

Dear Valued Investor,

After the market close on Friday, Standard and Poor's (S&P)—one of the three major U.S. rating agencies—downgraded the U.S. government debt from AAA to AA+. This is actually a drop of less than one level within the S&P rating system. According to S&P, an obligor rated AAA has “extremely strong capacity to meet its financial commitments” while one of AA has “very strong capacity to meet its financial commitments” and differs from AAA obligors “only to a small degree.” Therefore, U.S. debt is still rated very strong. In addition, the two other major U.S. rating agencies, Moody's and Fitch, have maintained their highest ratings for U.S. federal debt. S&P kept the short-term rating of the United States at the top rating of A1+. Short-term money market instruments are rated on a different scale, but the status quo with respect to these ratings implies no impact to money market funds.

Since the first U.S. rating agency was established in the early 1900s, the U.S. government has not been downgraded. Frankly, a downgrade just sounds and feels bad. The word “downgrade” has similar negative connotations to words like “demotion” or “decline.” However, while this is the first time that the United States has been downgraded by a U.S. rating agency, it is not the first time that the United States has been downgraded. The United States was downgraded one level by China's Dagong Global Credit Rating Company to A+ in November 2010 and by Germany's Feri Rating Agency to AA in June 2011.

There is also much precedent for other AAA-rated sovereign nations seeing their debt downgraded. Japan lost its AAA rating in 1998 and Canada was downgraded in 1994—however, both successfully regained their AAA status at later dates. Japan lost its AAA status again in 2009. Though this downgrade feels unique and unprecedented, it has already happened relatively recently to the United States without much attention and to other sovereign nations in the past.

As investors, we need to take this downgrade as what it is—a change in status that does not meaningfully diminish the term “full faith and credit of the U.S. government.” In fact, the debt of the United States continues to be viewed as preeminently high quality. One measure of this is to examine the credit default swap market, which is similar to insurance that institutional investors can buy to protect their bonds in case of default. Even after the downgrade by S&P, the cost to “insure” against the default of the U.S. government is much lower than nearly every country in the world, including many AAA credits like Germany, France, and the United Kingdom. Therefore, even though U.S. debt does not still carry a full AAA rating, the market still views the U.S. government's ability to meet its debt obligations as AAA worthy.

So, what does this all mean to the markets? S&P telegraphed their downgrade starting a couple of weeks ago while the debt ceiling debate was still ongoing. As a result, I believe that the markets have largely priced this downgrade news in. In addition, we have likely not seen the last of downgrades. Now that the United States has been downgraded, S&P will separately be reviewing government agencies and companies that rely heavily on U.S. government support—such as Fannie Mae, Ginnie Mae, and Freddie Mac—for potential changes in credit rating. That said, further downward price moves in the stock market are likely not attributable to the downgrade of U.S.

debt, but rather escalating concerns around the European crisis and decelerating global economic growth. In a sense, the downgrade of U.S. debt is not nearly as important to the market as is the potential downshift in the strength of the global economic recovery.

While we have to acknowledge that the risks for a double-dip recession have been creeping up as of late, I continue to believe that it is extremely unlikely. The market appears to be pricing in a far greater likelihood for a return to recession than the data actually indicates. As a result, stock valuations are cheap versus historical averages. The S&P 500 Index trailing price-to-earnings (P/E) ratio, a measure of how much the market values a dollar's worth of corporate earnings, is at 13 (the lowest since 1990) and the forward P/E ratio is 11 (same as March 2009 low). Essentially, the market is as cheap, or even cheaper, now than it was during the depths of the 2008–2009 recession.

The visceral, emotional reactions to this downgrade are normal, but I believe that the S&P rating downgrade is more disappointing than it is material for capital markets. While the market may react emotionally to the news over the short run, rational analysis will soon reveal that continued favorable economic fundamentals and attractive valuations point to potentially promising investment opportunities just around the corner. I believe that maintaining a cautious stance remains prudent, but systematic additions to risk at these levels will prove a wise investment as the year unfolds. As always, if you have questions, I encourage you to contact your advisor.

Best regards,



Burt White

Chief Investment Officer

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Credit rating is an assessment of the credit worthiness of individuals and corporations. It is based upon the history of borrowing and repayment, as well as the availability of assets and extent of liabilities.

Stock investing may involve risk including loss of principal.

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