

Credit Downgrade May Hammer Munis and Stocks Instead of Treasuries

By [Washington's Blog](#)

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Many have [noted](#) that the credit downgrade may - paradoxically - cause a rally in treasuries.

Specifically, they point out that few markets are large and deep enough to absorb the huge amount of capital which is currently parked in treasuries. For example, the German bond market may be safer, but it is too small to absorb the mountains of money now in treasuries.

And while America looks ugly at the moment, it is still winning the beauty contest as compared with Italy, Spain and the Eurozone as a whole (and France's AAA credit [may soon be downgraded](#)).

In addition, while S&P downgraded American credit, the other 2 big government-endorsed rating agencies - Moody's and Fitch - still peg the U.S. at AAA.

And, the downgrade is a reflection - or cause, depending on your view - of chaos. And chaos, paradoxically, tends to drive people into treasuries.

So if treasuries are unlikely to get hammered (at least in the short run), what will be adversely affected?

Munis Will Get Hammered

As I [reported](#) last month, Moody's has placed the credit ratings of 177 public finance issuers on review for a possible downgrade, based on the threat to a U.S. government downgrade.

Within the next day or so, S&P will publish a list of state and local entity downgrades.

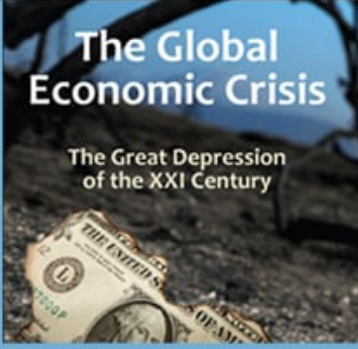
Tyler Durden [points out](#) that munis are likely to get mugged:

While the impact on Treasuries as a result of the downgrade may be limited (after all the other side of the Atlantic is about as ugly as the US, so where could \$8 trillion in marketable USTs practically go... at least for now), the same may not be said about the far smaller, \$2.9 trillion municipal market, which is about to see a blanket downgrade tomorrow as S&P warned on Friday night, and of which Matt Fabian of Municipal Market Advisors earlier said that **"There will be hundreds and hundreds of municipal downgrades, which will not do well to bolster investor confidence."** The scary bit: "Treasuries may be able to shake off a real impact from the downgrade. **Munis I'm less**

sure about.” Indeed, with futures already trading, and most risk assets experiencing a brief knee jerk reaction on a global coordinated PPT response by the G-7, there is still little clear understanding of what will really happen to not only the traditional system but to shadow liabilities such as repos and money markets. And munis are just one part of all of this. So what will happen if tomorrow the muni market starts unravelling, as Whitney, among so many others, has predicted? For that we turn to JP Morgan’s Peter DeGroot for some quick observations.

From JP Morgan on munis:

After S&P’s announcement of the US downgrade, expect follow-through on municipals directly supported by the US credit, as well as those highly reliant on the federal government



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Equities Could Be Adversely Impacted

CNBC [argues](#):

Standard and Poor’s historic downgrade of U.S. debt on Friday won’t have much impact on the Treasury market, instead most of the impact will be felt by the equity markets, a number of experts told CNBC.

“The panic you may see is out of equities into Treasuries. But I don’t think you’ll see a big panic away from Treasuries,” he said.

“Everytime S&P downgrades a AAA rated country, it’s taken about 10 years for that country to get back to a AAA rating again,” Kapstream’s Palghat explained. “Even if the gang of 12 come up with measures to cut the deficit down, that means there is less money that the government’s going to spend, which means the economy is not going to get that money so recovery is going to be even further delayed.”

Palghat believes that delay in economic recovery will further pressure equities. “I think you’re just seeing the beginnings of a correction in the equity market,” he said.

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