EYE ON THE MARKET
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Down But Not Out: Implications of the US debt downgrade

The loss of the AAA rating was not totally unexpected

Standard & Poor's downgraded the US AAA credit rating for the first time after the market closed on Friday (August 5). S&P lowered the debt rating one level to AA+ while keeping the outlook at "negative", citing that "the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than (they) envisioned when (they) assigned a negative outlook to the rating on April 18, 2011". In other words, the agency feels the US debt reduction programme announced last week is insufficient to improve the US medium-term debt profile. This move comes as no surprise – our Chief Economist had held the view that the debt ceiling/budget-cutting agreement was likely to lead to a downgrade by S&P – though the rapidness of the move may have caught the market off guard.

The deal hacked out between Congress and the Administration on August 2 has done little to change the appalling trajectory of the US debt profile. At the end of 2008, the US net debt to GDP was 50%; this year it is estimated to be around 75%. The problem has been the huge government deficit – estimated at about 9% of GDP this year and not much lower next year – which has driven the stock of debt sharply higher. As such, although Moody's Investor Service and Fitch Ratings affirmed their AAA credit ratings on August 2, it remains possible that they may follow suit with downgrades at some stage, especially considering that they have indicated the possibility should lawmakers fail to enact on US debt reduction measures and the economy weakens. Then again, the S&P downgrade could spur policymakers to engineer a more meaningful debt reduction plan than they would have done otherwise. And thus, may also 'head off' pending downgrade actions by Moody's and Fitch.

Does the downgrade make much difference?

Beyond the immediate knee-jerk spasm, the big question is whether the downgrade makes much of a difference to what is still the world's risk free rate. Citi's Global Investments Committee highlights that not much happened to yields even when there were concerns at the beginning of the month that the US could default. 10-Year treasuries hovered at around 3% - a model of stability, in their view, at a time when many other riskier asset markets were falling. They suspect that much of the same may happen again. For one thing, although foreign central banks are likely to be disgruntled, there are few alternative places where they can park their large foreign exchange reserves. Moreover, foreign central banks may not be able to sell their holdings without risking a fall in the worth of their remaining positions. All in all, the ratings downgrade itself may incur the US government higher interest charges down the line, but thus far investors have perceived the US government market to be a "safe haven" given the lack of attractive alternatives.

Trajectory of the US economy

Of greater importance to Citi analysts, is the trajectory of the US economy. A downgraded outlook and suddenly eroding financial conditions have challenged optimism about the US economic recovery and is likely to encourage Federal Reserve officials to strengthen their commitment to accommodation in coming months. With events moving quickly, Citi analysts believe the Federal Open Market Committee could signal a greater readiness to act as early as this week though a new round of asset purchases appears unlikely anytime soon unless inflation forecasts are reduced meaningfully or growth prospects and financial conditions deteriorate further. In Citi analysts' view, the preferred options likely entail altering guidance on the period of low rates and reinvestment, but officials could also choose to lengthen the duration of the existing portfolio.

Citi analysts still expect the pace of economic activity to pick up if healthy financial conditions can be preserved. A preliminary revision to their forecast shows second half growth close to 2% with risks tilted against upside surprises beyond that. They highlight that surprising gains in July vehicle sales, led by slowly rebuilding Japanese brands, suggest that the sharp slowing in consumer spending reflected temporary factors. Along with a better than expected 140,000 rise in payrolls in July, the data suggest that the economy was not entering a new recession at mid-year. Nonetheless, the unresolved threat of financial contagion and declining risk appetite could warrant a new policy tack.

Market opportunities

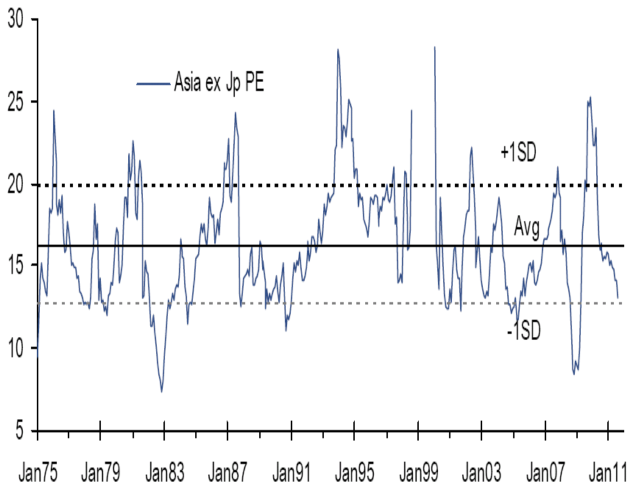
While markets are likely to remain under pressure in the near term and volatility is likely to heighten, Citi analysts continue to hold a constructive view on equities, especially Asia ex Japan.

Asian ex Japan equities

The credit downgrade, Citi analysts believe, is likely to lead to higher credit costs for the US, 50 bps over time. In the meantime it could make other asset classes more attractive. Asia ex Japan has the highest level of foreign reserves, runs current account surpluses and the corporate sector is only 29% geared. In light thereof, Citi analysts believe Asian currencies are likely to remain well bid, which means a benign interest rate environment.

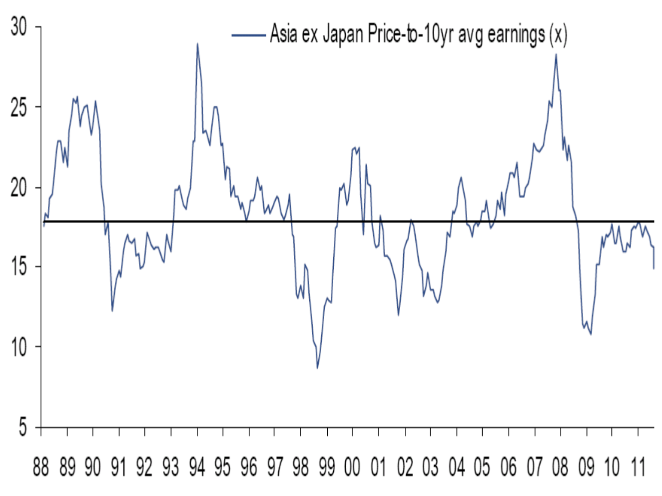
Citi analysts believe a lot of bad news may already be priced into the equity market. They note that valuations are lower than ahead of prior downturns, especially on trailing price-to-earnings (P/E) and mid-cycle P/E. Moreover, investors appear far from bullish on the market, nor are earnings forecasts totally unrealistic. Corporate earnings expectations are low versus nominal GDP – 13% earnings-per-share (EPS) growth with 11-13% nominal GDP growth does not appear aggressive, and EPS revisions are already below mean. They continue to believe a combination of value and momentum as investment factors could do well. On that basis Financials, Real Estate, Technology, especially Semiconductors, Energy and Industrials still look attractive. Korea, Taiwan and Hong Kong also look good.

Trailing P/E is now at minus 1 standard deviation below the mean – Same as in 1987, 1999 and 2001 recessions and SARS.



Source: MSCI and Citi Investment Research and Analysis.
As of August 8, 2011.

On a mid-cycle P/E the market is on 15x, 16% below historic average. The prior recession lows are on 12x, implying 18% downside.



Source: MSCI and Citi Investment Research and Analysis.
As of August 8, 2011.

US equities

Within the US equity market, Citi analysts see potential for large cap stocks to outperform. With corporate profit margins at elevated levels and economic growth likely to come in versus prior forecasts, it seems probable that margins have peaked and this is usually a good sign for large cap stocks versus smaller cap names. Moreover, the valuations of America's largest companies seem cheap versus historical averages. In this context, equity investors seeking respectable returns with relative safety may choose to hide out in these names. In terms of sectors, they prefer Food Beverage & Tobacco, Energy, Diversified Financials, Insurance, Semiconductors & Semi Equipment, and Technology Hardware & Equipment

Commodities

Commodity price volatility is expected to spike and then temper later as the market digests the US downgrade and macroeconomic headlines in Europe. While the potential for a global economic slowdown is likely to weigh on the demand picture, Citi analysts believe it is unlikely to derail the commodity bull-cycle.

They highlight that China represents over 40% of global copper consumption and is the fastest-growing consumer of liquid petroleum products. Meanwhile, global agriculture stocks have been adversely affected by flooding, drought and strikes and inventory still needs to be rebuilt. Additionally, they continue to see easy monetary policy in the US that could continue driving flows into commodities. And while Citi analysts do not expect to see a return of oil prices at the April peaks, they do not expect to see oil continue to fall too much lower, either. They also see potential for precious metals, especially gold, to outperform in the near term. Finally, staple grains such as rice and corn, which have seen demand increases and/or adverse impacts on acreage and weather related inventory concerns could also fair well.

Conclusion

Although equity markets are likely to stay under pressure in the near term and volatility is likely to heighten, Citi analysts continue to hold a constructive view on equities and believe current market weakness may present investment opportunities.

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