

# U.S. Rating Downgrade

## Insights from RCM

8 August, 2011



### Downgrade by rating agency Standard & Poor's

**Standard & Poor's (S&P) has downgraded the US credit rating for long-term bonds from AAA to AA+.** The short-term credit rating A-1+ has been confirmed. The outlook on the long-term rating (2 years horizon) is negative.

### Explanation for the downgrade

#### Two reasons were given by S&P for the downgrade:

- Firstly, the recently decided fiscal austerity package appears to fall short of the required savings in order to stabilize debt dynamics. Three weeks ago, S&P stated that fiscal austerity measures amounting to 4 trillion USD over the next decade would be required. The decisions taken last week envisage savings of 2.1 to 2.4 trillion USD.
- Secondly, S&P questions the effectiveness of US policy making and, hence, the ability of US politics to implement tougher fiscal austerity measures going forward.

#### The downgrade itself, was already widely discounted by market participants:

- On RCM's estimates, the fiscal austerity measures decided last week only help to stabilize the ratio of debt to the gross domestic product (GDP), but will not substantially reduce debt ratios, unless trend nominal GDP growth improves.
- In addition, S&P has already indicated in mid July that it was considering a US downgrade.

### Near term implications of the US downgrade

**It needs to be pointed out, that a formal default of the US Government is virtually impossible,** as the US could still turn on the US Federal Reserve (Fed) to monetize its debts, as long as the US\$ retains its reserve currency status. **For US investors in US Treasury securities, the risk remains, therefore, that US debts are serviced and paid back in inflated USD; for foreign investors, the risk is USD depreciation.** Historically, generating inflation above expectations has often been the way how governments managed to deleverage over a longer period of time.

#### The impact on U.S. government bond yields is likely to be small. RCM expects yields to rise by up to 50 basis-points, in the near term, for the following reasons:

- Even though the market was most likely prepared for a downgrade, 10 year US Treasury yields have fallen to 2.55 % during the last week. The downgrade by one notch only by one rating agency is unlikely to trigger forced selling by the banking and insurance sector for regulatory or risk management reasons. Foreign investors are also unlikely to switch out of US Treasury notes near term because of this one downgrade.
- For all investors, there is a lack of credible alternative to the US government bond market. Japan and many European countries are suffering from similar debt problems as the US and have already suffered downgrades to below AAA. Emerging market bond markets are unlikely to be perceived as credible alternatives at this juncture.
- Collateral requirements in the repo market may rise, but, ultimately, these requirements are primarily driven by market volatility and the impact of this one downgrade should be small.

## General risk of an increase in US Government bond yields

**What makes the bond market outlook difficult near term, are several factors (all unrelated to the downgrade):**

- Firstly, current valuations of US Treasury notes appear very high. Hence, a reversal in bond prices could happen any time.
- Secondly, the market could anticipate that international investors, in particular China, could reduce their share of US Treasury notes in their portfolios more quickly than originally planned, with the downgrade being the final trigger.
- Third, global and US economic data could continue to weaken, thereby providing a tailwind for bonds. As long as the US Fed Funds Target rate stays at current levels, however, US Treasury yields are very unlikely to exceed 3.75 to 4 %.

## Potential consequences for European bond markets

**The implications for the European bond markets are potentially significant.** Attention is likely to turn to the U.K. and France, who still retain AAA ratings. In the case of France, a loss of the AAA rating may put the effectiveness of the European Financial Stability Facility (EFSF) into question. **Thus, the U.S. downgrade may lead to a speed up of the ultimate move to a closer Euro area fiscal union (or breakup, if electorates revolt).**

## Implications for equity markets

The US debt downgrade comes at a difficult time for equity markets, both in the US and globally. Rising volatility near term and further downside cannot be excluded. However, **RCM believes that this downgrade does not fundamentally change the situation of the financial system.** The focus is likely to return to the growth deficit faced by most developed economies. In that sense, **the better than expected payroll numbers in the U.S. published on Friday may prove to be more significant in the short term.**

## Longer-term implications of the downgrade

**The downgrade is a reminder that public debt levels in most developed countries are extremely elevated. Specifically, US officials will have to apply all kinds of instruments in order to facilitate public sector deleveraging:**

- Low central bank rates for longer in order to compensate for fiscal austerity measures. This does not exclude any rate hikes, but interest rates will rise only moderately going forward.
- In order to keep yields at the long end the US Treasury yield curve rather low, the Fed is likely to increase the duration of its bond portfolio.
- If necessary, regulatory requirements will be changed so that financial institutions will be able to invest in US Treasury notes despite rating downgrades.
- Generating inflation above market expectations could be another means of keeping real financing costs for public debt rather low.

## Comments on the eurozone debt crisis

### **We are currently facing a eurozone government debt crisis, not a lack of trust in the Euro itself:**

The Euro has continued to show strength against the USD; in addition, investors are not questioning the solidity of EMU companies: corporate bond yields have remained fairly stable, on average. **In the opinion of RCM, recent decisions taken at the EU summit are a major step to solve the debt crisis as they have taken the Euro area closer to a sort of transfer union.** RCM stresses the necessity to make sure that the EFSF becomes operational to be able to stabilise eurozone peripheral bonds in the secondary market. **However, the downgrade in the U.S. could lead to a downgrade in French debt and that in turn to a loss of the EFSF's AAA rated status, increasing funding costs in Europe.** This may likely speed up moves towards quicker fiscal integration in Europe and/or a resumption and extension of the European Central Bank's bond buying programme.

## RCM's positioning in the current environment

While the current backdrop, accompanied by US and eurozone debt problems and moderating economic growth dynamics, is challenging for equity markets, **periods of high equity volatility have usually been times when adding to equities has paid off in the medium to long term.**

**RCM continues to prefer equities which are likely to benefit from strong and sustainable revenue streams.** Secularly, RCM is also holding on to the view that emerging market assets will continue to add value to global portfolios, also because of our expectations of appreciating currencies. **A portfolio strategy consisting of owning dividend stocks as well as growth stocks would appear to be a smart positioning now.** Particularly in the current low turnover environment, markets will continue to be volatile but now is not the time to sell risky assets. **Any signs of a more positive global growth outlook (currently discounted as unlikely by market participants) should provoke a strong rally of risky assets.**

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