

US Debt Rating Cut by S&P

The recent US Debt rating downgrade by Standards & Poors ("S&P") has sent shockwaves through global financial markets, reminding us all that Australia is part of the global economy.

In order to help you better understand the situation, we have included a summary below.

Latest market developments

- Earlier this month, US time, ratings agency Standard & Poors (S&P) cut the US debt rating by one notch from AAA to AA+, with a negative outlook. S&P is the only one of the 'big-3' ratings agencies to cut the US rating. Earlier last week both Moody's and Fitch kept their US ratings unchanged at the highest level, though had the US on credit watch for potential downgrade if fiscal cutting measures did not progress as expected over time.
- This announcement came after a volatile day on US markets. Non-farm payrolls data came in stronger than expected (+117,000 versus +75,000 expectation). This data supported the view that recent weakness in US economic data was consistent with a 'soft patch' not a full-blown, double dip recession. US markets opened up strongly on the better news but surrendered gains going into the end of trade, with rumours of an S&P 'announcement' trickling through prior to the close.
- The US Treasury Department released a statement saying that S&P had made a \$2 trillion error in the calculations it used to come to its downgrade decision. S&P later admitted this error, but said it was immaterial to the main reasons for their decision which was more to do with political uncertainty in addressing the burgeoning US debt levels and budget deficit (i.e. as well as the already massive current and projected debt & deficit levels). Note: the \$2 trillion difference amounts to 1.5% in a Debt/GDP sense, small when compared to numbers over 100%!
- The S&P decision has been well 'telegraphed' to the market in recent weeks. Although the recent US congressional agreement allowed for the raising of the debt ceiling with spending cuts, the staged cuts to commence over the next 18 months were only half the US\$4 trillion sought by S&P.
- In response, Asian markets have opened up weaker this morning. The ASX/S&P200 was down 1.5% within the first half hour of trade, while the New Zealand market was off 2% in early trade. The A\$ has held reasonable steady this morning trading at just above US\$1.04. US equity market futures are currently down 2% in early Tokyo trade, signalling that overseas markets are poised for further weakness tonight. The S&P500 is currently down around 11 per cent over the past two weeks, while the Australian market is down by a similar amount since the start of August.
- Early this month there have been numerous conference calls between European Finance officials and G-20 and G-7 Finance ministers. The G-7 (i.e. group of the 7 largest industrial economies) largely dismissed the S&P downgrade and issued a statement saying the monetary authorities and governments of the world's leading economies will take "all necessary measures to support financial stability and growth". This includes agreement to inject liquidity and act against disorderly moves in currency markets when necessary. The European Central Bank stated separately it will buy Italian and Spanish bonds to maintain liquidity and market stability, and the Bank of Japan signalled further currency intervention to slow the pace of USD declines against the Yen.

Key messages

- **The S&P downgrade will add another hurdle to restoring market sentiment in the short term, but should have no more significant impact than the other raft of issues already impacting the market. The US Treasury market remains the largest and most liquid bond market in the world – S&P’s latest decision does not change that fact.** US debt is widely held by Sovereign Funds and governments around the world to invest the proceeds of US\$ purchases resulting from activities such as foreign exchange intervention (especially on the part of China and Japan who are focused on limiting the appreciation of the Yuan and Yen against the US\$). Countries like China and Japan are highly unlikely to withdraw from the US Treasury market as this will send their currencies soaring and counteract their foreign exchange management policies. Other alternative destinations for bond holdings such as Europe and Japan are not as attractive as US bonds due to current Eurozone sovereign debt issues and lower liquidity and yields in Japan.
- **Whenever stock prices take as big a hit as they have over the past week or two, it will typically take a while to recover the market confidence and form a base from which to climb higher.** Again, volatility is the order of the day and prices may well fall further from here for a while. But that said, monetary and government officials around the world are becoming aware of the increasing disconnect between market movements and underlying fundamentals. This has sparked an immediate response to build a consensus for coordinated government and central bank intervention to provide a circuit breaker and give markets time to realign to a more ‘sensible’ appraisal of the issues currently confronting markets.
- **Despite the extreme movements of the past few days, there has been no fundamental change in the world economy in the past 72 hours – the S&P ratings downgrade has just been a sober reminder of what we already know, i.e. spending cannot go on forever and action to reign it in must be commenced sooner than later.** The fact is we remain in a volatile market environment, set against the backdrop of a grinding global recovery.

As a backdrop to the current market gyrations, it is worth re-emphasising the following key fundamentals:

1. **The recent softer US data is consistent with our long held view that economic data overseas will oscillate between good and bad for a while yet, but that the net effect is the continuation of a grinding recovery over the next year or more.** That is, the US is going through a soft patch rather than a return to recession (the non-farm payrolls data on earlier this month supports this, though they are still at anaemic absolute levels).
2. **Despite Eurozone debt concerns, core countries such as Germany continue to deliver strong growth,** and one of the best performing share markets in the world over the past year – despite everything going on with Greece.
3. **Equity valuations remain ok (on the cheap side of longer term averages). US earnings in particular remain robust** with 75-80% of reporting companies in the current earnings season beating expectations – 43% of these by more than 5% (though we do expect US earnings growth to slow to a more sustainable pace going forward).
4. **US government bond valuations are now considered to be at extremely expensive levels. The debt ceiling/deficit cutting issues will be worked through** and US default is an extremely low probability going forward.
5. **The S&P downgrade of US debt should serve to focus political attention on the need to stop playing politics and start making hard decisions** on deficit and debt reduction.
6. **The central scenario for Europe is that sovereign debt worries will continue to muddle through for now,** but with any agreement on a long term solution still a way off yet.
7. **Emerging economies remain the key drivers of global growth.** Central scenario is for a soft rather than hard landing in China (slowing to 8% pa or so – still impressive)

What should investors do?

- Whenever there are large market-driven movements like this week, it is likely there will be continued volatility for a while until things settle down again and some degree of confidence is restored.
- The key for investors is not to panic. We remain confident that while market conditions will continue to be volatile over the rest of the year, now is not the time to make knee-jerk reactions and run to cash (as many did in the depths of the GFC – with terrible results in the ensuing recovery).
- Keep your head, stick to your long term strategic plan, and look through the current noise to keep headlines in perspective (especially against the backdrop of market valuations and economic fundamentals). In our view, there is nothing in the market news and volatility over the past week that should automatically change your medium to long term investment strategy.

If you are concerned about how these latest developments affect your wealth plan, please contact Glen Jarvis.