GLOBAL VALUE
INVESTORS

MARKET IMPLICATIONS OF S&P DOWNGRADE

We believe that the impact will be limited. Our view is that this move was largely symbolic, a warning to the US that it needs to get its house in order.

It is important to keep the issue in perspective.

1. Who is the largest holder of US Treasuries? – Well actually, it's the US government by a significant margin ($1639.4bn) followed by China ($1159.8bn) and then Japan ($912bn). Is the US government likely to start unloading its Treasury holdings? Unlikely. Japan over the weekend re-iterated its support for the US bond market (as did South Korea, Russia and France). China can huff and puff, but where else can they go? Europe is not exactly a safe haven at the moment.

2. Moody's and Fitch re-iterated their AAA rating for the US, which essentially means that investors can pick and choose who they want to believe in terms of the methodology used to calculate the outcome. It's fair to say that the US (like many other developed economies) has been living beyond its means for some considerable time. Is this really new news?

3. Will there be an automatic trigger for the disposal of US treasuries as a result of this downgrade by institutions? Unlikely. Most investors will simply adjust their investment mandates to accommodate the new reality. Again, where else can they go; the New Zealand bond market?

4. S&P confirmed their short term credit rating for the US at the top A-1+ level. This is significant because it takes the pressure off any short term market impact in that part of the market. It was the longer term rating that was reduced (+10 years). The move means money market funds will not be forced to sell Treasuries. Indeed, S&P has warned since mid-July that a downgrade was likely, measures of distress in short-term funding markets have declined since then, suggesting that traders expect little disruption.

5. Two-year interest-rate swap spreads are trading at about one-third of the levels reached in May 2010 as the extent of Greece's fiscal troubles came to light and one-quarter of that in the weeks before Lehman Brothers Holdings Inc. collapsed in September 2008.

Make no mistake, this week is going to be a roller coaster, with the media having little else to report on over the coming weeks as the northern hemisphere holidays, they are going to have a field day!

We believe that the real '*elephant in the room*' is still in Europe. Unlike the US, Spain and Italy cannot control their currency by printing money. The German's have refused to pump more cash into the bail-out fund and their borrowing costs are still rising. This is not good.

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Sure, the recent economic data has not been good. US ISM and consumer demand data has been falling but we feel this is partly a result of the political (debt) uncertainty generated over the last month in Washington. Last Friday's unemployment data was better than expected and whilst it is dangerous to use one month's data as a basis for long term investment, we do not believe that we are about to enter another US recession. If anything, the current slowdown will take the inflationary pressure off Central Banks, particularly in Emerging Markets and therefore reduce interest rate pressures in Asia and Europe. On a 6-12 month view we therefore see the current pullback as a buying opportunity.

Grant Cullens
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