Comment
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SwissLife
Asset Management

Initial assessment of downgrading actions by Standard & Poor's

Nine EMU member states downgraded

The S&P rationale stresses that the policy response in recent weeks may be insufficient to fully address ongoing systemic stresses in the Eurozone. The reform process based on fiscal austerity alone would be self-defeating and further dampen growth dynamics. They said that issues of rising external imbalances and divergences in competitiveness needed to be tackled. The downgrading action had been announced in early December already.

Country	Down-graded	Former Rating	New Rating
Germany	No	AAA/negative	AAA/stable
Finland	No	AAA/negative	AAA/negative
Luxembourg	No	AAA/negative	AAA/negative
Netherlands	No	AAA/negative	AAA/negative
France	Yes	AAA/negative	AA+/negative
Austria	Yes	AAA/negative	AA+/negative
Belgium	No	AA/negative	AA/negative
Estonia	No	AA-/negative	AA-/negative
Slovenia	Yes	AA-/negative	A+/negative
Slovakia	Yes	A+/negative	A/stable
Spain	Yes	AA-/negative	A/negative
Malta	Yes	A/negative	A-/negative
Ireland	No	BBB+/negative	BBB+/negative
Italy	Yes	A/negative	BBB+/negative
Cyprus	Yes	BBB/negative	BB+/negative
Portugal	Yes	BBB-/negative	BB/negative
Greece	*	CC/negative	CC/negative

* Greece was not part of the latest revisions

Immediate market reaction

Rumours on the S&P action emerged already on Friday morning, triggering an immediate but modest market response. Bond markets reacted with increases in risk premia for a broad range of Eurozone issuers yet without reaching panic levels at all. Consequently, German five-year note yields slipped to match a record low level, yet the benchmark 10-year Bund was little changed, a tame reaction. The yield on French 10-year government bonds was pushed up by four basis points but remained well below levels reached in November 2011. France was already trading at an implied spread level that was several notches below AAA. Equities immediately lost some ground on Friday, but started to recoup some of those losses as early as Monday morning. The Euro took a dive against all major currencies, falling to a record low against the Japanese Yen. Friday 13, as one would expect, marked yet another safe haven day with FX markets reacting the most. The next hurdle emerged as early as Monday evening, as the downgrade of the EFSF followed suit.

Medium-term consequences for financial markets

As a consequence of France and Austria losing their AAA rating, the EFSF got equally downgraded by one notch to AA+. That may keep investors on high alert for a while longer. On a positive note, France and Austria are not endangered to be downgraded as well by other agencies according to statements by Fitch and Moody's. Still, given the propensity of rating agencies to announce facts after one another, potential further headlines may cause nervousness and volatility in markets. Since certain credit enhancements could be put in place, the downgrade of the EFSF was not totally automatic. The AAA rating of the rescue fund could have been retained if the remaining four AAA states increased the amount of their pledges, particularly Germany would have been called upon. Moreover, the existing funds in place to support Ireland and Portugal have not been fully used and are even sufficient to pay out planned allotments for Greece. Beginning of July, the ESM will succeed the EFSF and this instrument is less rating sensitive since it will depend on upfront paid up capital rather than guarantees. As demand for EFSF bonds by non-European investors was already anemic prior to the downgrade, we do not regard the latest developments as a major game changer. Yet, much will depend on the policy reaction from the governments as market participants may fear further downgrades of sovereign paper. Certain banks, namely so in France and Italy, may be now prone to downgrades as well, yet this is largely anticipated by the investment community as well.

Potential political reactions and ECB response

From a political and structural point of view, we actually regard the downgrade event as an accelerator for overdue structural measures to be launched throughout the region. Even if government borrowing costs do not move higher from here, the rating action should place pressure on France and other states to adopt the so-called golden rule which is to enshrine a rule for a virtually balanced budget in their respective constitutions. Tougher commitment to deficit control is what market participants demand and this should pave the way for some kind of fiscal union. In the domestic political arena, the loss of AAA status is a blow to electoral prospects of Nicolas Sarkozy, being behind Francois Hollande already in the latest opinion polls. Tensions may rise in the run-up to the elections in April/May and keep investors alert.

The ECB, furthermore, may also be pleased to observe stricter fiscal policy rules throughout the region, having criticised the watering-down of the agreements reached at the December summit. With Italy not being too far from non-investment grade rating anymore, however, the ECB may be forced into buying more Italian sovereign paper, given the huge size of the Italian bond market and the decreasing interest of investors.

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Macroeconomic implications

Austerity means a prolonged period of subdued growth. A prolonged period of subdued growth means less tax income and potentially higher spending by governments. It can lead to a vicious circle. Subdued growth dynamics (not only in Europe obviously) have been one of our key assumptions since the outbreak of the debt crisis and will result in moderating underlying inflationary pressures. Inflation rates could be temporarily affected by increases in taxes or higher administrated fees but the trend remains one of eroding pricing power and price concessions on the producer side while wage demands are restrained by loose labour markets. As highlighted before, the latest developments are viewed to be positive from a longer-term perspective as it should force governments to complement fiscal austerity with deep-rooted structural reforms in labour and product markets to regain competitiveness. Finally, it should also be noted that last summer's downgrade of US paper actually marked the low point of US growth dynamics with prospects improving ever since.

Illustrative charts