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Market Bulletin

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- Standard and Poor's has downgraded the long-term sovereign credit rating on the US from AAA to AA+, with a negative outlook.
- This is the first time in history that the US has had a rating lower than AAA, both Moody's and Fitch have affirmed a AAA credit rating.
- The move by S&P was not unexpected given the move in April to place the US on negative outlook and then in July on CreditWatch.
- The long-term trajectory of US public debt against AAA sovereign peers and the renewed political uncertainty in the US prompted the downgrade.
- Markets are now challenged by an environment where the US is no longer rated AAA, as well as dealing with the economic consequences of a tightening of fiscal policy at a time when economic data is showing a clear loss of momentum in the US recovery.
- Market volatility is expected to continue, with investor risk aversion and a selloff of risk assets occurring, although as detailed in our note "US debt ceiling: How many say I" published on 3 August, the downgrade is not expected to see forced selling of US Treasuries.

S&P downgrades the US from AAA to AA+:

After market close on Friday 5th August, Standard and Poor's announced it had lowered its long-term sovereign credit rating on the US to AA+ from AAA. The short-term credit rating was affirmed at A-1+. The outlook on the long-term rating is negative.

This is the first time the US has not been rated AAA since initiation, 1941 from S&P and 1917 from Moody's. It is important to remember that Moody's has affirmed the highest ratings of Aaa since the increase in the US debt ceiling on 2 August 2011. Fitch is currently undertaking a scheduled review of the US credit rating, which should be released by the end of August.

The downgrade from S&P was not unexpected given the clear financial metrics that had been provided in the lead up to the increase in the debt ceiling. S&P had said they expected $US4tr in budget cuts to accompany the increase in the debt ceiling, $US2.1tr prevailed.

S&P first placed the US on negative outlook on April 18 2011 and then on CreditWatch for downgrade on July 14 2011. Refer to "US debt ceiling: How many say I" which was published 5 August 2011 for more analysis and detail on the possible implications from the downgrade.

Given we are in unprecedented circumstances, there remains a degree of uncertainty in financial markets. It is important to remember that a AA+ credit rating remains an extremely high credit rating, in fact the difference between AA+ and AAA has been described is infinitesimal.

It is helpful to look at analysis done by Moody's of cumulative default rates at the sovereign level for the period 1983-2011 to understand the possible difference between the two ratings. It shows that historical default rates between AAA and AA sovereigns are both 0%. Given the small sample size of sovereign defaults, it is also helpful to look at the analysis at the corporate level. In this case the default for corporates rated AAA are 0.186%, compared to AA+ of 0.501%. The increase in potential default is very small according to this analysis.

Rationale for the downgrade

The rationale behind the S&P downgrade centres on the political situation in the US, particularly around the debate that occurred in the lead up to the increase in the debt ceiling, as well as the long-term trajectory of US public debt, especially when compared to other AAA sovereign peers.

Some key statements are below:

- "We lowered our long-term rating on the U.S. because we believe that the prolonged controversy over raising the statutory debt ceiling and the related fiscal policy debate indicate that further near-term progress containing the growth in public spending, especially on entitlements, or on reaching an agreement on raising revenues is less likely than we previously assumed and will remain a contentious and fitful process".
- "We also believe that the fiscal consolidation plan that Congress and the Administration agreed to this week falls short of the amount that we believe is necessary to stabilize the general government debt burden by the middle of the decade".
- "Our lowering of the rating was prompted by our view on the rising public debt burden and our perception of greater policymaking uncertainty".
- "The political brinkmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed".

One other key issue for S&P remains the long term trajectory of public debt in the US, especially after the modest savings that were negotiated as part of the increase in the debt ceiling. S&P note "it appears that for now, new revenues have dropped down the menu of policy options. In addition, the plan envisions only minor policy changes on Medicare and little change in other entitlements, the containment of which we and most other independent observers regard as key to long-term fiscal sustainability."

S&P go on to state "elected officials remain wary of tracking the structural issues required to effectively address the rising US public debt burden in a manner consistent with a AAA rating and with AAA rated sovereign peers". While the political consensus on these issues could change post 2012 elections, the concern for S&P is that given the changing demographic dynamics it will get harder to make meaningful inroads into reducing public debt, the longer it is left.

One key point when considering the outlook for other AAA sovereigns is "in contrast with the US, we project that the net public debt burdens of these sovereigns will begin to decline, either before or by 2015".

In terms of the outlook for the US credit rating, S&P have noted that the AA+ rating could stabilise if further fiscal consolidation is implemented, however a downgrade to AA is possible if a higher public debt trajectory occurs.

Likely impact from the downgrade

The downgrade to the AAA rating by S&P comes at a time when the sovereign situation in Europe continues to make headlines and is adding to market volatility.

It is noted that the European Central Bank (ECB) announced over the weekend post an emergency meeting that it would actively implement its Securities Markets Programme. This is interpreted to mean the ECB will begin buying Spanish and Italian government bonds in the secondary markets (although unconfirmed at this stage), which has not occurred to date.

Instead the ECB has only been buying Greek, Irish and Portuguese sovereign bonds. The ECB is aiming to prevent dysfunctional markets and over time would hope to lower government bond yields in Spain and Italy, currency trading at 6.04% and 6.09% for 10-year securities as of August 5 2011. There is also a meeting by the Federal Reserve on August 9 2011, which could potentially lead to market moving announcements.

Over time it would be expected that US government bond yields should rise given the lower credit rating, however this could be muted given the current weaker economic outlook. This could place a lid on a potential bond market sell-off in the short term. It is important to remember that the analysis conducted by S&P is not a forecast as how the US economy is expected to perform over the long term, instead focused on the projection of US government debt levels in a variety of political and economic scenarios.

The immediate reaction has been a sell-off in risk markets with equity markets trading lower, the oil price has fallen and the gold price up. The reaction in bond and credit markets has been relatively muted, although it is important to remember that European and US markets have not traded with this news yet.

Importantly S&P maintained the US short-term rating of A-1+. This should sooth concerns for short term money markets as bank access to funding remains unaffected. The Federal Reserve has detailed that the downgrade to the long-term credit rating should not change the repo markets, collateral or capital requirements and should limit the degree of forced selling of US Treasuries in the near term.

In other news, S&P have said that Asia-Pacific sovereigns are not immediately affected by the US downgrade, but in the long-term there could be negative consequences.

S&P noted "the U.S. rating change, together with the weakening sovereign creditworthiness in Europe, does point to an increasingly uncertain and challenging environment ahead" and "the potential longer-term consequences of a weaker financing environment, slower growth, and higher risk aversion are negative factors for Asia-Pacific sovereign ratings". The biggest risks for ratings actions could come from reliance on international liquidity and funding, export dependent economies and those with stretched public balance sheets as a result of intervention during the GFC.

Other rating actions are expected over the course of coming days and are likely to impact the ratings for government-linked issuers, supranationals linked to the US sovereign rating, insurance companies and possibly some financial intermediaries.

This is an evolving situation at a time where the global economic outlook remains weaker than expected and governments need to meaningfully reduce sovereign debt levels. Combined with fiscal consolidation plans, economic growth will continue to be limited.. This is a challenging environment and it is expected that news from Europe and the US will continue to impact on financial markets for some time.

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