

With the recent Standard & Poor's downgrade of the U.S.'s bond rating, many are concerned with the broader issue of the current state of the economy, and the effect of the downgrade on the debt crisis. Dun & Bradstreet has provided observations on the economy and the business impact of the downgrade.

### **S&P Downgrade of U.S. Bond Rating**

D&B is not overly concerned about the particular rating. We do not rate Government bonds, so we cannot elaborate on the justifications of the S&P rating beyond the fact that it was a split rating. Moody's and Fitch did not downgrade their AAA rating. Although the debt crisis was anticipated, the particular rating was not. The stock market, at the moment, is responding to the downgrading—and to the crisis in Europe—with extreme volatility. It will, in time, revert back to reliance on the fundamentals. The market absorbs anticipated events much more easily than unanticipated shocks.

D&B is, however, concerned about the fundamentals. It is more about not having an adequate fiscal plan in place than the S&P rating. A much bigger short term crisis is a technical default, which has been averted due to lawmakers reaching a deal. Yet, there is general acceptance that the deal is inadequate to solve the fiscal problem. The uncertainties and risks in Europe will also have an impact on the global economy. The world is more closely connected than ever before, with many local crises eventually becoming global. Most economists have increased their estimated probability of a new recession (a second dip) for U.S. However, these economists are not saying that a second recession is likely. The estimated *consensus* of the probability of a new recession is around 25%, compared to a 15% probability prior to downgrade.<sup>1</sup> Lack of job growth has been a persistent problem throughout this recovery. Current unemployment is at 9.1%—with non-farm employment increasing by 117,000 in July and private sector adding 154,000 jobs.

### **D&B's Downgrade of U.S. Country Risk**

In July, D&B's Country Risk Services team, which provides ratings on the riskiness of doing business in foreign countries, downgraded the U.S.'s country risk rating by one quartile from DB2a to DB2b (where DB1a is the least risky and DB7 the most risky). While the U.S.'s new rating still puts it within the "Low Risk" DB2 category (and only three quartiles below the best ranked country, Switzerland at DB1c), the downgrade reflects the increased uncertainty that the country's medium-term fiscal framework places on the business environment. The federal debt is now approaching 100% of GDP, and much politicking remains before plans to achieve full debt-sustainability are in place. Until then, investors will begin to demand a premium for the longer-term risks posed by the lack of a comprehensive fiscal consolidation plan. Ultimately, the large fiscal deficits of the past three years and the rapidly expanded debt represent a burden that now threatens to be passed on to households and businesses in the form of spending cuts, taxes, higher interest rates, and inflation. Currently, plans for spending cuts, while needed, will certainly provide a drag in an already-slowing economy.

It is important to differentiate between the Country Risk rating and D&B scores and analytics. Country Risk is an assessment at a country level based on macro-econometric studies. D&B scores and analytics services are at individual business level based on statistical analysis of data on those businesses. D&B tracks key economic indicators—especially small business delinquency and failure rates. D&B's delinquency and failure statistics had been consistent with economic recovery in 2010. Though it never dropped to the pre-recession level, percentage of delinquent dollars (a statistic unique to D&B as a metric of business health) stabilized in 2010. There was a spike in December 2010, and the trend continued in Q1 2011, with stabilization in Q2. Based on this information, D&B predicts slow recovery.

### **Potential Impact to Business**

Our advice continues to be utilization of rigorous analytics. In order to protect themselves in challenging economic times, business owners should err on the side of caution and perform rigorous analytics before making business decisions. Looking at past performance and historical trends is very important, but may not be enough. Predictive scores that forecast delinquencies and failures are crucial elements in the decision making process. A refinement and balancing of historical inputs with predictive indicators can significantly enhance the bottom line.

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<sup>1</sup> CNN Money - 8/10/2011

D&B will not downgrade our scores in response to the debt crisis, for there is no evidence for a blanket downgrade of scores in the data. Higher government borrowing costs could potentially transmit to higher interest rates, which could potentially curb private sector investment and consumption. Private sector could also react to the uncertainty by holding on to cash, hiring freezes, not buying new equipments, and in some cases not paying their vendors. In our most recent analysis, D&B saw larger companies holding onto cash. As large companies pay their vendors slower—with the majority small businesses—the impact would transmit through the economy. Payment based predictive indicators are the most important component of D&B scorecards. As payments slow, scores will shift downward. The anticipated debt crisis is not going to cause a fundamental shift that would require an across the board point reduction.

### ***Minimal Impact to D&B Scores***

D&B scores are not directly contingent to macro-economic events. As newer versions of scores become available, we should expect default rates to be associated with score bands. For example, our latest version of Commercial Credit Score suggests if a customer accepts everyone with a risk class of 3 (score 404+), they will be approving 70% of the applicants and face a delinquency rate of 14%.

<b>Commercial Credit Score</b>					
<b>Risk Class</b>	<b>Score Range</b>	<b>Percentile Range</b>	<b>% of Accounts</b>	<b>Delinquency Rate</b>	<b>% of “Bads” Identified</b>
1	481-670	91-100	10%	6.0%	97.5%
2	451-670	71-100	30%	9.1%	88.4%
<b>3</b>	<b>404-670</b>	<b>31-100</b>	<b>70%</b>	<b>14.4%</b>	<b>57.2%</b>
4	351-670	11-100	90%	18.3%	29.9%
5	101-670	1-100	100%	23.5%	0.0%

As the economy moves through a cycle (with or without a crisis), the 70% and 14% cannot remain true for an extended period. Theoretically, it is possible to build a score that is pegged to GDP or another macro indicator, with scores very quickly adjusting to the economy. If the economy turns for the worse, customers with 404+ acceptance rule will still face 14% delinquency but the acceptance rate will fall. The other extreme—not using economy driven predictors—would keep the acceptance rate at 70% and delinquency rates would fluctuate. D&B scores do not follow either of these extreme paths. Thus, if the economy worsens, D&B score distribution will shift downward, but not as extreme as the changes in the economy.

### ***Risk and Opportunities***

D&B recommends that businesses closely monitor score movement and cut-offs. Risk policy makers need to be agile, and follow a more flexible, customized, and possibly stricter credit policy. For example, the performance table above is based on a representative sample of credit active businesses—it is unlikely to mirror any single customer’s portfolio or supplier base. We recommend customers not only use a customized table, but benchmark their customers against their peers.

Times of turmoil also often offer the greatest of opportunities. There are pockets of opportunities within the U.S. economy. There are regions, industries, and segments within each that are sheltered from economic uncertainties—as well as contain pockets of growth. A granular segmentation of one customer and prospect base, and analysis of segment level performance will also add value. D&B can assist with data analysis and analytics to identify proper action.

Upon request, D&B can send a score migration analysis of our base for benchmarking against a customer’s base. Our custom analytic services group will also assist customers with analysis of their own data, or customize the D&B report according to a customer’s specific needs. Please send any questions or analysis requests to [IndustryTrendReports@dnb.com](mailto:IndustryTrendReports@dnb.com) or contact your D&B relationship manager.