Britain has lost its AAA credit rating. Sterling crisis or storm in a tea-cup?

"We will safeguard Britain's credit rating with a credible plan to eliminate the bulk of the structural deficit over a Parliament…"
- **The Conservative Party Manifesto 2010**

Oops. I guess it's easy with hindsight to say now that this was a bold call then, but frankly it was probably a call that George Osborne didn't really have to make anyway.

This month we examine the impact of Moodys' downgrade of our sovereign debt and wonder "In the greater scheme of things, does this downgrade really matter?"

Firstly, let's take a step back to examine the credit ratings agencies and how they work. The three biggest agencies are Moodys, Fitch and Standard & Poor. One of their major roles is to work out what is going on under the bonnet in the major economies and sectors and amongst other things to then give their view as to the creditworthiness of our governments. In other words, **if we lend a government money (i.e. buy their bonds), how likely is it that they will pay us back?** Whilst it is perhaps obvious that Greece will be rated as a higher credit risk than the US (for example), it is the more detailed scale that is pivotal in determining what governments have to pay to borrow money when compared with their neighbours. In other words, assuming that we believe what these agencies say, their ratings of our governments will directly influence how much those governments have to pay to borrow money (i.e. our government bond yields). **The big questions are "Do we believe their assessments?" and "Should we do something about it if we do?"** So with these questions in mind consider that Moodys has recently downgraded UK Government (and therefore its bonds) from Aaa to Aa1. Whilst this leaves us with a credit rating that is lower than either Luxembourg or the Isle of Man, before we all move to Canada, consider the following:

Firstly, during the credit crisis in 2008, it was these very same credit ratings agencies that rated some of the providers of the most toxic US Mortgage Backed Securities as AAA (i.e as safe as it gets) but yet these providers still went bust. Whilst confidence has been partially restored since, this does still prove that **rating countries and corporations is as much an art as it is an inexact science.**

Aaa	Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.
Aa	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
A	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
Baa	Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.
Ba	Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
B	Obligations rated B are considered speculative and are subject to high credit risk.
Caa	Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
Ca	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
C	Obligations rated C are the lowest rated class of bonds and are typically in default, with little prospect for recovery of principal or interest.

***Note:** Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category.*

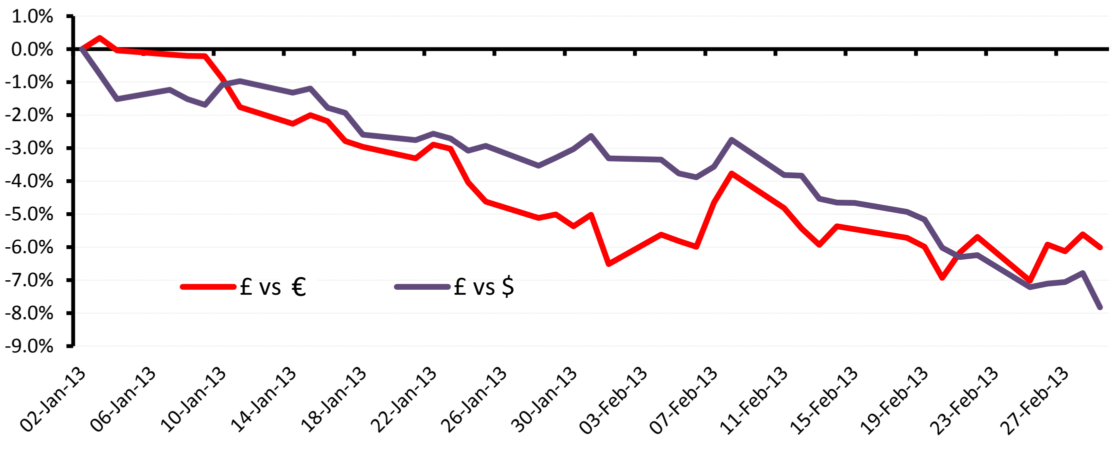
Secondly, as the chart above shows **Aa (as rated by Moodys) is still a very strong rating** and demonstrates a country whose obligations are "of high quality and are subject to very low credit risk".

Thirdly, we are in good company. **Both the US and France had their ratings downgraded** and in the case of the US this downgrade had no tangible longer term impact on either the currency or indeed their government bond yields.

Finally, this downgrade was not unexpected. The other two major agencies, S&P/Fitch, had the UK on "negative watch" for some time and after the chancellor's autumn statement confirmed that the UK was struggling to control its budget deficit, it was considered only a matter of time before one or other agency would capitulate.

Given the current state of the UK's budget deficit and sluggish growth outlook, we think that **the downgrade is justifiable** and we do believe Moodys' assessment. Therefore this begs the follow-up question **"Should we do something about it?"** Well, the recent downgrade has certainly had a material impact on sterling, as seen below:

Tumbling Sterling Vs USD and Euro in 2013



After a good run over the last few years, with foreign investors buying our bonds and our property, **Sterling has been the weakest major currency of all in 2013**, reaching almost three-year lows against the US $ and 16 month lows against the Euro. This is all the more concerning given that these two economic blocks have their own major problems, with "sequestration" (spending cuts) in the States and the Italian political shambles in Europe.

A weaker currency has a number of impacts, some positive and some negative. Apart from making our skiing holidays more expensive the main negative factors are:

Foreign investors are less likely to buy UK assets such as property and government bonds because they will fear losing money as our currency falls. This **may push up our bond yields**, which makes our debt re-financing more expensive, which in turn adds to our deficit – a much greater economic problem.

A weaker sterling "imports inflation" into the UK. This is because we import more than we export, and as our currency falls, so the price of foreign goods that we import rises, and therefore prices go up in the UK.

In addition, **it's the "wrong type" of inflation** because it is due to costs increasing, rather than demand increasing.

On the positive side, **a weaker sterling is great news for exporters**, as our goods and services are cheaper for foreigners to buy. This is a very significant by-product of a weaker currency, so much so that some of our peers (Japan for example) are desperately trying to devalue their overpriced currencies to kick start growth. **Stronger exports make our economy more competitive and should lead to growth.**

SUMMARY

Despite a weakening currency, we believe that we shouldn't be too spooked by this downgrade because the jury is out as to what impact it will actually have and this is reflected in bond yields, which show no sign of rising aggressively (yet).

On balance, notwithstanding malaise in the Eurozone and concerns over the fiscal cliff in the US, we can see sterling continuing to weaken from current levels and we expect this to be inflationary.

We have been positioning our clients' portfolios so that they are more exposed to global investments in both bonds and equities. We prefer global equity funds because of their foreign currency exposure and we are also looking to increase exposure to global themes such as healthcare and infrastructure. In addition we are buying into very large UK companies with good yields, as these derive a large % of profits from overseas.

Market "Stance" - the chart on the right illustrates our current general "market stance". Each of the dots on this chart represents a change in this market stance over time.

Our current stance is: **NEUTRAL**