

FEATURE ARTICLE: Keeping perspective on the rating downgrade

Credit ratings agency Standard & Poor's (S&P) has lowered the long-term sovereign credit rating on the United States to 'AA+' from 'AAA'. The lowering took place due to S&P's belief that recent events suggested that:-

" further near-term progress containing the growth in public spending or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process."

The ratings house also stated that the fiscal consolidations plans agreed to last week by U.S. authorities fell *"short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade."*

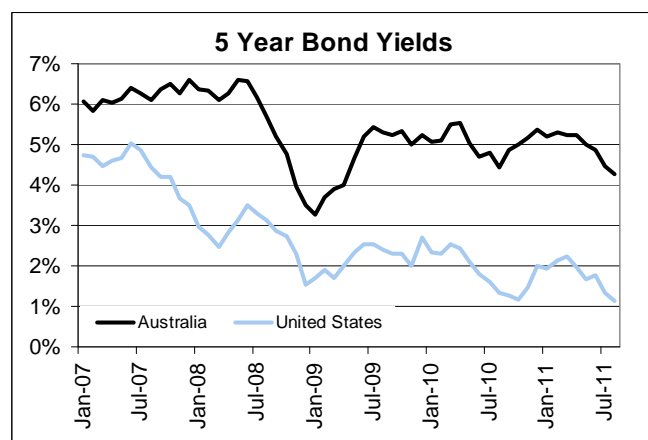
A credit rating effectively reflects an assessment of the likelihood the issuer of a debt or loan will default on that debt or loan. The downgrading in the U.S. credit rating is somewhat in conflict to the judgment shown by financial markets last week when considerable buying support for U.S. Treasury bonds saw bond prices rise and yields fall. Since the agreement was reached over the raising of the U.S. debt ceiling last week, yields on 10-year Treasury bonds dropped from 2.8% to 2.5%. As a point of comparison, Greek 10-year bonds are currently trading at around 15%. Few in financial markets, it would seem, have had any real fear of securities guaranteed by the U.S. Government defaulting.

Does the change in credit rating matter?

So if bond markets, with the access to same information as S&P, and the two other major ratings houses (Moody's and Fitch) not changing their assessment of the prospect of a U.S. default, then perhaps there is an argument to suggest that the recent credit downgrading has no fundamental implications for the global economy or financial markets.

However, there may be some real and tangible impacts of the change in the U.S. credit rating. Some investment funds, for example, will be operating under a set of controls that only allows them to hold securities with a 'AAA' rating. These funds

may therefore be forced to sell U.S. issued securities, which may see bond prices fall and yields rise. The need to exit U.S. Treasury bonds may also lead to an exit out of United States dollars, putting downward pressure on the U.S. currency. Potentially, however, selling pressure on U.S. Treasury bonds and the \$US could be neutralised if the markets continue to make their own judgments about the credit worthiness of the U.S. and continue buy bonds as a preferred "safe haven" asset.



Source: RBA. U.S. Federal Reserve.

The lower credit rating is likely to impose an additional spending discipline on the U.S. Government, and perhaps other governments, to restrain spending. Equity markets were already reeling at the prospect of lower rates of economic growth across the United States and Europe. There may be now less latitude provided to governments to either delay spending cuts or take stimulatory action in order to support growth in periods of weakness.

A rise in U.S. bond yields and additional constraints being placed on government spending is not favourable news for equity markets. Given recent price falls however, valuations would imply that stock markets have already assumed a relatively unfavourable environment. Irrespective of any fundamental influence on company earnings outlook, the historic change in the U.S. sovereign credit rating is yet another source of uncertainty for investors, which may lead to additional selling and volatility in the short term at least.

Alternate safe havens may be sought

The habitual use of U.S. Treasury bonds as the default “safe haven” place to invest may start to be revised as a result of the events of the last week. Investors could look to diversify their safe haven assets a little more. Gold could be the obvious choice for some investors. However, from an investment perspective, gold is effectively a speculative asset, with no income stream from which to anchor its value. It not inconceivable that gold prices could fall by 50%, should financial markets move into a new era of stability and predictability. So whilst the tendency of gold to rise in price when riskier assets fall gives it an attractive property as a defensive component of a portfolio, uncertainty over its longer term value precludes it from acting as a core part of an investment portfolio that has long term wealth accumulation as its objective.

Other assets that could take on a more important role as “safe haven” assets may include Japanese or Swiss government bonds or bank deposits. Given Australia’s favourable debt position, we too could figure more prominently in any flights to safety, which could see our Government and bank funding costs lowered. The property and infrastructure asset classes may also come into more prominence as desirable “growth” asset classes, given the underpinning of real assets with inflation linked cash flows and lower sensitivity to economic cycle changes than equities.

Some perspective required

The escalation in fear and volatility that is likely to grip financial markets in the aftermath of U.S. ratings downgrade will significantly test the nerve of investors. In times like these, it is important not to blindly follow the herd, which may tend to sell on the emotion of fear alone. Some perspective on what has actually changed and the long term implications of this change is required.

Most countries operate without a ‘AAA’ rating. In fact there are few than 20 ‘AAA’ countries rated by S&P, with the vast majority of nations having a rating below that of the ‘AA+’ now carried by the U.S. Whilst this is the first downgrade for the U.S., it is not overly uncommon for nations to experience downgrades and continue to operate as generally prosperous economies. For example, Australia experienced two downgrades in its credit rating in the 1980s, before its ‘AAA’ rating was restored in 2003 – providing an example of how governments can turn around their position and implement prudent and fundamental returns.

Certainly the U.S. credit rating change could lead to real fundamental changes. Interest rates in the U.S. may be forced higher and greater global fiscal restraint may slow global economic growth further. However, interest rates and economic growth are variables which constantly change. What share market investors need to assess is how significant these changes are to the future earnings of the companies they invest in. For companies listed on the Australian share market in particular, these fundamental influences may be relatively minor.

If there is any good to come out of the S&P decision hopefully it is that it prompts a new level of urgency and commitment from governments around the globe to restore global imbalances. Should these imbalances be managed, the private sector is cashed-up and well placed to start providing some meaningful returns for shareholders.

This newsletter is provided by Hillross Financial Services Limited (ABN 77 003 323 055 & AFSL No. 232705) an AMP Group Company. It is of a general nature only and any advice is not based on your objectives, financial situation or needs. Accordingly you should consider the appropriateness of any advice to your personal circumstances before acting on the advice. Before you make any investment decision, you should read the current Product Disclosure Statement available from Hillross or your financial adviser. Although this information was obtained from sources considered to be reliable, we do not guarantee it is accurate or complete. The information in this publication is current as at 8 August 2011, and may change over time. Hillross is part of the AMP group of companies. No additional remuneration or other benefits are paid to us or our related companies or associates in relation to the advice provided on this page. If you decide to purchase or vary a financial product, your financial adviser, Hillross and other companies within the AMP Group or associates of Hillross will receive fees and other benefits, including fees calculated as a percentage of either the premium you pay or the value of your investment. Further details are available from your adviser or Hillross. Past performance is not a reliable indicator of future performance.