MARKET UPDATE

A Message for Retirement Investors

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Downgrades and High Anxiety

Last Friday, Standard & Poor's downgraded longer-term U. S. debt from AAA to AA+. While the action did not increase interest rates, it precipitated a big sell-off in worldwide stock markets as investors worried about the possibility of a "double-dip" recession.

Ironically, interest rates on U.S. Treasury bonds fell dramatically, as investors sought the comfort and safety of U.S. bonds. Despite the downgrade by Standard & Poor's, the U.S. dollar remains the world's reserve currency and the U.S. Treasury market is the place investors go when times are rough. The yield on two-year Treasuries fell to a record low. With the S&P 500 down 6.7% today, the market is projecting that the sovereign debt crisis in Europe and a lack of consumer confidence here at home will combine to create more economic headwinds. But there are some reasons for optimism as well.

Corporate earnings have been very strong this quarter, though the good news has been overshadowed by market volatility. Companies are also sitting on large cash balances, which mean they are better positioned to handle downturns. The big question is: Do things get better than expected from here?

There are strong indications that the Fed will continue to take an accommodative stance in order to boost economic growth and investor confidence.

What happened?

Standard & Poor's, one of the "big three" rating agencies, downgraded longer-term U.S. debt from AAA (the highest rating) to AA+ (the next highest rating). Moody's and Fitch, the other two major ratings firms, have maintained their highest ratings for now.

S&P did not downgrade short-term U.S. Treasury bills (those with less than one year to maturity). This was important, since money market funds tend to hold these shorter-term U.S. securities. Later in the day on Monday, S&P downgraded Fannie Mae, Freddie Mac, and other lenders. These actions helped to drive a significant sell-off in world equity markets.

Why was this action taken?

S&P announced that it believes that longer-term U.S. debt no longer deserves the highest level credit rating, which has been in place for many decades. S&P based their action on the belief that the current political deadlock in Congress is undermining the ability to establish fiscal policy that will stabilize and reduce the federal debt in the medium term.

What does this mean?

In the near term, it means that longer-term U.S. debt will no longer enjoy the highest credit rating from all three agencies. It doesn't mean that U.S. debt is at risk of being unpaid. Lower credit ratings tend to result in higher interest rates for borrowers. But in this case, because of the current low-growth environment, interest rates are actually falling. The U.S. dollar remains the reserve currency for global markets. And, in times of high volatility, we have seen tremendous demand for U.S. debt pushing yields to historic lows. Historically, other countries that have experienced downgrades (such as Canada and Japan) have not seen

lasting damage to their equity markets.

What happens now?

It is difficult to predict the full consequences of the U.S. debt downgrade. Most likely, it will contribute to higher volatility in equity markets in the near term. Today, markets reacted to both concerns around the downgrade as well as the evolving debt crisis in Europe.

Longer term, if the root causes prompting the downgrade are not addressed by the U.S. government (balancing spending with revenues), we may see somewhat higher interest rates, particularly if economic conditions improve. This could make borrowing more expensive for consumers, such as credit cards, loans, and mortgages.

What should I do now?

Most likely, nothing. If your portfolio is diversified and at a risk level that is appropriate for your retirement horizon, there is no reason to make sudden changes to your investment strategy.

There is rarely any value in jumping out of the market after a major downturn. For instance, investors who panicked and jumped out of the market in late 2008 or early 2009 had much higher losses over the long run than those who stuck it out. By moving out of the market when times seemed bleak, they missed out on the high equity returns in the middle part of 2009. Often such positive moves in the market occur at unpredictable times.

Higher volatility means a greater chance of big moves in either direction—up or down. You are much better off in the long run with a disciplined and diversified strategy, rather than trying to time the market. Finally, if your horizon is longer than ten years, keep in mind that much of your retirement income will be based on future contributions that have not been invested in the market yet. Your future income is not as sensitive to the current market as your account balance. Maintaining an appropriate long-term perspective increases your odds of success.

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