Economy, not debt rating, will send markets lower

The world economy, and not just the US debt rating, likely to make stock trading volatile

Associated Press

Chip Cutter and Pallavi Gogoi, AP Business Writers, On Sunday August 7, 2011, 6:24 pm EDT

NEW YORK (AP) -- U.S. investors will have their first chance Monday to react to Standard & Poor's decision to strip the U.S. government of its top credit rating. But the bigger issues facing Wall Street and stock markets worldwide remain debt-ridden countries in Europe and concerns that the global economy is weakening.

Friday's first-ever downgrade of U.S. long-term debt from AAA to AA+ wasn't unexpected and may have little impact on interest rates. But it's the kind of news that stock markets don't need when investors are already nervous.

Even before the downgrade, the Dow Jones industrial average last week fell nearly 700 points, or 6 percent. Investors were worried because economic signals in the U.S. and overseas were pointing toward trouble:

--On July 29, the government dramatically lowered its estimate of how much the economy grew during the first quarter. It had said the economy grew at an annual rate of 1.3 percent, but revised that number down to 0.4 percent. Second-quarter growth was also weak, a 1.3 percent rate.

--European officials are trying to help Italy -- the world's eighth-largest economy -- avoid the kind of bailouts that Greece, Portugal and Spain were forced to accept to prevent them from defaulting on their debt. And those bailouts haven't solved all the problems in those countries.

--The first reports on the economy during the third quarter have been mixed. Manufacturing, which helped pull the economy out of the recession, fell to its weakest level since July 2009 -- the month after the recession officially ended. The Labor Department said 117,000 jobs were created last month. But that came after 99,000 jobs were created in May and June combined -- and 250,000 new jobs are needed each month to reduce unemployment.

As a result, financial analysts interviewed Sunday said they expect markets to be volatile this week -- and beyond.

"We are in unchartered territory and, therefore, should all brace for volatility over a number of days if not weeks," said Mohamed El-Erian, CEO and co-chief investment officer of the bond mutual fund company PIMCO.

Mark Zandi, chief economist at Moody's Analytics, said he expected the downgrade to cause a selloff Monday. "There's a lot of fear and misunderstanding and confusion, and that all could come out in the stock and bond markets. I don't think it takes much to unnerve investors given the current environment. I think anything could drive investors to sell given how fragile sentiment is," he said.

Former Federal Reserve Chairman Alan Greenspan, who appeared on NBC's "Meet the Press" Sunday, expects the selling to last for some time. "It is very unlikely that (this) isn't going to take a while to bottom out," he said.

The reason: "It depends on Europe, not the United States," Greenspan said. "The United States was actually doing relatively well, sluggish but going forward until Italy ran into trouble." He said that half of U.S. corporations operate in Europe, and that the region "has been a very important driving force in the overall earnings of U.S. corporations."

The Dow fell 513 points on Thursday alone after concerns about Italy's problems were compounded by anxiety ahead of Friday's jobs report from the Labor Department. That report came in better than expected; the economy got 117,000 new jobs in July. But it wasn't enough to calm investors. The Dow has fallen nearly 10 percent in two weeks -- a period that included the budget debate that averted a default on U.S. debt.

Greenspan noted that S&P had "hit a nerve" with its downgrade. The ratings agency said it was lowering the U.S. rating not just because of the country's debt load, but because S&P doesn't believe Congress has the ability to resolve the country's debt problems. And it warned that another downgrade could be forthcoming.

On Saturday, David Beers, S&P's global head of sovereign ratings, said his agency was concerned about "the degree of uncertainty about the political policy process" in Washington.

S&P was looking for $4 trillion in budget cuts over 10 years. The deal that Congress passed on Tuesday would bring $2.1 trillion to $2.4 trillion in cuts over that time. S&P said it was also concerned about the ability of Congress to implement those cuts because of the division between Republicans and Democrats.

"Right now, the markets don't believe anybody anywhere and the uncertainty premium is very high. Since the end of World War I, the United States has been an unquestioned AAA credit, until now," said David Kotok, chairman and chief investment officer of Cumberland Advisors.

Prudential Financial market strategist Quincy Krosby said, "The rating is in essence an indictment of Congress and puts the president on the defensive. While both sides came up with a package that was short on the cuts that we needed, ultimately it happened on this president's watch. So, it takes on a very symbolic indictment of his ability to run the United States."

Investors are worried about debt not only because countries and many people are overwhelmed by it. Debt is what financed economic growth for decades. Now countries and people are cutting back on debt -- deleveraging is what economists call that process -- and that means economic growth in the future will be slower.

Economists had widely expected the U.S. economy to pick up in the second half of the year after its soft patch in the spring. But the stock market, which looks six to nine months ahead, doesn't see an improvement until well into 2012.

Investors may get more insight on Tuesday, when the Federal Reserve holds a regularly scheduled meeting on the economy and interest rates. It's expected the central bank will state that interest rates will need to remain at their current low levels for at least another year.

Even with this bleak outlook, some analysts see a chance for stocks to rise, at least in the short run.

The stock market could recover next week if European leaders make progress in averting another debt crisis in that region, said Ryan Detrick,