

BEHIND THE NUMBERS

John Rathbone

Executive chairman,
JC Rathbone Associates



US debt downgrade not likely to affect pricing of money market instruments or swaps in US and UK debt markets

The prospect of GDP growth in the US is poor, but it is a lot better than that of the UK's

The last few weeks have seen utter mayhem in the equity markets, coinciding with Standard & Poor's cutting the US's debt rating from AAA to AA+ with a continuing negative outlook.

At the same time in the eurozone, finance ministers and the ECB were attempting to ward off further pressure on Italian and Spanish government bond yields.

We would doubt if the US rating downgrade will have very much of an effect on the pricing of money market instruments or swaps in the US and UK debt markets. The downgrade is not sufficiently large to make any of the major holders, and in particular the money market funds, into forced sellers. Although the downgrade will automatically be reflected in the credit standing of some AAA-rated issuers, such as insurance companies.

It may also have a knock-on effect on financial institutions that are assumed to have government support.

The timing of the announcement has provoked some interest. Evidently, S&P felt it necessary to warn the Treasury Department of its impending announcement at 1.30 New York time on Friday 5 August and duly presented the findings on which it was based.

The Treasury retorted with the claim that S&P has a \$2tn error in its discretionary spending forecast. Nevertheless, S&P decided to go ahead with the announcement of its downgrade at 8pm.

How long before ratings agencies look at the UK?



REX FEATURES

The Treasury Department, in debating S&P's figures, might like to consider the following. The increase in the debt ceiling of \$2.4tn has only been achieved through the removal of scheduled discretionary spending and, therefore, the \$2tn hole would appear to be illusionary.

Furthermore, the future deficit reductions are based on the assumption that US GDP will grow by 3% this year, rising to 4% in following years.

This will require a miracle and these estimates are due to be revised this week following review by the Congressional Budget Office and the Office of Management and Budget, with the almost certainty that their forecast of the projected 10-year deficit will be increased.

None of this is likely to persuade the rating agencies that the US is likely to regain its AAA status anytime soon. Indeed, a further downgrade would seem a more likely proposition.

S&P also made it clear that the political shenanigans in the acrimonious process in arriving at approval of the debt ceiling had also influenced its decision. The Budget Control Act requires Congress to pass the legislation approving the spending cuts by 23 December, with failure to do so almost certainly leading to another rating adjustment. Not

a situation that inspires hope for a less volatile market.

Since then, Italy has agreed to more stringent spending cuts in order to bring about a balanced budget by 2013, a year earlier than previously.

This new package is due to be agreed by the end of August, at which point parliament will be brought back early from its summer break to approve them. Berlusconi also announced an intention to add the requirement for Italy to run a balanced budget as being enshrined in the constitution.

At the time of writing, it would appear that the assumption that the ECB will extend its bond-buying activities to Italian and Spanish issuance appears to have generated some calm, with Italian bond yields falling back to below 6%.

The ECB has little alternative other than to support these markets under stress, but it will probably require an announcement that this is a permanent situation in order for the markets to do much other than sell down their exposure into Trichet's charity bucket.

The UK has been watching from the sidelines, although the chaos allowed swap rates to fall sharply in all markets, including the UK. George Osborne made some typically self-congratulatory

↑The US has already had its rating lowered

comments about the UK escaping from the turmoil due to the action taken by the government when it came into power. He might like to ask himself why, therefore, the pound has not appreciated in the same way as the Swiss franc if the UK is such a safe haven.

Given the buffeting that the US dollar and euro have suffered over the past week or so, the pound starts this week at almost identical parities with both as it had seven days ago.

He should also look at S&P's rationale for downgrading the US, part of which was based more on the trajectory of the deficit to GDP ratio than on the actual level of debt.

Given that the prospect for GDP growth in the US is poor but at least a lot better than that of the UK, it may not be that long before the rating agencies start muttering about placing the UK's rating back on a negative outlook.

While domestic attention was temporarily diverted this week with the release of the inflation report, the rest of August is likely to witness both politicians and investors on their prayer mats hoping that the markets manage to regain some semblance of confidence.