The week that was: What has the real impact of the US downgrade been?

Too little, too late – that was the verdict of Standard & Poor's decision after trading finished last Friday evening to downgrade US debt from AAA status to AA+. Despite an agreement only a few days before to raise the US Debt Ceiling to avoid default, the ratings agency expressed their concerns over the handling of the World's largest economy. These concerns were not helped by the political circus surrounding an eleventh hour compromise, although this was always to be expected with the division in political power between Congress and the White House. So after a week of more market volatility, a period of trading that resembled the turmoil following the collapse of Lehman Brothers in the autumn of 2008, how much of this can be blamed on the US downgrade?

The financial markets had already assessed that a US default was never really a risk and even expected some degree of political brinkmanship that would lead to a final hour agreement. However the public nature of the squabbling between the Democrats and the Republicans as they compromised on a package of spending cuts served as a timely reminder to all that political risk is a real threat to economic growth. The Budget Control Act, the legislation allowing the US Debt Ceiling to rise, was signed into law on 2nd August by President Obama. An Act which allows the Debt Ceiling to rise by up to $2.4 trillion, an amount adequate enough to allow the US to sustain its projected borrowing path passed next year's Presidential Election and into 2013. It was agreed that this would be offset by spending cuts of an equal amount over the next ten years. However only $900bn of these cuts were outlined in the agreement, the remaining $1.5bn will be decided by a new committee comprising of members from each political party.

A figure of $2.4 trillion of spending cuts sounds a big deal, but in reality it does very little to address the long term underlying issues faced by the US economy. Furthermore, the $2.4 trillion comes out of the projected increase in Federal spending, so there are no real savings and it hard to see how the deficit will reduce over the next ten years. Hence you can now see why most commentators have been so underwhelmed by the plan and why Standard & Poor's took the decision to downgrade US government debt after a few days of digestion. The agreed policy fails to scratch the surface of the US deficit as it would require trillions of spending cuts and tax hikes to make a significant reduction. With the US consumer already stretched in a weak housing and labour market, it is not surprising that there is very little appetite for drastic action, especially coming into an Election year. The general consensus is that this agreement will have only a minor impact on economic growth in the medium term.

The US authorities have been rather dismissive this week of the downgrade, from just one of three recognised rating agencies. The US equity market reacted rather differently falling sharply on Monday, the S&P 500 Index fell over 6%, which brought about a global sell off in risk assets with a flight to safe haven assets such as gold. This included Treasury bonds, the name for US government debt, whose prices rose sharply despite the lower credit quality status. The fact that US Treasury bonds rallied on the news of a downgrade may not make sense to some of you but highlights to us that investors still view this asset class as a safe haven with few defensive alternatives to US Treasuries and the US Dollar.

The timing of the US downgrade could have hardly been worse and we certainly believe that this has contributed to the overall market volatility. However this was not the only reason for the ups and downs we have witnessed this week. Investors began to hunt for the next sovereign candidate with the potential to be downgraded and turned their attention to France because of their high exposure to Greek government debt. It was only a few weeks ago that the Eurozone governments announced their latest plan to resolve the issue of sovereign debt in peripheral Europe and this week the ECB, the European Central Bank, has been purchasing both Spanish and Italian government debt in an attempt to reassure markets. These woes in Europe coupled with recent weaker economic data in Developed Market economies which increases the risk of a double dip recession and inflation in Emerging Markets have all had a significant impact on investor sentiment and confidence.

So, where does this leave us? The ability of the US to stimulate the economy through further fiscal spending is surely limited now and any further boost to growth will have to be delivered via the Federal Reserve in the form of more quantitative easing. Indeed, Ben Bernanke, the Governor of the Federal Reserve, announced earlier in the week that interest rates would remain at zero until 2013. This announcement may result in higher inflation with US unable to raise the cost of borrowing for fear of crippling their economy. We do not subscribe to the double dip recession theory despite recent events and believe that very little has actually changed. Our core scenario remains that developed economies plod along on with anaemic growth for the foreseeable future, with drivers of the global growth to be found in the emerging economies, who seem to be getting on top of their inflationary issues. We believe the pitiful coupons and as such returns on US Treasury bonds will encourage more investors to look elsewhere for returns in excess of inflation. Good quality high yielding equities to us are the obvious choice. In stark contrast to the balance sheet of the UK or US government, corporation's finances are in great health and we believe they shall be able to continue to grow their already attractive dividends over time. The equity markets still offer the best long term returns and this week we have taken the opportunity to buy at discounted prices. Once the focus moves away from economies and back to the prospect of companies, we are confident that markets will begin to recover fairly swiftly.

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