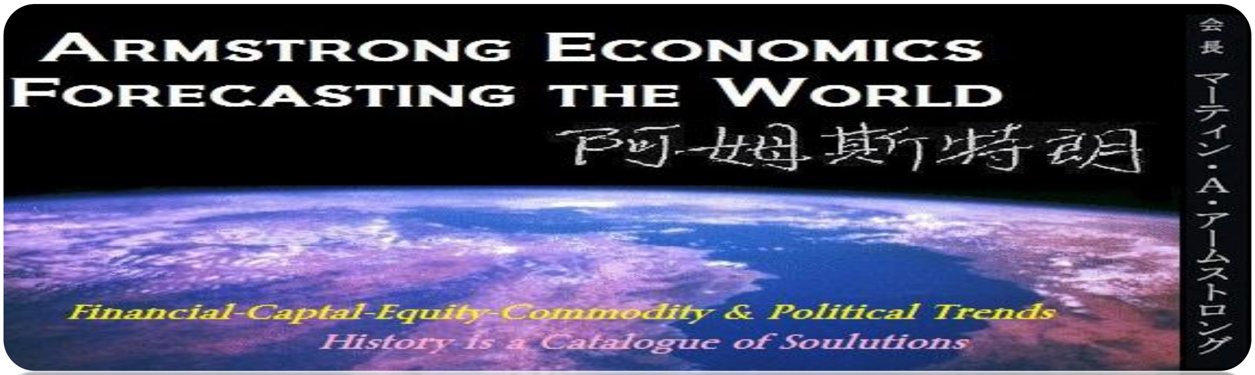
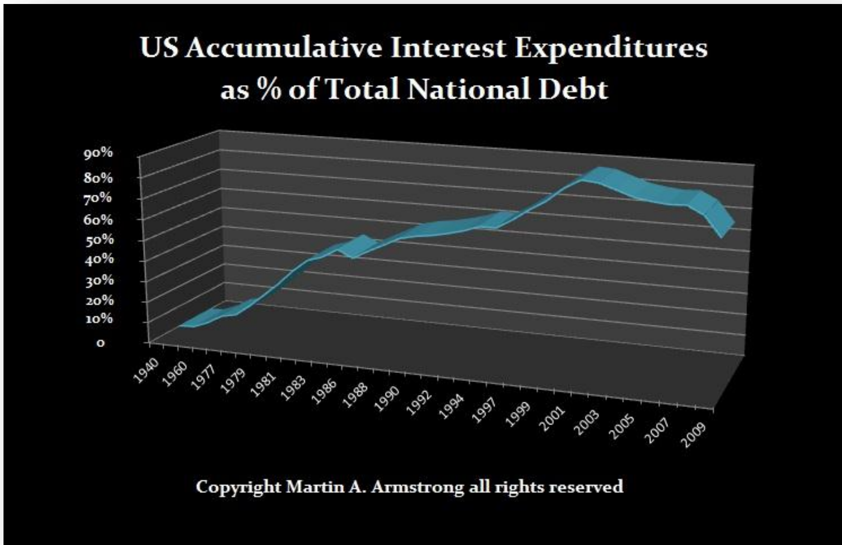


DID STANDARD & POOR SHOOT ITSELF IN THE FOOT BY DOWNGRADING THE USA FROM AAA TO AA+?



DID STANDARD & POOR SHOOT ITSELF IN THE FOOT BY DOWNGRADING THE USA FROM AAA TO AA+?

By: Martin A. Armstrong
former Chairman of Princeton Economics International, Ltd.

The rumors that the Standard & Poor would still downgrade the USA that sent the markets in a tailspin have turned out to be true. Information was running around most likely within the inner sanctum as usual and was the cause of selling by the "***well connected***." But the rules have already been changed by the Federal Reserve and ***he who has the gold, makes the rules***. The other two major credit rating agencies, Fitch and Moody's, had reaffirmed their versions of AAA ratings earlier in the week after the end of the debt ceiling fight. But Fitch also said it was keeping its USA rating under review until the end of August. "***Investors have voted and are saying the US is going to pay them. US Treasurys are still the gold standard***," said Mark Zandi, chief economist of Moody's, according to the Associated Press. Indeed, credit ratings typically **FOLLOW** the markets; they **NEVER ANTICIPATE** markets. This raises some doubts as to what S&P is actually doing when there has been no flight from the bonds. As Moody's put it, the investors "***have voted***" indicating precisely that credit ratings **FOLLOW** the market, never **ANTICIPATE** the market. This will expose S&P to future allegations of pushing the world into the **Sovereign Debt Crisis** particularly when this action is unilateral.

The credit rating agency Standard & Poor's has stripped the USA of its top-notch AAA credit rating, downgrading it to AA+ and **WARNING** of further future **LONG-TERM** downgrades because of political and economic uncertainty within the nation. This was a bold unilateral move no doubt, and one that seems to be a desperate action to perhaps regain a reputation that was tarnished by the **Mortgage Crisis. Now** they are strangely trying to get out in front of the curve. It most assuredly appears to be political in nature and can backfire for this is dealing with the **RESERVE CURRENCY** upon which the entire world is constructed. This ain't Kansas, Greece, Spain, or Ireland for that matter Dorothy!

The astonishing downgrade by S&P, one of the three credit agencies in opposition to its competition, concerns the world's **RESERVE CURRENCY** and teetering **Financial Capital of the World.** To do this on anticipation was questionable but it came late on Friday night but it was obviously running around the halls of Wall Street in advance. S&P notified the US Treasury on Friday afternoon that it was planning to lower the credit rating, according to government officials, and the company sent a draft of its analysis to the White House. The White House sprang into action trying to convince S&P that its figures were faulty. Any hint of this news was confined to the rumor mill as it did not appear on TV. White House officials argued they discovered a $2 trillion hole in their calculations and briefed journalists. Nonetheless, they failed to win a delay from S&P that proceeded with the downgrade. Defending itself against attack by the Treasury, S&P later issued a statement flatly rebutting the criticism, saying it "***had no impact on the rating decision***" and effectively they dug in their heels. Whether or not this has any future impact upon the US debt market remains debatable since it is **ONLY** one out of three credit ratings. This means that nothing has to be changed insofar as can US Treasurys be acceptable in **REPO** and as collateral at exchanges. That is a given since these markets would not exist without US Treasurys. Thus, S&P will just be ignored.

In this respect, S&P may have shot themselves in the foot for it is unlikely that suddenly the markets will follow S&P's lead. The intraday price action shows professionals covered shorts after 12noon. Where else do you park big money? TBills are acceptable by exchanges for collateral. If they stopped accepting Treasurys there would be no market and the hedge funds would be out of business. So it is hard to see precisely what S&P stood to gain except bravado and such bragging rights could be turned on their head into an allegation that they now caused the problem.

After the announcement, there was no immediate reaction from the White House when the downgrade was made public. The US Treasury swung into attack mode assaulting S&P's calculations, saying: "***A judgment flawed by a $2 trillion error speaks for itself***". The S&P blamed the dysfunctional US political system for being unable to make significant fiscal reform. This appears to be a loaded political assessment rather than a pure economic one. No doubt, this will now set off yet another debate about US government spending and chaos that took place over the raising of the debt ceiling that ended earlier in the week. The young Republicans are no doubt going to be denied any tea in their cups on the Hill and will suffer the blame for their absolutist insane approach that drew far too much attention to the debt issue that was hiding well under the rug.

But people don't realize, sources on the Hill were already upset because by the end of September there will be the year-end fiscal budget to deal with where they were expecting another round of infighting. The Young Republicans were already preparing for round TWO. The S&P downgrade may now have the opposite effect and strengthen President Obama's hand in any plans to allow the Bush-era tax cuts to expire, raising an additional $3 trillion over the next decade. So if your taxes now go up, and the economy still fails to recover, you might want to send a thank you note to S&P for a brilliantly timed decision that is going to now escalate the **Sovereign Debt Crisis** to new levels.

The Doom & Gloomers are cheering S&P's downgrade, but in reality, it will have no real affect in the total mix. The dollar is the **RESERVE CURRENCY** and lowering the credit rating normally means higher borrowing costs for the debtor nation. However, as I have pointed out, about two-thirds of central bank reserves are in dollars thanks to the residual of **Bretton Woods** that is alive and well. The size of the US debt and economy along with its deep capital markets plays a crucial role as the cornerstone of global finance and this simply cannot change absent revising the entire world monetary system. S&P's decision shows how unsophisticated they are and the decision was highly parochial. It cannot change the demand for dollars since everything trades in dollars. So no matter how much China and Russia complain, oil, gold, wheat and just about everything else trades in **DOLLARS** because it is the **RESERVE CURRENCY**! There will be little impact causing any shift from the dollar for it is just not practical until we reach that sweet spot. This sweet spot will be a forced global monetary reform to a one world currency that will become the new **RESERVE CURRENCY** untied to any particular nation ensuring political neutrality eliminating the antics of the Tea Party as took place in the debt ceiling crisis. That will eventually be the future replacement. It is just a question of TIME!

The claims that the world would end if the US was downgraded will now be shown for their lack of reality. There is simply no **DEEP** investment vehicle that offers an alternative. Japan was downgraded in 2002 and that had no material effect on selling their debt. Normally, the credit agencies downgrade **ONLY** after the market shows that capital is moving away. This downgrade is precisely opposite and why it appears to be highly political and may have been even an attempt to manipulate markets. It could have been a political staged event to force tax increases. The US bond market **DID NOT** crash in light of the debt ceiling debate showing that capital **WAS NOT** moving away from the US market. So S&P's decision is highly unusual given that they historically have been a **FOLLOWER** never a **LEADER**. So what could possibly get them to downgrade when there was no flight in the actual capital markets? If it is not a political setup, some prosecutor will be looking to make a name for himself on this one.

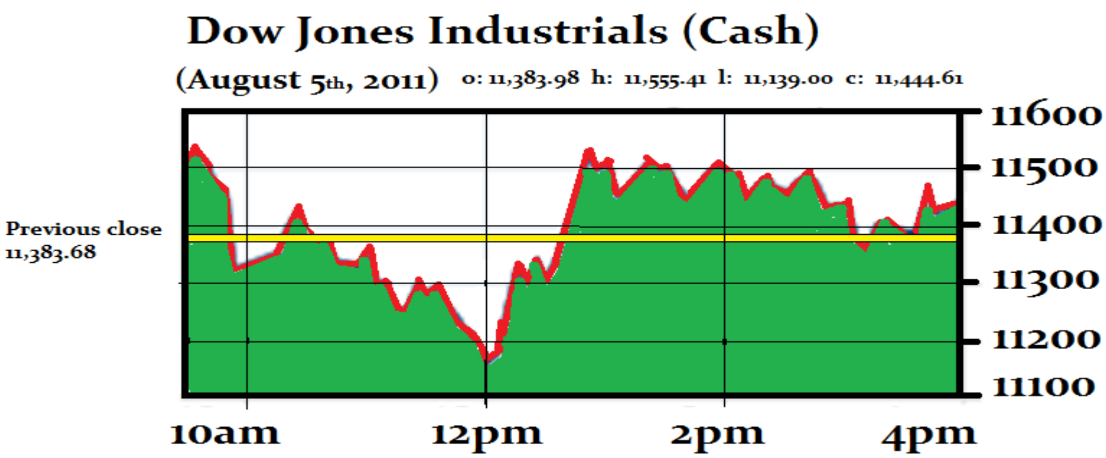
So precisely what did S&P think it would accomplish? Foreign holders of US debt including reserves among central banks currently hold 46% of the total debt. The S&P decision is about as stupid as the absolute approach of the Young Republicans (Tea Party). So let us cut domestic spending, the interest payments are still owed, and the bulk of interest expenditures will be exported. So how is either the S&P decision or the Young Republicans absolutist ideas going to accomplish anything but push the US off a cliff? Foreign bondholders will rejoice for in theory they should get more interest, and the Tea Party crowd demand of no new taxes, cut all the social spending, will honor the interest payments to the foreigners. This is the same lethal recipe the **IMF** is shoving down the throat of Greece and it is the same policy that created the Great Depression. Does anyone remember that Keynes argued it was the government trying to maintain a balanced budget to honor its debts that created the deflation? Was it not argued that a deficit in such times would offset the contraction in money supply?

As I said, ***he who has the gold makes the rules***. The Federal Reserve announced that US government securities such as bonds would still be counted as AAA-rated under risk management regulations. So much for those who thought everything would collapse. There is no alternative. S&P's decision does not seem to be well thought out and remains highly suspect given their traditional follower status. The Fed's decision is the one that counts for banks, insurance companies and other investors who would otherwise have been faced with making massive movements in their portfolios lacking a AAA rating do not have to sell anything.

S&P first awarded AAA status to the USA back in 1941. Even this was clearly political for that was done to help sell war bonds. If the debt was exploding due to war, why would S&P raise the rating when no country ever paid off its war debt? All we will hear now is a lot of spin. The Republicans will blame the Democrats who in turn will blame the Young Republicans, but behind closed doors, the Tea Party is going to suffer the blame and taxes may rise after all. S&P's announcement bluntly stated: "***We have changed our assumption ... because the majority of Republicans in Congress continue to resist any measure that would raise revenues.***" S&P further blamed the lack of budget savings agreed by Congress at the start of the week was too meager, and thus blamed the political weakness and instability for triggering the downgrade. This is what makes the downgrade suspect. S&P stated: "***The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics,***" S&P said in their a statement issued late Friday, after financial markets were closed for the week. Nobody questions the USA will not pay interest. So what's up?

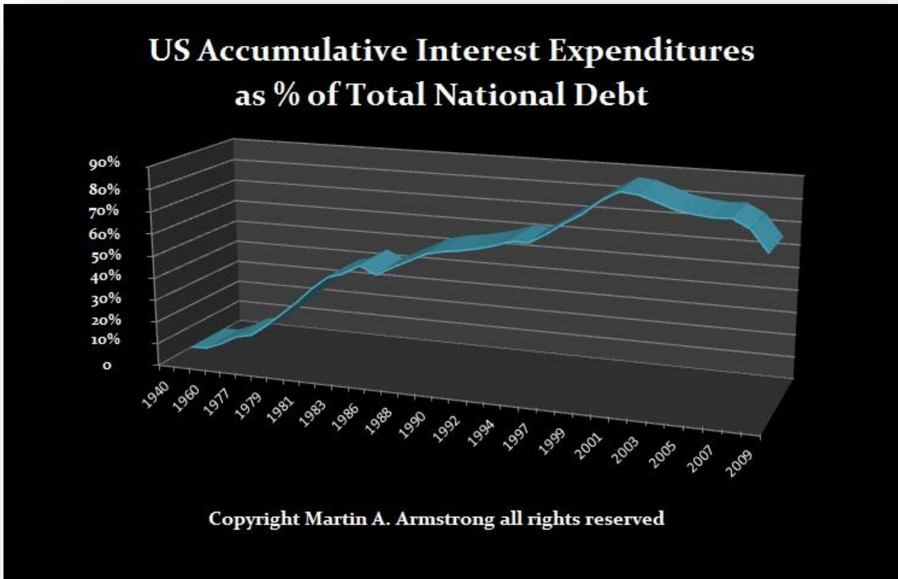
There is little doubt that there is rising political instability within the United States. However, that is ***political risk*** and the S&P does not have a good track record in this department, although in all fairness, they assigned a **NEGATIVE** political outlook on April 18th, 2011 to the USA. The unwillingness of the Tea Party to follow the Republicans I have warned may be the beginning of a third party. This has the potential of making fiscal debates still much worse and in this respect S&P is correct that there is a rising political risk to the United States. S&P also stated that its outlook on its **LONG-TERM** rating was **NEGATIVE**, warning that it could still lower the long-term rating to AA within the next two years "***if we see that less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period result in a higher general government debt trajectory than we currently assume***".

The S&P downgrade will no doubt keep market on the edge after a week of plunging financial markets. However, the rally after 12 noon indicates that those who had the news were covering their shorts. There many now be further downgrades of debt issued by government agencies, such as mortgage entities Fannie Mae and Freddie Mac. This has the potential to send mortgage rates up between 0.5-1%. So it is hard to imagine precisely how the downgrade is supposed to be forward looking.



The far more interesting aspect is the intraday price action where we can see the rally that took place after **12 noon**. This is highly curious given that the traditional rule is **SELL THE RUMOR** but then **BUY THE NEWS**! This does not look good at all. On the surface, this clearly appears that the S&P leaked what they were about to do to somebody and that accounted for the massive sell off. Then when the news is hitting the White House, strangely the rally begins. This is highly coincidental. Anyone in the industry and not on the fringe is going to know the Fed rules will be instantly changed to accommodate the lower credit rating. The banks can't follow the S&P lead. Neither could the insurance companies or central banks. So it certainly appears that the spin-artists will make a big deal which always is good for the selling by the unsophisticated. However, it is unlikely that the downgrade will have any real effect beyond the headlines. Central banks can't dump US bonds and dollars are still needed to buy commodities. The downgrade of Japan in 2002 had no real material effect. Institutions still buy Japanese debt today. The same result will transpire with the United States debt.

In the end, the real damage of the S&P downgrade is merely highlighting the **Sovereign Debt Crisis**. Because the USA is the **RESERVE CURRENCY**, it cannot be the first to fail for the rest of the world would go with it all at one time. Those at the S&P better hide under their beds at night. The first causalities are always the fringe as we are seeing in Europe. Domestically, you are still better off with federal paper than state or municipals. The S&P is merely confirming the **Sovereign Debt Crisis**.



There is no doubt that we have a serious **Sovereign Debt Crisis**. However, if that is the real reason for the S&P Downgrade, then it should apply to **ALL** countries and the real rating should be **BELOW JUNK!** Why? There is **NO** collateral! If a country defaults, you cannot go to court and seize property. You can't run down to the National Art Gallery and start walking out with Renoirs. Illustrated above is a chart of the ***Total Accumulative Interest Expenditures as a Percent of Total***. Had we just printed money and **<u>NOT</u>** borrowed this would have eliminated 68.2% of the entire national debt. There would have been **NO** competition with the private sector to borrow reducing economic growth, raising unemployment, and causing taxes to rise. We would **NOT** need a credit rating and inflation would have been at least half the rate over the last two decades. It costs **MORE** to borrow than it does to print and there is NO empirical evidence that borrowing is less inflationary than printing. Oh well! That's just another of those stupid myths. To make matters worse, 46% of these interest expenditures are exported and have just **ABSOLUTELY NO** domestic stimulus affect whatsoever. So ya! Get those rich bastards. Tax all their money to export it and stimulate the world. Keep that theory going and you should succeed in accomplishing the socialist goal of the perfect world. Nobody will have any money and we should be a third world country by then. But what the hell; we got those rich bastards! As Herbert Hoover wrote in his memoirs; ***Sometimes government burns down the barn to get the rat***.