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So, What Happened?

The S&P 500 dropped from 1337 two Mondays ago to a close of 1119 on Monday, August 8, a drop of 218 points or 16.3%. Also last week, the U.S. Congress passed a bill to increase the debt limit at roughly the last possible minute, and S&P downgraded U.S. Treasury debt from AAA to AA+.

Economically, the news was tame. Gross Domestic Production (GDP) growth for the first two quarters got revised down to 0.4% and 1.3% annual rates, respectively, but they were both still growing. Friday's employment numbers showed job growth of 117,000 workers and the prior readings were corrected upwards, as unemployment fell from 9.2% to 9.1%. Admittedly not gangbusters, but not negative. So, why the panic?

For the last month or so the media noise about the Federal debt limit and 'risk of default' had been getting louder and louder as we got closer and closer to the day when the U.S. government would reach that limit. Republicans in Congress, particularly the newly elected members of the House, wanted to use this moment as leverage to do something to reduce the debt, and the resulting political conflict generated lots of uncertainty, which weighed on the markets.

Most of this was noise; there was never any question that the U.S. would pay its bills. The best indicator of this was to keep an eye on the interest rates demanded by investors to hold U.S. Treasuries. Over the last week the yield on the 10 year Treasury has dropped from 2.6% to 2.3%; if investors were worried about a default the interest rates would have shot up to near the 15% where Greece debt trades. Our debt limit was introduced in the 1970's to supposedly reduce U.S. debt, and it has worked as well as you would expect, i.e. not at all. It's been raised 74 times since with no notable effect on reducing U.S. debt, at least not until now.

S&P highlighted political bickering as a key factor in undermining its confidence in U.S. debt, with governance "becoming less stable, less effective and less predictable than what we previously believed."