EAGLE | Asset Management

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Standard & Poor's on Friday downgraded the United States' long-term debt rating one notch from AAA to AA+. In summary, S&P said – particularly in light of the debt-ceiling debate that went to the 11th hour – it lost faith in Washington's ability to deal meaningfully with reducing the nation's burgeoning debt.

We asked Eagle portfolio managers today (Aug. 8) for their thoughts on the move by S&P and, perhaps more importantly, how it may impact their portfolios.

What is your initial reaction to S&P's move?
"The reality is that the United States wasn't an AAA-deserving entity before the downgrade," said James Camp, CFA, head of Eagle's Fixed Income team.

What's been more disappointing than the downgrade has been Washington's "shoot-the-messenger" response and efforts to get into methodology debates that not only miss the point but are, in fact, counterproductive, said Camp.

The downgrade really shouldn't have come as a surprise because none of what S&P said in its decision is "new news," said Jack McPherson, portfolio co-manager of Eagle Boston's Small Cap Core Value program.

The market is a forward-looking mechanism and the issues S&P raised – increased federal spending without a corresponding increase in federal revenues – have been public knowledge for some time, said McPherson. Consequently, the stock market already had processed that information and S&P's decision, on the heels of two poor days in the stock market primarily on concerns about European-debt issues, served primarily to stir the waters.

What is your interpretation of the market's reaction to the news?
"The U.S. Treasury market has rallied and will continue to rally," said Camp. "We are approaching the low yield on the 10-year (at about 2.40 percent).

"Why? The perceived safety of U.S. Treasuries – notwithstanding the downgrade – still rules the trade," said Camp. "The main issues continue to be massive debts globally."

Ed Cowart, portfolio co-manager of Eagle's Equity Income and Value portfolios, agreed: "The recent downturn has been more about Europe than about the United States or its credit downgrade." If there were real concern about the U.S. government's ability to pay its creditors, interest rates would have gone UP – not down – on Monday.

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Fixing Europe's issues is a daunting task. The European Central Bank is buying the debt of Italy and Spain in an effort to shore up those countries, a move Camp said is likely to fail ultimately. Further, added Cowart, the euro is a singular currency but getting it back on its feet is going to require its member countries – each with its own fiscal policy – to align interests: something increasingly less likely as countries that are on solid footing (e.g., Germany) lose patience with those that aren't (e.g., the PIIGS: Portugal, Italy, Ireland, Greece and Spain).

Meanwhile, the equity markets are down (Monday) because the downgrade has brought into focus how federal fiscal policy (e.g., the second round of quantitative easing, or QE2) is really what kept the equity rally going, said Bert L. Boksen, CFA, head of Eagle's Small Cap Growth and Mid Cap Growth programs. "More importantly, it shows the government is running out of rabbits to pull out of the hat."

What, if anything, is the U.S. government likely to do now?

The Federal Reserve's first quantitative-easing program helped stabilize a financials market that was teetering, said Cowart. The results of the recently ended so-called QE2 are murky: It clearly allowed corporations to borrow more money at historically low interest rates but didn't spark widespread solid growth.

A potential "QE3" is likely to be subtle, said Camp. It might come in the form of the Federal Reserve publicly stating a zero percent interest-rate policy for at least a two-year period, extending maturities of existing balance-sheet holdings and lowering interest paid on reserves.

The worst thing Washington can do at this point is nothing, said Scott Renner, portfolio co-manager of Eagle's Small/Mid Cap Core portfolio. The best result of the credit downgrade would be for elected officials not to wait for the October 2012 elections (more than 14 months down the road) but, rather, to put aside partisan bickering and get to work immediately on comprehensive plans to address the country's significant economic issues, said several managers.

"(The recent debt-ceiling debate and now the downgrade) are, at a minimum, scaring individuals and freezing companies," said McPherson. "How can you play a game if you don't know the rules? Companies need to know what's happening with interest rates and taxes and the fallout from the healthcare-reform law before they will make moves to hire more people or buy more equipment."

What happens to the bond markets from here?

"As we said at the end of last year, high-grade municipal bonds of intermediate and longer terms will be the best-performing asset class in the U.S. markets and, to date, that thesis holds," said Camp. Many municipal bonds will suffer downgrades (more than 150 have been placed on negative watch in the last couple of weeks) as have the federal mortgage agencies.

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On the corporate side, “the interest rates on higher-risk corporate bonds already are widening. We have serious concerns about the balance-sheet issues surrounding Bank of America in particular,” said Camp.

What, if anything, have you done portfolio-wise either in anticipation of or in reaction to the downgrade?

Eagle does not own Fannie Mae or Freddie Mac debt, which is downgraded and falling marginally in price, said Camp.

We believe our portfolios are very well-positioned for the “repricing of risk” in the debt markets, said Camp. “We were not lulled into reaching for yield for yield’s sake. We believe those stretching for yield are likely to get seriously hurt in the coming months.”

In Small Cap Growth and Mid Cap Growth portfolios, we have raised cash slightly and reduced our exposure to economically sensitive areas, such as industrials and materials, said Eric Mintz, CFA, Boksen’s co-manager. “The current market provides very compelling valuations but we are waiting for the market to show signs of stabilization before putting the cash back to work.”

It is important to wait for the water to clear before making any drastic moves, said McPherson.

“We’re trying to keep a steady head amid all the negativity,” said McPherson.

The downgrade has not prompted the Small Cap Core Value team to alter its long-term investment outlook nor make any portfolio shifts, said McPherson. He and his team are aware of macroeconomic conditions but build portfolios from the bottom up.

They will review the debt-maturity schedules of the companies in their portfolio, said McPherson, but don’t expect to shift their thesis on any company since the credit markets appear to be OK.

The major investment questions and concerns of our time remain unanswered and undiminished, said Richard Skeppstrom, head of Eagle’s Large Cap Core team. It seems clear that our recovery will remain slow and vulnerable to setbacks.

Stocks remain attractively priced, in our view, relative to bonds and cash but the macroeconomic problems do not have near-term solutions and so they likely will act as a counterweight for quarters to come, he said. We are comfortable being patient, keeping some powder dry and trying to use this volatility to profitably enhance the positioning of the portfolio.

There hasn’t been a significant shift in either Equity Income or Value portfolios, said Cowart. After all, large-cap companies’ balance sheets are in good shape.

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Valuations are attractive in the small- and mid-cap universe, said Renner.

“The thing I think this does is put a premium on companies that can grow despite the economy,” he said. Those are the ones that have solid free cash flow and don’t need the capital markets to fund their growth.

“That said, I do think you have to re-evaluate projected growth rates and the visibility of companies’ paths to achieve those growth rates. Are you reliant on Europe? Are you reliant on federal spending?”

The key, said several Eagle managers in conclusion, is to continue to pay attention to the fundamentals, ignore short-term noise and maintain a long-term focus.

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