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Threat of $100bn hit if US top rating lost

By Michael MacKenzie in New York

Investors in the US government bond market could face losses of up to $100bn if the largest economy loses its triple A rating, according to a research arm of McGraw-Hill, the parent of Standard & Poor's.

A ratings downgrade that results in higher bond yields and lower prices could also mean the US Treasury paying $2.3bn-$3.75bn a year more in interest on financing a $1,000bn annual budget deficit.

"If Standard & Poor's or any of the other major rating agencies downgrade the US, Treasuries would likely drop in value, possibly by as much as $100bn," said analysts at S&P Valuation and Risk Strategies, a research team separate from the agency.

Currently, Treasury yields do not reflect concern about the US losing its top rating. The yield on 10-year Treasury notes fell to 2.85 per cent on Friday, a low for the year. Investors are concerned about a weaker economy and financial contagion from the euro debt crisis. Yields on four-week Treasury bills have been driven below zero.

While the threat of a US downgrade is remote, it remains a possibility given the projections of large long-term deficits and the impasse over raising the $14,300bn Treasury debt ceiling.

In April, S&P affirmed its US rating but revised its outlook to negative because of the deficit and the risk that it will not be cut meaningfully by 2013.

Moody's has said it could place the US government on review for downgrade if there is no resolution of the impasse over raising the Treasury debt ceiling before the August 2 deadline.

Many in the bond market say it is unthinkable that the US would actually default over the debt ceiling and expect a deal before the deadline.

But prominent bond investors such as Bill Gross at Pimco have warned about the US's long term fiscal position for some time. Earlier this year, Mr Gross eliminated Treasury holdings in the total return fund that he manages.

Michael Thompson, managing director at S&P Valuation and Risk Strategies and one of the three authors of the report, said the analysis is based on the debt ceiling being resolved and focuses on whether Congress addresses the long term fiscal outlook.

The S&P analysis calculates a reduction in the rating to double A or single A would spark a decline of 2 per cent and 3.2 per cent respectively in the price of the 10-year Treasury note, sending yields higher.

The price of the 30-year bond would drop by 3.9 per cent and 6.3 per cent under these scenarios. The analysis focuses on Treasury debt with a maturity longer than two years as this sector is least affected by the Federal Reserve's near zero interest rate policy. As such, the estimate of costs associated with a downgrade is considered conservative.

A ratings downgrade applied across all Treasury maturities could raise the cost of financing an annual budget deficit of $1,000bn by an additional $20bn