BROWN BROTHERS HARRIMAN

SPECIAL FX

www.bbh.com/fx

Implication of S&P Downgrade and Possible Policy Response

Standard and Poor's downgraded U.S. creditworthiness to AA+, becoming the first to remove the triple-A status from the world's largest economy and largest debtor. Moreover, a negative outlook has been retained. The element of surprise lays in the timing more the in substance of the decision. Many, like us had expected a decision to be made after the special bipartisan fiscal commission had made its report later in the year. The other two main rating agencies, Moody's and Fitch have not joined S&P. Last week, Moody's reaffirmed the US triple-A rating but adopted a negative outlook. Fitch has not formally reaffirmed its AAA rating, and is expected to announce the outcome of its rating review late August or early September. ***We will first look a bit closer at the S&P decision, discuss some of the market implications and then turn our attention to the possible policy responses.***

S&P Decision

Few can argue against the proposition that the U.S. fiscal trajectory is alarming. The recent debate in Congress over the debt ceiling gives air to reasonable concerns about the U.S political process and its ability to address the fiscal challenges, for which the financial crisis and recession have brought forward in time and intensified.

These considerations drove the S&P decision. Ironically, within 24 hours of S&P's decision, Moody's said it was not concerned about the political gridlock S&P cited. In fact, Moody's lead analyst on U.S. government debt told the N.Y. Times. That "Despite the contentious political environment and difficulties in coming to an agreement—even if it's not the ideal one—they still reached an agreement which we think is a turning point in fiscal policy." Fitch seemed to echo this sentiment, noting that by various debt ratios, the U.S. is not out of line with other AAA-rated countries.

Ultimately, we suspect, and expect many investors, to conclude that S&P's decision was as much about marketing and politics as the fiscal facts. We recognize that among the class of professional investors, the ratings agencies have lost a great amount of credibility. They are seeking to rehabilitate their reputations for their business-related reasons as well as to attempt to head-off official actions that would diminish their influence and/or spheres of operations.

With Moody's and Fitch taking a considered look, S&P seized upon a first mover advantage and the fact that their calculations were off by $2 trillion provides a prima facie case for a "rush to judgment." S&P will forever be known as the agency that was first to downgrade the U.S. credit rating

Market Implications

Our assessment is that investors do not believe that U.S. is less creditworthy that other sovereigns that are rated AAA. The near record low yields on U.S. Treasuries and low CDS price (e.g., lower than Germany, France and the UK). In addition we think that the downgrade was partially priced into market valuations, though, as we noted, the timing was a surprise.

We expect some negative fallout, largely as a result of forced selling based on portfolio guide lines which mandate AAA-rated investments. Regulated entities, which are forced bylaw to respect the judgments of that official "Nationally Recognized Statistical Rating Organization" may find it most disruptive. This is particularly true for in Agencies, MBS and pre-funded municipal bonds, where the impact of S&P sovereign rating cut will also be felt. Ironically, the Treasury market may actually benefit.

We recognize a number of different considerations that drive U.S. interest rates, including the still resolved sovereign issues in Europe and the flow of economic data, and of course, the policy response. Treasuries may benefit if the S&P downgrade was catalyst for stronger bipartisan commitment to putting the U.S. back on a sustainable fiscal path. Nevertheless, we expect risk assets like equities and corporate credit will outperform government bonds over the intermediate period.

Obviously, the downgrade is not a dollar positive, but we do not expect it to be a driver of the dollar for anything but the shortest of terms. We expect the euro to remain confined to its recent broad range of roughly $1.4000-$1.4600, a test on the upper end of that range. Having built a base around $1.62, sterling can move toward $1.66. We are skeptical of the efficacy of the recent intervention by the BOJ and the quantitative easing measures by the Swiss National Bank. The key to their safe haven status appears to be their net international investment creditor position. Given the challenges faced by the U.S. and Europe, various investor groups will continue to desire the safe haven.

This capital preservation thrust turns us more cautious on the emerging markets. Some emerging markets, especially in Latin America and Asia can still outperform the developed markets, but their ability to become decouple has been compromised. Mounting evidence that the German economy has lost momentum may weigh on Central and Eastern Europe, while the strength of the Swiss franc is a problem for Hungary and to a lesser extent Poland.

Possible Policy Response

Policy makers have to get their hands around the uniqueness of the current events. The crisis in the capital markets does not appear to be a function of current nominal or real interest rate levels, but appears to be more an issue of liquidity. Like others, we had been concerned about the Lehman-like risks of a Greek default, with known and unknown unknowns, to borrow a phrase. Compound this with marked weakness of the US economy, a distracting debt ceiling debate, and now the downgrade, and the worsening of the European debt crisis, and there is little wonder than by a number of metrics, financial conditions are the worst since the Lehman debacle.

Several central banks have responded, though it does not seem particularly coordinated, unlike in October 2008. The Bank of Japan intervened in the foreign exchange market and increased its asset purchase program. The Swiss National Bank boosted its money supply (sight deposits) and cut interest rates, raising the cost of using the Swiss franc to hedge euro exposure. The ECB re-introduced the 6-month repo facility and extended its commitment to the 3-month facility. It also signaled a resumption of its sovereign bond purchase program, though it had not really formally announced its cessation.

Attention now turns to the Federal Reserve. We have argued that the bar to QE3 is high and we believe it remains high. Conditions and risks have changed from a year ago. The 6-month average private sector job growth stands at 175k vs 114k last August. The core PCE deflator is at 1.3% and rising recent trend, while a year ago, it was at 1.4% and falling. U.S. monetary policy is already considerably easier than a year ago, through expanded size of the Fed's balance sheet. Real and nominal yields are considerably lower. Lastly, we suspect officials are cognizant that each round of asset purchases is riskier because of the challenges associated with orderly unwinding.

Federal Reserve Chairman Bernanke outlined four policy options back in April. The Fed could purchase more assets. It could structure its balance sheet differently, which seemed to hint at increasing the average maturity of its holdings. It could cut the rate on excess reserves. Finally, it could provide more guidance to keeping rates low for a long term, which could include the period it reinvests the MBS proceeds into Treasuries.

We think that the Fed will respond to evidence of a slowing of the U.S. economy. It will likely downgrade its assessment of the economy and lower its GDP forecasts for this year and next. However, we expect the policy response to take the form of explicit language assuring investors that rate changes will not be forthcoming and may even define a period. The Fed is also likely to extend their securities portfolio from shorter maturities to longer maturities, with the intention of inducing a flatter yield curve. It is possible that the Fed also announces an explicit yield target for specific maturities.

We do not expect the Fed to renew its Treasury buying operation, as in a QEIII or to buy non-government obligations (such as corporate bonds or equities), which some have suggested.

BBH Currency Strategy
www.bbh.com/fx