

Global Event Market Alert

S&P follows downgrades of France and Austria with downgrade of European bailout fund

17 January 2012

The facts and our interpretation

After markets closed in Europe on Monday, the rating agency Standard & Poor's ("S&P") confirmed that it had downgraded the credit rating of the eurozone's bailout fund, the European Financial Stability Facility ("EFSF"), by one notch to AA+ (from AAA previously).

The downgrade was largely anticipated by the market and follows similar ratings cuts on Friday evening for government debt issued by both France and Austria.

This move was not a big surprise to most observers as S&P had previously indicated on December 6th that EFSF debt could be downgraded in the event that it cut the AAA AAA rating on one of the EFSF's underlying guarantor nations. As such, the rating downgrade simply reflects the downgrade on January 13th of two of those sovereigns, France and Austria, to AA+. Before their downgrades, France and Austria had provided to the EFSF some €180 billion in AAA-guarantees.

(Please refer to our January 16th Global Event Market Alert "S&P downgrades Euro region economies" for further details on the earlier ratings downgrade of France and Austria).

The EFSF was designed to fund rescue packages for Greece, Ireland and Portugal partially through bond sales.

In announcing the downgrade, S&P added that if the EFSF adopts any credit enhancement options that are "sufficient to offset its now-reduced credit worthiness," it "would likely raise" the rating back to AAA, but that if such such enhancements were not forthcoming that they may change the outlook for EFSF issues to negative, matching the negative outlooks they have for both France and Austria.

The chief executive officer of the EFSF, Klaus Regling, tried to reassure the market in a statement that "the downgrade to 'AA+' by only one credit agency will not

reduce (the) EFSF's lending capacity of €440 billion (US\$557 billion)." He also indicated in an email statement that the EFSF had sufficient means to fulfill its commitments to the bailouts of Ireland and Portugal, as well as for the rescue of Greece, specifics of which are expected to emerge in the coming weeks.

The other major ratings agencies, Moody's and Fitch, still have their EFSF ratings at AAA. So bonds issued by the EFSF continue, at least currently, to qualify as top rated AAA investments for most professional investors around the world. That could change in the event that further downgrades of the EFSF, or of other EU sovereign debt issuers, follow from either Moody's or Fitch.

Market outlook

The move from S&P came after markets closed in Europe. With the US market also closed on Monday for the Martin Luther King holiday, it is difficult to precisely anticipate how markets in Europe will react when they reopen on Tuesday morning.

Both bond and equity markets in Canada and currency markets globally appeared to be largely unaffected following S&P's announcement.

The move was largely anticipated by the markets and it was noteworthy that most European equity markets seemed to take the earlier downgrade of France and Austria in their stride on Monday. The FTSE 100 in the UK finished Monday up +0.37%, with the French and German equity markets also higher on the day (France's CAC40 was up +0.89% and Germany's DAX up +1.25%).

Encouragingly, France was also able to successfully issue €5.9 billion of 3, 6 and 12-month paper on Monday and at a lower yield than seen in the previous week as investors appear to shrug off news of S&P's downgrade of France's AAA rating.

We expect Euro-country leaders to continue to bolster communication around their collective efforts to introduce new fiscal measures and to urge investors to ignore S&P's downgrades. On January 18th, Greek government officials are expected to reconvene with their major creditors following stalled discussions last week.

Possible investment implications

Our core scenario anticipated negative news-flow surrounding the European debt crisis. This further downgrade of EFSF fits into that picture and was largely expected given the earlier ratings downgrades of both France and Austria.

It is possible that these downgrades could be catalysts for more positive steps toward a longer term solution. The loss of AAA status for France will be a blow to one of the EU's most influential countries. At the margin, it may encourage more positive action from European leaders to address the crisis.

Portfolio positioning

Our central views have not changed. We continue to retain a modest overweight position overall to equity markets. Equity market valuations are attractive by historical standards and the news background that markets have absorbed has been extremely negative. Any improvement in news flow and sentiment is therefore likely to be met positively.

In bond markets we continue to have a clear preference for corporate bonds over government bonds. Corporate issuers generally have stronger balance sheets than governments currently and also offer an attractive yield pick-up over government bonds.

Given the continued uncertain picture and potential for risks and volatility, our key recommendation continues to be for investors to remain well diversified.

Source of macroeconomic data:

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

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