S&P downgrades France and Austria from triple A

At a glance: **January 2012**

The familiar pattern of the Eurozone debt crisis reasserted itself on Friday as Standard & Poor's downgraded France and Austria from triple A by one notch to double A plus. Italy, Spain and Portugal were also downgraded two notches, while 14 of the 16 eurozone countries were given a negative outlook.

- The downgrades to France and Austria leaves Germany, the Netherlands, Finland and Luxembourg as the four triple A sovereigns in the euro currency area. Italy, Spain, Portugal, Slovakia, Slovenia, Cyprus and Malta were also downgraded.
- The downgrades to France and Austria are not a surprise. Indeed, the fact that French bond yields did not sell off dramatically despite rumours of the announcement suggests much of the impact may be priced in. French 10-year bond yields edged up to 3.05%.
- Nevertheless, the downgrades reignite fears over the EFSF rescue fund, suggesting its triple A rating could be under pressure due to the downgrades of its guarantors. France contributes a fifth of the $780 billion in sovereign guarantees behind the EFSF. There is a possibility that European nations may be called on again to increase contributions.
- Encouragingly, the benchmark European Financial Stability Facility bond (maturing in 2022) did not sell off significantly and in a bond market where liquid alternatives are scarce, there is reason to believe that the demand for EFSF bonds should hold up, in much the same way as demand for treasuries did after the US downgrade.
- The news come at the same time that debt-restructuring talks between Greece and holders of its debt broke down over how large bondholders' losses should be, raising the possibility of a Greek default in March.
- Standard and Poor's criticised the response of policymakers to the crisis so far, stating that austerity and budget discipline alone were not sufficient to resolve the situation, and that these policies risked becoming self-defeating. Nevertheless, the downgrades provoked a predictable backlash from eurozone politicians.
- "It is not good news ... but it is not a catastrophe." **François Baroin, French Finance Minister.**

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The downgrades in detail

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S&P Ratings of Eurozone Member States

Country	Previous Rating	New Rating	Action	Outlook
Austria	AAA	AA+	One notch, loses top rating	Negative
Belgium	AA	AA	No change	Negative
Cyprus	BBB	BB+	Two notches to junk	Negative
Estonia	AA-	AA-	No change	Negative
Finland	AAA	AAA	No change	Negative
France	AAA	AA+	One notch, loses top rating	Negative
Germany	AAA	AAA	No change	Stable
Ireland	BBB+	BBB+	No change	Negative
Italy	A	BBB+	Two notches	Negative
Luxembourg	AAA	AAA	No change	Negative
Malta	A	A-	One notch	Negative
Netherlands	AAA	AAA	No change	Negative
Portugal	BBB-	BB	Two notches to junk	Negative
Slovakia	A+	A	One notch	Stable
Slovenia	AA-	A+	One notch	Negative
Spain	AA-	A	Two notches	Negative

"The downgrade of France was largely expected and it is certainly not as bad as a broader downgrade of triple A rated nations including Germany would have been. Italy and Portugal both experienced two notch downgrades. This leaves Italy with the same rating as Ireland, with Standard & Poor's being the first agency to move Italy into BBB. The downgrade of Portugal relegates them to junk status, in line with Fitch and Moodys.

The change in Finland's outlook to negative is slightly surprising, as we believe that, in many respects, it has stronger fundamentals than Germany. There are positives for Belgium and Ireland who both avoided downgrades, with the latter country receiving what looks like a vote of confidence in their commitment to fiscal reforms. Slovakia can also take some comfort from the fact that, despite its one notch downgrade, its outlook is one of only two countries to be left at stable."

Andrew Wells, CIO, Fixed Income

Source: Standard & Poors, as at 13.01.12

Reaction from our fixed income team

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"I don't think this news comes as surprise to bond markets. Early indications suggest that the market impact could be relatively limited. The US S&P500 turned upwards during late trading while long-dated Treasury prices came off their intraday highs. Although the official news was confirmed after the close in Europe, rumours had been circulating during trading hours and I think that much of the impact may have already been discounted.

I would suspect that any weakness in Italian or Spanish Government bonds will be met with heavy ECB purchases to ensure markets remain functional. Indeed, the ECB was active in the market late on Friday and Italian 10 year bond yields closed roughly unchanged, following a sizeable rally during the course of the week. This was despite the clearing house LCH raising margin requirements on Italian bonds due to heightened spread levels over Christmas and the strong rumour of the imminent 2 notch downgrade. Inevitably, there could be some follow–through weakness in markets, but I'm far from convinced that this event spells the end of the Eurozone as some commentators are suggesting."

David Simner, Portfolio manager, European Fixed Income

"Germany clearly emerges best from this spate of ratings downgrades. It is now the only eurozone sovereign with a triple A rating and a stable outlook. This will encourage more 'safe haven' flows into German government bonds. The yield on 10 year German bonds fell to 1.75% on Friday as rumours of downgrades began to circulate. Given that S&P cited market access and cost of funding constraints as reasons, the rating action is a pro-cyclical one that encourages existing trends supporting Germany versus the rest.

Market interest is likely to quickly move towards the EU supranational bodies and support mechanisms, particularly the EFSF rescue fund, since the changes undermine the strength of France and Austria's guarantees and lowers its potential firepower. The downgrades could also complicate the political relationship France has with both Germany and the UK, given the different rating treatment."

Andrew Wells, CIO, Fixed Income

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Thoughts from Dominic Rossi, CIO, Equities

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"While the downgrade to France may not be too surprising to markets, it is still disappointing news that will drag down the Euro and equity markets. The Eurozone crisis is now dominating market activity again, after a period in which better economic news from the US, and easier monetary policy in China had helped markets move higher.

The downgrades confirm our view that we are witnessing a general re-pricing of sovereign debt. This re-pricing started with the weakest sovereigns such as Greece, but has now decisively moved to the primary bond issuers. We expect it to spread further. There will be another round of policy action to shore up markets, but policy credibility has been dealt another blow. Speculation around an EFSF downgrade will now grow, complicating its ability to raise capital and displace the ECB in the sovereign bond purchasing programme. Both the ECB and the IMF will get sucked further into central roles.

At the same time, the profit outlook for European companies has deteriorated, and we have had a disappointing start to the corporate reporting season. Corporate earnings were the one bright spot last year and this supportive driver is now fading. If European equities are to escape another downward spiral, we will need help from elsewhere. The picture in the US is more promising and Chinese equities are rebounding thanks to looser monetary policy, now that inflation has peaked there. One thing is for sure, the pressure on the euro will continue."

Dominic Rossi, Chief Investment Officer, Equities

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