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MACROCOSM

Downgrade: At Least the News is Out

Monday, August 8, 2011

Donald Luskin

The timing couldn't be worse, but it could be the capper on two weeks of panic.

There's so much going on all at once we scarcely know where to begin. So let's dive into some of the specifics -- and we'll talk about the stock market and the US economy at the end.

THE US DOWNGRADE Nothing unexpected here but the timing (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011) -- and the timing couldn't be worse, adding fuel to the already raging fire of global mistrust of sovereign credits.

- Standard & Poor's key rationale for its downgrade was the failure of the "effectiveness, stability, and predictability of American policymaking." This is exactly what we have identified as the blow to sentiment that has soured markets despite what is really a very growth-positive budget deal (again, see "Debt Ceiling Crisis Over").
- Since the downgrade was announced Friday night, the Obama administration has tried to undercut S&P's credibility -- on the one hand an exercise in carrying coal to Newcastle, and on the other a case of the lady protesting too much. The media has generally supported the administration's allegation that S&P made a $2 trillion calculation error. But the so-called error could be just as easily understood as a legitimate disagreement as to which budget baseline is most realistic to use.
- All that said -- *so what?* The real issue here, long-term, is whether the downgrade will raise funding costs for the Treasury -- and by extension, perhaps for the rest of the economy -- more than would have happened anyway just based on the fundamentals. We just don't see why it should. Ultimately, risk premia are set by millions of individual judgments, not by ratings agencies.
- In the short term, the question is whether the downgrade has any systemic vicious cycle properties.
- We think the Fed is in an excellent position to deal with any dislocations that may arise in the short-term funding markets.
- In the bond markets, we think the consequence of the downgrade will be to increase demand for Treasuries. The uncertainty engendered by the downgrade makes safe-haven assets more attractive, and even in their downgraded state, Treasuries will be

Update to strategic view

US BONDS, HIGH YIELD BONDS: The US Treasury downgrade is, in the short term, good for Treasuries and bad for corporates as certain funds rebalance in favor of Treasuries to restore their target average ratings. This will be a long-awaited opportunity to get back into high yield debt at more attractive yields. **EUROPE BONDS:** The ECB has officially committed to buying Italian and Spanish bonds, pending ratification of the new more powerful EFSF, the promise of which was strengthened by Merkel's and Sarkozy's joint statement. This should be sufficient to staunch the vicious cycle in Italy, the one peripheral country arguably too big to save. **GOLD, US FED:** The ECB's bond buying makes "Plan B-plus for gold" official. We could revert to "Plan A" if the Fed undertakes QE3, taking gold to $2000. The Fed will drop hints at Tuesday's FOMC, but it won't act now -- nor until unemployment rises and/or inflation falls.

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perceived as a safe haven -- at least relative to alternatives. Safe haven status is determined by grading on a curve.

- The worst risk is from a cascade of downgrades in *associated* securities -- such as mortgage-backed securities and certain tax exempt securities -- reliant on explicit or implicit federal guarantees and thus getting their high ratings derivatively. With S&P's downgrade of Fannie Mae and Freddie Mac this morning -- though fully expected by the market, no doubt -- that risk is in motion.
- While funds whose guidelines specify Treasury securities can continue to hold Treasuries regardless of their rating, associated securities might be forced sells if they lose their present ratings.
- Certain diversified bond funds promising a particular average rating would be forced to buy more Treasuries to bring the average back up in light of the Treasury downgrade. This would necessitate selling all other types of bonds. So we would expect to see corporate spreads and junk spreads continue to widen until that selling pressure is accomodated. If we are right and all the present turmoil doesn't portend a double-dip recession, this would make an opportunity to the get back into corporates and high yield after a period of frustratingly narrow spreads.
- These scenarios involving forced sells would not come into full effect unless other major ratings agencies follow S&P's lead -- and so far they are indicating they will not do so, at least not immediately.

ITALY AND SPAIN We have argued that the main driver of last week's market panic was the acceleration of the speculative attack on Italy's and Spain's sovereign debt, driving a sharp decline in bank stocks across Europe, and raising the specter of global bank contagion (see "On the ECB Rate and Bond Buy Decisions" August 4, 2011).

- On Sunday the European Central Bank announced officially what had been only rumored Friday -- that it "will actively implement its Securities Markets Programme." In other words, it will intervene in scale to support the Italian and Spanish bond markets.
- This morning the ECB published statistics showing that, contrary to market rumors -- and indeed contrary to what seemed to be much more than hints by ECB President Jean Claude Trichet last Thursday -- that there were no SMP purchases last week.
- On the heels of Sunday's announcement, it seems certain that the SMP is active today. As of this writing, yields on Italian and Spanish debt are dropping sharply. But today's move brings them back only to the middle of the very elevated range of the last month. We need to see more to declare this crisis over.
- *Italy is the market to watch.* Spain less so -- it's already an open secret that it will someday require significant support from the European Financial Stability Facility, and the EFSF is big enough to do it. But Italy is not as fragile as Spain. Yes, it is Europe's largest debtor -- but it runs a primary budget surplus, which means that its small deficit is entirely a function of debt service. Its big risk is that a speculative attack precipitously raising its interest rates would be a self-fulfilling prophecy that throws it into a death spiral of ever-

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US MACRO, US STOCKS: With the S&P downgrade, it's another lost quarter for US growth, but we don't expect a formal recession. For stocks, it means the news it out. We've been too optimistic so far, but we still see this as nothing more than a bad correction.

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larger deficits. The purpose of intervention by the ECB is to break that vicious cycle. After several weeks, the work of intervention will be taken over by the new and more powerful EFSF -- ringingly endorsed last night in a joint statement by German Chancellor Angela Merkel and French President Nicholas Sarkozy, in advance of its offiical ratification by Euro area parliaments.

- In addition, Italian Prime Minister Silvio Berlusconi said on Friday that Italy will accelerate spending restraints and adopt a balanced budget amendment to its constitution. With that, and with the ECB/EFSF intervention, if a vicious cycle in Italy can't be arrested that's a signal that we are dealing with a buyer's strike in sovereign debt of truly calamitous proportions. That would call for political responses -- specifically, wholesale moves toward federalism -- that Europe probably will not be willing to make on the rapid timescale required.

GOLD AND THE FED The ECB's announcement last night made it official: we're definitely in what we've been calling "plan B-plus for gold" (see "Plan B-Plus for Gold" July 14, 2011). By that we mean a new surge of liquidity creation emanating from Europe -- as of this writing it has driven gold to a new all-time high above $1700.

- There's some chance now -- but we're still skeptical -- that we could switch back to "Plan A for gold." That's where the Federal Reserve would re-engage in quantitative easing -- which we had all but ruled out (see "FOMC Preview: In Praise of Ben Bernanke" June 22, 2011). If that happens, then gold goes to $2000. We're still skeptical.
- After Tuesday's FOMC meeting, we expect that the written statement will contain a promise to launch QE3 should the need arise. But we see the chances of an actual launch on Tuesday as essentially zero.
- We note that the fed funds futures market now doesn't fully expect the first tiny hike in the funds rate until mid-year 2013, 22 months from now -- that's a new record for the market's estimation of the "extended period" of a zero funds rate. But given the controversy surrounding QE within the Fed and without, we think it would take far more serious evidence of economic weakness than the Fed has now before QE3 would be activated. The Fed would have to see a rise in the unemployment rate -- and on Friday, the unemployment rate *fell* (see "On the July Jobs Report" August 5, 2011) -- and/or a fall in core personal consumption expenditures inflation -- and at the last report, for June, it *rose* on a year-on-year basis.

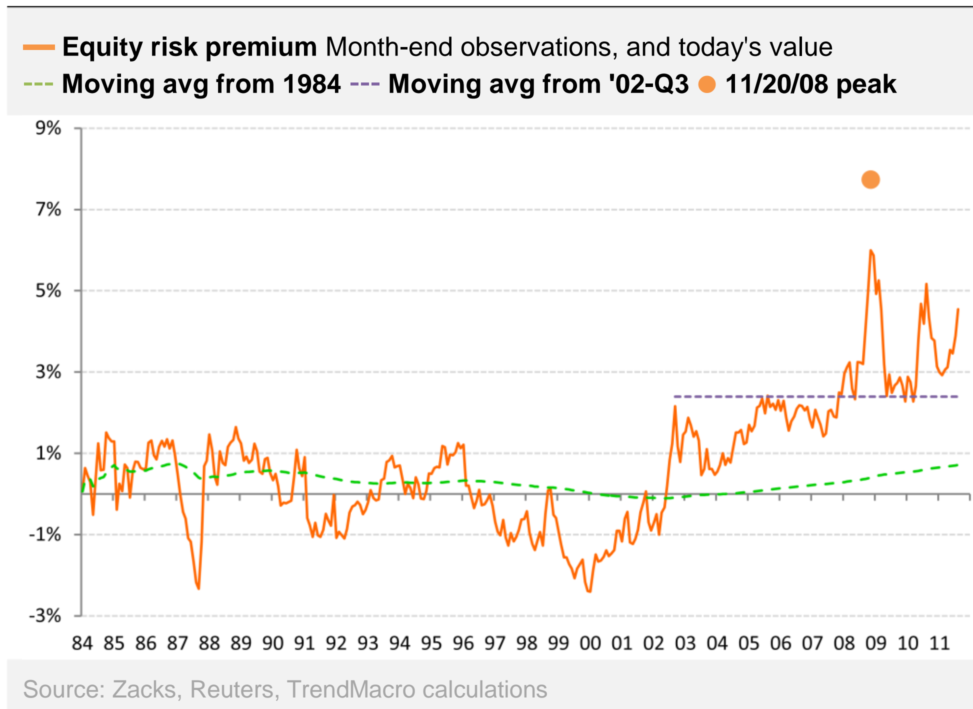
THE US ECONOMY Well, it looks like another lost quarter. Q1 was the oil lost quarter. Q2 was the Japan lost quarter. Now Q3 is the downgrade lost quarter. If it isn't one thing, it's another. Assuming that we aren't facing a new round of systemic risk to the banking system somehow arising from the Treasury downgrade, we don't see how this leads to the kind of hard-stop that could trigger anything we'd want to call a formal recession. How much slowing can we expect from an economy that isn't really growing anyway (again, see "Debt Ceiling Crisis Over")?

US STOCKS We must start by noting that obviously were were wrong a week ago when we said, "We just can't be bearish here" (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). We like to draw your attention to our successes, so it's only fair we draw your attention to our mistakes, too.

Based on a macro view of fundamentals, we *still* find it hard to be bearish here -- more so, with stocks 9% lower as of this writing from when we said that last week. With the S&P downgrade, *the bad news is out* -- this is where you buy, not where you sell, unless you expect chaotic systemic consequences.

What are we to make of sentiment? Last week was certainly something of a panic, and over the weekend the media has been stuffed with statistical comparisons demonstrating what an historically miserable week it was for stocks. That shows what you can do with statistics -- we can think of *single days* in the panic of 2008 when stocks did worse than they did all last week.

- From the April 29 top, as of this writing stocks have fallen 15% over 101 days. Bad indeed, but they fell 16% over just 71 days in the correction that began in April 2010.
- The equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the 30-yeear Treasury yield -- is very elevated, but it is not at the level seen at the worst of the 2010 correction (please see the chart below). And, obviously, it's miles away from the once-in-a-lifetime levels seen in late 2008.
- By these two simple metrics, stocks are not as beaten down as you might otherwise think. So we could conclude that there is more room on the downside before we strike irresistible levels of value.



Source: Zacks, Reuters, TrendMacro calculations

True enough, yet this actually cuts two ways: if all the seemingly catastrophic developments going on all at once in the world were really so bad, wouldn't stocks be down much more already?

- We are inclined to adopt the latter view. Granting that the world is not actually going to end here -- that's our belief -- then we would expect to see in the aftermath of the great bear market that ended in March 2009 a series of successively less volatile corrections. We think that's what we're seeing -- a correction, but nothing more.

Bottom line

The US Treasury downgrade is, in the short term, good for Treasuries and bad for corporates as certain funds rebalance in favor of Treasuries to restore their target average ratings. This will be a long-awaited opportunity to get back into high yield debt at more attractive yields. The ECB has officially committed to buying Italian and Spanish bonds, pending ratification of the new more powerful EFSF, the promise of which was strengthened by Merkel's and Sarkozy's joint statement. This should be sufficient to staunch the vicious cycle in Italy, the one peripheral country arguably too big to save. The ECB's bond buying makes "Plan B-plus for gold" official. We could revert to "Plan A" if the Fed undertakes QE3, taking gold to $2000. The Fed will drop hints at Tuesday's FOMC, but it won't act now -- nor until unemployment rises and/or inflation falls. With the S&P downgrade, it's another lost quarter for US growth, but we don't expect a formal recession. For stocks, it means the news it out. We've been too optimistic so far, but we still see this as nothing more than a bad correction.