranking of U.S. debt. The market makes the ultimate judgment on credit quality, and with rates falling, Treasuries do not seem especially concerned about the downgrade. Treasuries do, however, reflect concern about the state of the U.S. economy. In summary:

- Treasury yields have fallen, reflecting a flight to quality. This does not suggest the Treasury market is particularly concerned with the downgrade.
- S&P is one of three main rating agencies. Moody’s Investors Service and Fitch Ratings have maintained the highest rating for U.S. debt.
- The state of the economy is more important than one rating agency’s ranking of U.S. debt.

Following a tumultuous week in the equity markets, S&P downgraded its rating of long-term U.S. debt from AAA to AA+ after the markets had closed on Friday, August 5th. The unprecedented announcement represents the first time the U.S. has not held the highest quality rating in over 70 years and adds to recent market concerns about a weak U.S. economy and renewed stress in the Eurozone. While S&P had signaled the potential for a credit rating downgrade, the timing of the decision, just days after the debt ceiling compromise, caught many by surprise.

While S&P’s downgrade means that the U.S. now ranks below about a dozen countries with AAA status, it is important to remember that S&P is just one ratings agency. The other two main ratings agencies, Moody’s Investors Service and Fitch Ratings, have maintained the top quality rating for U.S. debt. Specific credit ratings aside, Friday’s downgrade reflects serious, well-known issues that the U.S. faces. Simply put, the U.S. government has a debt level that is unsustainable, a problem that was only exacerbated by the deficit-financed spending needed to support the economy during the deep recession. The U.S. is not alone in its debt predicament, though. Many developed countries are grappling with outsized debts, and others have been through this process before. In fact, Canada lost its AAA status in the 1990s and only regained the top-notch rating after several years of hard work. Ultimately, while the U.S. credit rating downgrade may be a shock to the markets and could intensify any near-term volatility, in the long-run we believe the heightened attention to the U.S. debt dilemma may not be a bad thing. The government needs to make some tough decisions to improve the U.S. fiscal condition, and this rating downgrade could put additional pressure on politicians to eventually agree on a solution.

The underlying U.S. debt problem resulting in S&P's downgrade is not new news. Nonetheless, the downgrade itself could have some implications to consider, although the full impact may be unclear for some time. To provide some perspective, a rating in the AA range still reflects high credit quality and is on par with countries such as Japan, which is ranked AA-. Indeed, Japan's experience helps show the potential impact on interest rates. A decade after Japan lost its AAA rating, ten-year Japanese government bond yields are still only just over 1% and the yen is as strong as ever. What this suggests is that a country's bond yields depend less on its actual credit rating and more on factors such as inflation, growth prospects, and the overall outlook for short-term interest rates. In other words, the economy is a more important driver than the S&P credit rating.

Furthermore, while credit rating agencies are helpful in determining a government or company's credit standing, the market makes the ultimate judgment. Current Treasury yields do not reflect major concern about the S&P credit rating downgrade. Instead, Treasury yields have fallen noticeably in recent weeks, suggesting that investors still consider Treasuries the safe place to go in the midst of uncertainty. In fact, 10-year Treasury yields started the month at 2.75% and have fallen to about 2.57% as of August 8th. This decline in rates suggests that investors are flocking to quality (i.e., Treasuries) amid concern about the economy, not what you would expect if investors were retreating out of Treasuries because of concern about the S&P downgrade.

In addition to the S&P downgrade, there are several key factors weighing on investor sentiment. U.S. Gross Domestic Product (GDP) expanded at a lackluster 1.3% annual rate in the second quarter and growth in the first quarter was revised down to show an almost stagnate economy. Consumer spending also ticked down in the latest report and both manufacturing and non-manufacturing survey data reflect a broad slowdown in activity so far this year. Moreover, the employment picture remains murky with job growth insufficient to act as a driving force behind a broader pickup in the economy.

The situation in Europe is also exacerbating market fears. Recent action in European fixed income markets suggests that investors are becoming increasingly concerned that Spain and Italy will soon require some form of financial assistance. The ambiguity surrounding these concerns has broadly impaired investors' risk appetite, hence the distinct downward moves we've seen in major indices since late July.

Understandably, the recent volatility is unnerving for investors. Despite being several years removed from the latest recession, clear paths for growth in equity markets and the economy remain elusive. That being said, when disappointment driven by unmet expectations descends into fear and panic, compelling long-term value opportunities can emerge. Manning & Napier has a long history of successfully navigating volatile and uncertain environments much like the current one. Our active and disciplined investment process helps us take advantage of market fear and position portfolios for the long-term. In our view, growth in the U.S. economy is likely to

continue at a slow and uneven pace for the foreseeable future. Along this path we think investor sentiment will continue to ebb and flow with choppy economic data and stresses related to government debt problems in Europe and the U.S.

Throughout market fluctuations, Manning & Napier's bottom-up stock selection process remains focused on individual companies that we believe will provide compelling value for clients over the long-term. With slow growth likely to remain a reality for some time, we are investing in businesses that we expect to do well despite a muted and bumpy economic backdrop. We realize that times will be tough for many companies in a slow growth environment. As such, we are leaning away from businesses that are particularly sensitive to broader economic growth, as well as companies that may rely on the U.S. consumer to drive growth. Instead, we are investing in industry leaders with strong balance sheets that we think can capture growth even when it is scarce. We are also seeking businesses with significant and growing operations in foreign markets that are expanding at a quicker pace than the broader global economy. Ultimately, we believe there are pockets of opportunity in this volatile and difficult environment, and we continue to target those opportunities using the same disciplined investment approach we have used for the past forty years.

Analysis: Manning & Napier Advisors, Inc. ("Manning & Napier"). Unless otherwise noted, all figures are based in USD.

Manning & Napier is governed under the Securities and Exchange Commission as an Investment Advisor under the Investment Advisers Act of 1940.

Sources: FactSet, The Wall Street Journal, Montreal Gazette, Bloomberg, Financial Times, The U.S. Bureau of Labor Statistics, The U.S. Department of Labor, Yahoo! Finance, The Sydney Morning Herald.

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