

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

Investment insights

Dr Shane Oliver, Head of Investment Strategy and Chief Economist, AMP Capital Investors

Key points

- Standard & Poor's has been true to its word that it would downgrade America's sovereign credit rating if budget savings fell short of those desired to stabilise its debt to GDP ratio. Savings did fall short and so it has downgraded the US from AAA to AA+.
- The impact on US borrowing costs is likely to be minor and 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 New Zealand dollar (NZD) and Singapore dollars, but in the short term it only adds to uncertainty.
- For share markets, the downgrade should have been discounted already, but it adds to uncertainty and reinforces the pressure for premature fiscal tightening in the US. It's also a blow to US confidence.
- However, while shares may remain rough for a while yet there are indications that policy makers may be swinging into action again, with signs from the European Central Bank that it will now move to buy Italian and Spanish bonds, and the G7 leaders committing to stabilising financial markets and injecting liquidity into markets.

Introduction

As expected, Standard & Poor's has downgraded the US Government's sovereign credit rating from AAA to AA+. Standard & Poor's indicated last month that as part of the negotiations to increase America's debt ceiling it was looking for US\$4 trillion in budget savings over ten years in order to stabilise its debt to GDP ratio. Ultimately the debt ceiling negotiations only delivered between US\$2.1 to \$2.4 trillion in savings¹. So S&P has been true to its word in downgrading. What are the implications?

Less impact likely on borrowing costs than feared

Contrary to expectations that the ratings downgrade will result in a big increase in borrowing costs for Americans, the actual impact is likely to be minor:

¹ This amounts to an already agreed US \$900bn in spending cuts and another US \$1.5 trillion in cuts to be agreed by November, or if there is no agreement then US \$1.2 trillion in automatic spending cuts.

- Forced selling of US bonds is likely to be limited as most investors can still hold AA rated debt as it's still investment grade. In addition, many take the higher of several ratings agencies and so far the other two major ratings, Moody's and Fitch, have maintained America's AAA status.
- While there is some risk of a follow on downgrade to some US financial companies, the impact on US non-financial corporates is likely to be minor as only four have a AAA rating anyway and it is possible for corporates to have a higher rating than their government.
- While countries with huge investments in US Treasuries 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, they are more likely to continue intervening in foreign exchange markets to buy US dollars and invest some of the proceeds in US bonds. This was clearly evident in Japan's forex intervention over the last week to push the yen lower.
- The deteriorating credit quality of US bonds is a force acting to push their yields higher. But against this, safe haven buying of bonds is likely to continue whenever investors fret about shares. Slowing economic growth and declining expectations for the US Federal Reserve (Fed) rate hikes are also forces acting to push bond yields lower. This has been evident recently, with US bond yields falling from 2.8% to just 2.33% over the last week, despite the general expectation the US would lose its AAA rating from S&P.
- The experience of other countries downgraded from AAA to AA suggests a rise of around 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% over the following week.
- In any case, if US bond yields do back up too much it's likely the Fed will start buying them again (via QE3) for fear higher bond yields will slow the economy.

Overall there is unlikely to be much impact on US government borrowing costs, and by implication US private sector borrowing costs, to the extent they are priced off US bond yields.

Talk that higher US bond yields will drive up borrowing costs elsewhere around the world, including in New Zealand, 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.

Negative for the US dollar longer term

The uncertainty created by the downgrade may be positive for the US dollar in the short term against cyclical currencies, for example, high yielding commodity currencies like the Australian or New Zealand dollar. However, this impact is hard to gauge. Over time it is likely to be a negative for the US dollar. The US dollar is likely

to continue to trend down to encourage investors to keep buying more US Treasuries despite their increasing riskiness. Potential beneficiaries are the currencies of other AAA rated countries:

- Core European countries such as Germany, France and the Netherlands figure highly here but are unlikely to be key beneficiaries as they are being called upon to increasingly bail out southern European countries. And a cloud hangs over the continued AAA rated status of some of these countries, notably France.
- This leaves Scandinavian countries, Switzerland and commodity currencies such as Canada, Australia and New Zealand.
- Finally, a key beneficiary is likely to be gold, as investors continue to seek a hedge against ongoing weakness in the key debt ridden paper currencies of the US dollar, euro and yen. Gold prices have already bounced by 6% or so in a reaction to the downgrade news.

Adds to uncertainty for equity markets

While the downgrade should be largely factored into equity markets, given the sharp falls over the last two weeks, it does add to the general air of uncertainty. It also makes the economic outlook less certain. Ideally, the US should not be embarking on fiscal austerity for another few years, when the economy is on a sounder footing. However, the downgrade will only further increase the focus on America's debt problems and further accelerate the pressure over time for more fiscal austerity – much as has been occurring in Europe. This in turn will further constrain economic growth. The downgrade is also a further blow to American national confidence, like Watergate was in the 1970s.

Are the ratings agencies to blame? Ever since the role they played in inflating the credit bubble prior to the GFC, they have copped a lot of flak. Criticism of them is on the rise again, particularly in Europe, and the US is now joining in. However, it's well known they are somewhat pro-cyclical but it's hard to see an alternative.

Concluding comments

The rating downgrade was well flagged and hardly a surprise. While the worst case fears are overstated, it adds nothing to our conclusion that the ride for share markets and other growth assets is likely to remain rough in the months ahead and it is a time for caution for short term investors.

One big positive for investment markets though are indications from the European Central Bank that it will start buying Spanish and Italian bonds, partly in return for enhancements to Italy's fiscal austerity program. To the extent 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 very 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.

Contact us

Wellington office
AMP Capital Investors (New Zealand) Limited
Ground Floor, PWC Tower
113 - 119 The Terrace
PO Box 3764 Wellington
Telephone: +64 4 494 2200

or visit www.ampcapital.co.nz

Auckland office
AMP Capital Investors (New Zealand) Limited
Level 7
21 Queen Street
PO Box 5346 Auckland
Telephone: +64 9 927 1600

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors (New Zealand) Limited makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.