ING Global Perspectives

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Trimming the Sails After the Unprecedented U.S. Credit Downgrade

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Sailing from a global perspective is most exhilarating, efficient and productive at full sail, but there are times when it is prudent to trim the sails to weather a storm. This is one of those times, given the Standard & Poor's downgrade of the "United States of America Long-Term Rating Lowered to 'AA+' On Political Risks and Risking Debt Burden; Outlook Negative" published on Friday, August 5th.

The Standard & Poor's downgrade of U.S. Federal debt is "the straw that broke the camel's back". The world, not just the U.S., is in unchartered waters, and all the ramifications of a debt downgrade of the global reserve currency are unfathomable at this time. Some points of concern:

- Markets will likely be slow to react to the real implication of the debt downgrade.
- The S&P downgrade has the long term outlook as negative indicating a greater potential for a future downgrade than not.
- European banks are in serious trouble and are undercapitalized. The U.S. downgrade is a blow to the worldwide financial system but European banks have more urgent problems emanating from Italy and Spain.
- Europe's problems have gone from bad to worse as large countries are now in trouble. Italy has the 4th largest debt in the world behind US, Japan, and Germany. So the integrity of the banks and sovereign nations that hold their debt is affected.
- In the Eurozone, Italy is huge compared to Greece, Portugal and Ireland. It is the 3rd largest country in Europe based on GDP. Spain, also in trouble, is the 4th largest in Europe based on GDP.
- Europe's 90 largest banks collectively hold Italian debt with a face value of 326 billion euro, compared to 90 billion euro in Greek debt held by the largest banks.
- The European experiment is in jeopardy, and it will require incredible political will and support from its constituents. On a positive note, the ECB announced it stands ready to buy Italian bonds. Late Sunday, the ECB upped the stakes and declared they "will actively implement" a bond buying program. However, news and rumors suggest that Germany believes Italy is too big to save. If this is true, it would devastate European banks and to a lesser extent U.S. banks.
- Refunding of U.S. debt could be problematic. If demand dries up, which is highly unlikely given the depth of our markets and a lack of alternatives, global ramifications will follow.
- Municipal governments have also shown signs of renewed stress. This U.S downgrade further exacerbates their problems, as municipal debt is adversely impacted by a lower federal credit rating.
- Standard & Poor's has stated that the long-term debt rating is negative and will be evaluated in the next two years.
- The bottom line is that global risk has increased, and risky asset prices will likely be marked down to appropriately discount this event. This is not a forecast but the math of finance.

We also do not want to overstate the problem as the fundamentals are strong:

- Corporate profits have found a sustainable source of growth in the global economy.
- In the global economy, emerging markets in particular, have low debt
- Manufacturing, although volatile, remains a pillar of the expansion in the U.S. and globally.
- Consumers are resilient and are at near record highs in income and spending despite 9.1% unemployment.

At the start of 2011, we forecasted a banner year for equities. We also stated that the major risk to our forecast was that aggregate debt levels could trigger a debt crisis. We also pointed out the potential risk of the European sovereign debt crisis spreading. While the Greek debt problems were "much ado about the euro", continued contagion of debt issues across countries is not. So, despite strong fundamentals, we feel that increased risk and uncertainty as a result of this downgrade warrant changes in two of our forecasts:

- U.S. GDP growth is reduced from 3.5% to 2% due to significant uncertainty and increased global risk.
- Gold is increased from $1,250 to $1,700 given its increased attractiveness as an alternative reserve currency.

We will be monitoring Standard & Poor's in the event of an upgrade back to AAA. However, ratings changes occur slowly if at all. We can look to the Canadian experience to see how they overcame a credit downgrade. Their top notch credit was reinstated using a combination of fiscal austerity and pro-growth economic policies. In fact, our Global Perspectives "Corporate Tax" slide shows Canada as an example of low corporate tax rates that get reduced "automatically" every year, dropping next year to 15% (vs. 35% for the U.S.).

As always, we will continually provide updates as market events unfold, and we caution investors to avoid panic selling. ■