

# Global Event Market Alert

## S&P downgrades Euro region economies

16 January 2012

### The facts and our interpretation

S&P have once again caused something of a stir with their announcement late on Friday European time of ratings downgrades on a number of European countries. France and Austria have been stripped of their AAA status and join the US at AA+. Italy and Spain, seen by many as the key battle ground in the Euro crisis, were each downgraded by two notches, taking Italy to BBB+. Portugal and Cyprus were also downgraded by two notches leaving Portugal below "investment grade" and therefore likely to cause some forced selling from mandates with an investment grade credit limit. Only Germany within the eurozone now remains AAA and with a stable outlook from S&P.

Market reaction to the announcement was quite muted. The CAC 40 index in France dropped over 2% as the news broke but subsequently recovered somewhat to end Friday 1.88% higher than a week ago. In the US the S&P 500 recouped almost all its early losses to close the week 0.88% higher. Bond market reaction was equally muted with 10 year German government bond yields falling by 0.07% on the day while those on French and Italian government bonds rose by 0.03% and 0.01% respectively. On the currency market the Euro continued its weak trend of recent months, falling 0.60% against the US dollar on the day.

The muted market reaction partly reflects the level of confidence markets have in the rating agencies but is mainly a reflection of the fact that such action was not unexpected. Indeed such developments are just a small part of the wider Eurozone crisis.

### Market outlook

Stock markets around Asia are generally down around 1% as the time of writing. Currencies are showing little change. This type of move is in line with the muted reaction from European and US markets and suggests the news of the downgrade is fully absorbed already. Markets will therefore look elsewhere in the newsflow for short term direction. However with the US on the Martin Luther King day holiday it may be that further consideration of the S&P action could continue to have some impact.

The most serious potential consequence appears to be on the rating of the European Financial Stability Facility (EFSF). If the EFSF were rated less than AAA it would raise concerns that finding a solution to the debt crisis could be even more difficult. However a number of

considerations need to be borne in mind before over interpreting this news. First, rating agencies do not have the best track record in guiding investors. Having been over-generous in their rating of certain mortgage products in the past it is not inconceivable that they are being over-cautious in their attitude towards sovereign nations today. Secondly, not having a AAA rating need not have any impact on borrowing costs. Japan has been demonstrating this for years and the US has confirmed it since its downgrade from S&P in August last year. Third, it is worth restating that markets know that the Eurozone debt crisis is a problem that will take years, even decades, to play out. This news is just a small element that fits into that bigger picture.

### Possible investment implications

Our core scenario anticipated ongoing negative news surrounding the European debt crisis. S&P's actions fit neatly into that broader picture. However it is possible that it could be the catalyst for more positive steps towards a longer term solution. The loss of AAA status for France will be a blow to one of the European project's most influential countries. At the margin it may therefore encourage more positive action to properly address the crisis.

Since late October 2011 the Euro has lost around 10% versus the US dollar, somewhat more against the Japanese Yen and Chinese renminbi. These moves will help companies in Europe both in the translation of non Euro earnings and the ability to compete in export markets. With equities in Europe already attractively valued, this is another positive.

### Portfolio positioning

We retain a modest overweight to equity markets. Valuations are attractive and the news background that markets have absorbed is an extremely negative one. Any improvement is therefore likely to be met with higher prices.

In bond markets we have a clear preference for corporate over government bonds. Companies generally have strong balance sheets and offer an attractive yield pick up over government bonds.

Source of macroeconomic data:

Bloomberg, HSBC Global Asset Management (Hong Kong) Limited, as of 16 January 2012

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