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The US loses its AAA credit rating from S&P. Not good but maybe not as bad as feared

AMP capital INVESTORS

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Key points

- Ratings agency Standard & Poor's (S&P) has followed through with its threat to downgrade America's sovereign credit rating. Budget savings fell short of the desired levels thought to stabilise the debt to gross domestic product (GDP) ratio, so America's rating has been downgraded from AAA to AA+.
- The impact this downgrade will have on US borrowing costs is likely to be minor, although the market will be swamped by the impact of weak economic growth and safe haven demand for bonds.
- Over time it could be a positive for the currencies of other AAA rated countries including the Australian dollar (A$) and Singapore dollar, but in the short term it only adds to existing uncertainty.
- The downgrade should have been priced into share markets already, but it reinforces pressure around fiscal tightening in the US as well as being a blow to US confidence.
- While shares could remain volatile for a while, there are indications that policy makers will swing into action, with reports the European Central Bank (ECB) will buy Italian and Spanish bonds while the G7 leaders commit to a liquidity injection to stabilise markets.

Introduction

As expected, S&P downgraded the US Government's sovereign credit rating from AAA to AA+. Last month, S&P indicated that debt ceiling negotiations would need to result in US$4 trillion in budget savings over ten years in order to stabilise the country's debt to GDP ratio. Ultimately the debt ceiling negotiations only delivered between US$2.1 and US$2.4 trillion in savings[1]. S&P has remained true to its word, following through with a US credit rating downgrade.

So what are the implications?

Likely to have less impact on borrowing costs than feared

Contrary to expectations, the ratings downgrade is not likely to result in a major increase in borrowing costs for Americans, the actual impact is likely to be minor:

- Forced selling of US bonds is likely to be limited as most investors can still hold AA rated debt. Additionally, many investors take the higher of several ratings given by rating agencies. So far the two major rating agencies, Moody's and Fitch, have maintained AAA status for US debt.
- While there is a risk that some US companies might also be downgraded, the impact on US non-financial corporates is likely to be minor. Only four companies have a AAA rating and it is possible for corporates to have a higher rating than their government.
- While countries with large exposure to US Treasury investments, such as China and Japan, are unlikely to be impressed (China has already complained) they aren't expected to offload their holdings or stop buying US bonds. In fact, unless they want to see their own currencies rise against the US dollar (US$), they are more likely to continue intervening in foreign exchange markets, buying US$, and then investing some of the proceeds in US bonds. This was evident in Japan's foreign exchange intervention over the last week to push the yen lower.
- The deteriorating quality of US bonds might push bond yields higher. However, safe haven bond buying is common whenever investor sentiment regarding shares declines. Slowing economic growth and declining expectations for a US rate hike is pushing bond yields lower at the moment. This was evident as US bond yields fell from 2.80% to 2.56% over the last week, despite expectations the US would lose its AAA rating from S&P.
- Historically, countries that have experienced AAA to AA credit downgrades have seen a rise of 0.2% in long-term bond yields over a period of a few months. However, this tends to be unsustainable as other factors drive bond yields back down. In fact, when Japan was downgraded from AAA to AA+ in February 2001, its ten year bond yield fell by -0.24% the following week.
- In any case, if US bond yields do rise too much it's likely the US Government will intervene and start buying US bonds, for fear higher yields will slow the economy.

Talk that higher US bond yields will drive up borrowing costs elsewhere around the world, including in Australia, is pure nonsense. Even if US bond yields do rise, it is America that has seen its credit rating reduced, not other countries or borrowers in those countries.

[1] This amounts to an already agreed $US900 billion in spending cuts and another $US1.5 trillion in cuts to be agreed by november, or if there is no agreement then $US1.2 trillion in automatic spending cuts.

Negative for the US dollar longer term

The uncertainty created by the downgrade may be positive for the US$ in the short term against cyclical, high yielding commodity currencies like the A$. However, this impact is hard to gauge and over time is likely to be a negative for the US$. The US$ is likely to continue to trend down, encouraging investors to keep buying more US Treasuries despite their increasing amount of risk. Potential beneficiaries are the currencies of other AAA rated countries:

- Core European countries such as Germany, France and the Netherlands are unlikely to be major beneficiaries, as they are being called upon to again bailout southern European countries. A cloud hangs over the AAA status of some of these countries, notably France.
- Beneficiaries are likely to be Scandinavian countries, Switzerland and commodity based currencies such as Canada and Australia.
- Finally, a notable beneficiary is likely to be gold, as investors continue to seek a hedge against ongoing weakness in the debt ridden currencies such as the US$, euro and yen. Gold prices have already bounced by +2% or so on the news of a US debt downgrade.

For Australia, a US downgrade may further spur demand for Australia's AAA rated government bonds, pushing yields down, with capital inflows adding to the upwards pressure on the A$, once short-term uncertainty around the carry trade unwinding dissipates.

Adds to uncertainty for equity markets

While the downgrade should already be factored into equity market prices, given the sharp falls over the last two weeks, it adds to the general air of economic uncertainty as well as being a blow to US national pride. Ideally, the US should not be embarking on fiscal austerity for another few years, when the economy is on more solid footing. Unfortunately the downgrade will only further increase the focus on America's debt problems and accelerate the pressure for more fiscal austerity, similar to current events in Europe, which will constrain economic growth.

Are the ratings agencies to blame? Ever since agencies were blamed for inflating the credit bubble prior to the global financial crisis, they have been criticised. Criticism directed towards ratings agencies is on the rise again, particularly in Europe and more recently from the US. It's well known they are somewhat pro-cyclical, i.e. they can magnify economic or financial fluctuations, but it's hard to see an alternative.

Concluding comments

The rating downgrade was predicted and hardly a surprise. While the worst case fears are overstated, it adds nothing to our comments from last week that the outlook for share markets and other growth assets is likely to remain volatile in the months ahead. It is a time of caution for short-term investors.

A positive result for investment markets is that the ECB has indicated it will start buying Spanish and Italian bonds, partly in return for enhancements to Italy's fiscal austerity program. The ECB's failure to buy Italian bonds last week was a trigger for the sharp falls in global share markets on Thursday and Friday, a move to now start buying Italian bonds could be positive in helping to calm fears about a further escalation of European debt problems (at least for a while). Speculators will now have to think twice about selling or shorting Italian and Spanish bonds knowing the ECB will be acting against them.

More broadly it does seem that policy makers globally are swinging into action with the commitment of liquidity injections into markets from the G7.

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