On Friday evening, Standard & Poor’s lowered the rating of US Government long-term debt from AAA to AA+ with a negative outlook. The premise of the downgrade was twofold: political risks and a rising debt burden, in that order. The political risk speaks to the obvious struggles our political leaders have had in agreeing to a substantive and feasible plan to rein in the trajectory of outstanding debt with the debt burden moving to a higher and higher percentage of GDP. While not over 100% of GDP, it’s approaching that level and likely to exceed it in the coming years absent a slowing in government spending and/or increase in revenues. S&P further stated the rating ‘could’ be lowered to AA in the next two years if there is less reduction in spending than agreed to in the just passed debt deal or higher interest rates or fiscal pressures resulting in a higher government debt trajectory than in S&P’s base case. On Monday, S&P subsequently reduced most government agency ratings (including FNMA and FHLMC) from AAA to AA+ given the reliance of the agencies on the US Government for support.

What does this mean to the typical bank portfolio that contains perhaps not so many Treasury securities but does have a plethora of agency debentures and mortgage-backed securities issued by Fannie and Freddie? Well, the nation’s five federal banking regulators were quick to issue their own press release Friday evening following the S&P downgrade reaffirming the risk-based capital risk weights of US Treasury debt and other debt issued by the US government, government agencies and government sponsored entities as it pertains to the risk-based capital requirements. Thus, risk-based capital weights remain the same for the affected securities. (Complete press release from the regulators is attached).

The other primary concern is what does this mean to the likely direction of interest rates on the affected debt. There are several things to keep in mind in regard to this. The other two nationally recognized rating agencies, Moody’s and Fitch, both have reaffirmed the AAA standing of US Government long-term debt but have made clear their own concerns that ratings could be reduced in 2012 if steps aren’t taken to improve the trajectory of the debt. In addition, keep in mind two notable sovereign downgrades from AAA to AA (Canada in the 90’s, and Japan in the early 2000’s). In both cases, interest rate levels weren’t indicating signs of stress prior to the downgrade, nor did rates climb following the downgrade. Thus, there is precedent that the markets themselves are the final arbiter of perceived credit risk. And in this case, in Monday trading Treasury yields dropped to levels not seen since early 2009, levels reached during the depths of the financial crisis. Granted, much of the move lower in yields was due to the ratcheting down of economic expectations and the fleeing of equity money looking for a port in the storm. But it’s immeasurably instructive that market players continue to find safe haven in Treasuries, the deepest and most liquid asset class in the world, and it’s likely to remain so for the foreseeable future.

That is probably the main point to discern from this whole matter. Treasuries and agencies will continue to trade as they did prior to the S&P downgrade, with yields and rates being driven more by economic developments rather than any perceived slight change in the credit quality of the issuer. That doesn’t mean investors should dismiss the situation because the debt position of the federal government is obviously a serious concern and a constructive resolution is far from settled. It is, rather, a shot across the bow of the ship of state and one our political leaders should take with seriousness and gravity. There really is no choice, they must work together to achieve a solution that addresses not only the concerns raised by the rating agencies but also gives investors confidence as they are the ultimate judge of the perceived ability and willingness of the US Government to repay its debts.