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Market Tactics

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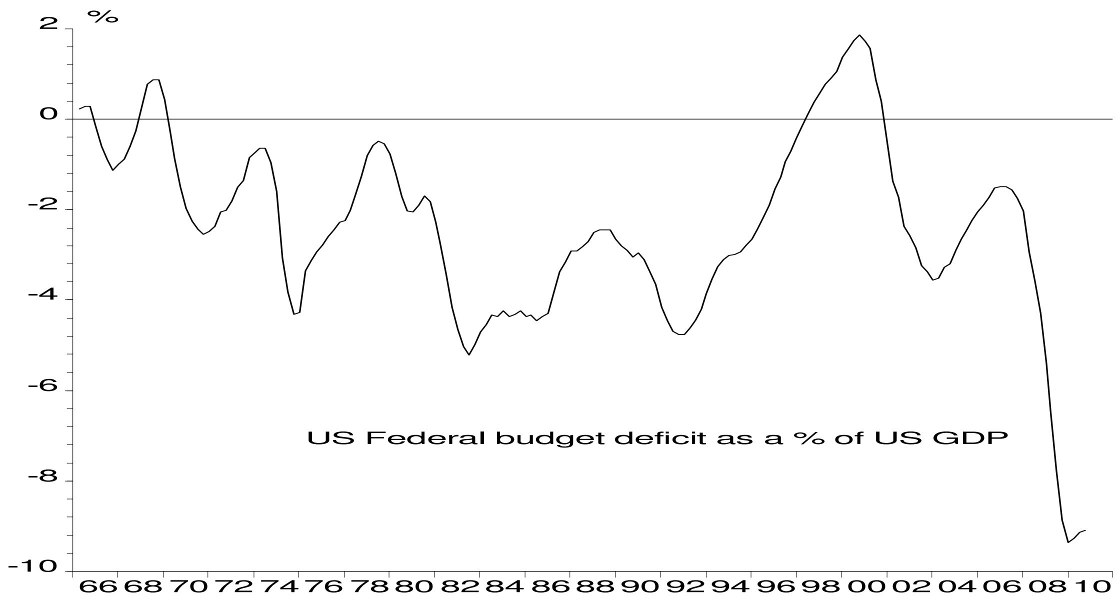
INVESTMENT RESEARCH

18 April 2011

Standard & Poor's delivers a shock for a shake-out!



Source: DATASTREAM

Standard & Poor's Rating Services downgraded the outlook for the long-term rating on US sovereign debt from stable to negative but left unchanged the actual credit rating for both long and short term debt. The downgrading was on the basis of the very large budget deficits, as illustrated in the chart, and rising government indebtedness together with an unclear path towards addressing these. As the credit rating agency stated, '... we believe there is at least a one-in-three likelihood that we could lower our long-term rating on the US within two years.' Not what President Obama nor Congress nor the American people want to hear!

While it is hard to imagine a situation in which the US government would be unable to borrow, service and redeem its debt the fact is that the warning comes as an unwelcome shock. In a sense the gilt market may even be a beneficiary in view of the steps taken by the UK government to impose not just fiscal discipline by cutting spending and raising taxes but also a framework involving an Office for Budget Responsibility for ensuring that the discipline works to reduce budget deficits over the medium term.

But leaving this aside, the warning from Standard & Poor's is precisely ... well, a warning. Moreover, it may be even positive in providing a galvanizing moment for Congress to get down to business speedily and iron out a gimmicks free and credible way forward in dealing with budget deficit reduction and America's growing indebtedness.

Right now there might not even be a better way than a message from Standard & Poor's to redress the fiscal balance – or rather the imbalance. It might be one sure way to restore confidence in US government and encourage investors – foreigners as well as domestic – to retain the faith and their holdings of US Treasuries. Bill Gross may see it differently but then, being a bond guy, he's just waiting for a buying opportunity.

If equity markets were in search of a shake-out, they've got it. But another day of the action and they are bound to look oversold. Also, investors are bound to remind themselves of the underlying fundamentals which remain favourable.

Corporate confidence is running high pretty well everywhere. Is the message from Standard & Poor's likely to put a dent in this? As it's only a warning, it's doubtful. More critical will be the US earnings season, which is just starting. Before getting worried, let's see how this plays out. The very early and admittedly tentative indication is that could prove to be yet another quarter of earnings surprising on the upside.