

Credit where it's due

S&P UK debt downgrade scare a red herring

May 22, 2009 – A warning from Standard & Poor's about deteriorating government finances in the UK rattled debt and equity markets last Thursday. The credit rating agency warned that the UK is on the verge of losing its prized AAA credit rating for its sovereign debt, as the country's national debt is expected to more than double to 97% of gross domestic product by 2013 from a current level of about 40%. Sounds ominous, doesn't it? And there's nothing that the financial media like more than "ominous." Good thing the financial press doesn't run the world (which is not to say they don't want to), because after a rocky day of trading to the downside on Thursday, equity markets actually recovered somewhat on Friday.

Not everyone is as keenly exercised about the possibility of a downgrade of British gilts as the screaming web page headlines might suggest. Sovereign debt downgrades are not uncommon – even Canada lost its triple-A status for awhile back in the mid-'80s. And currently, Ireland, Spain, Portugal, and Greece are all below triple-A.

The S&P report didn't actually lower the UK's credit rating. It simply downgraded the "outlook" to "negative" from "stable," and indicated that there's about a 33% chance of a downgrade over the next three years as the debt closes in on 100% of GDP.

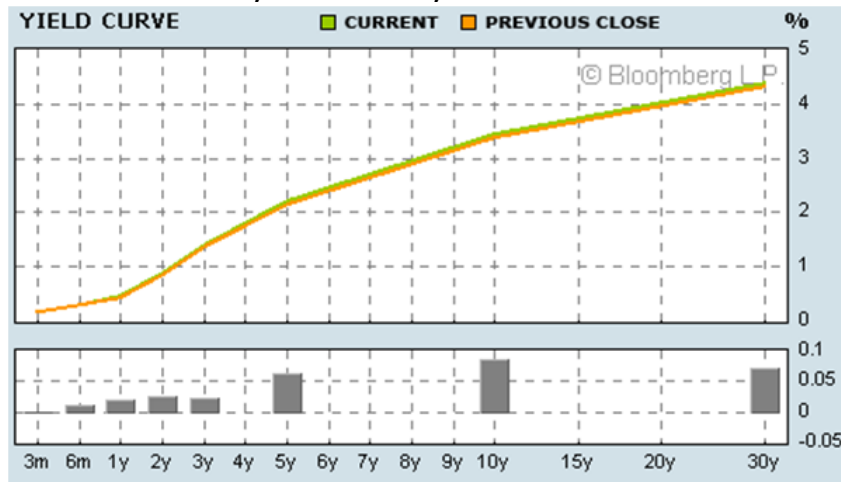
The big buzz in the markets last Thursday was not really about the UK's outlook (interesting how the markets are nearly always about something other than the obvious). The UK's national debt situation is pretty much a *fait accompli*, and already discounted by equity markets and anyone else who can count – hence the relatively shallow reaction and rebound last week. What started the twits twittering was the knock-on possibility of the potential for a similar downgrade for US Treasurys.

The US government debt to GDP ratio is about 65% and growing as more bonds, notes, and bills are issued to fund the couple of trillion dollars' worth of bailouts, boondoggles, pork barrels, and deficits that are now framing the Obama administration's economic legacy. So naturally, US bond prices plunged and yields soared on Thursday, as credit markets began to anticipate a potential US ratings downgrade as well. Of course, things had cooled down a bit by Friday as the spread between 2-year and 10-year US Treasurys narrowed to 2.36 percentage points from as high as 2.51 points last Tuesday. Seems it will take a few years yet, and some egregiously incompetent fiscal policy (not at all out

of the question, by the way) over the next three years to ensure that US debt is downgraded to the same level as Portugal's.

Last week's kerfuffle over rising long-term yields in fact masked a more positive signal. The widening yield curve is in and of itself cause for some optimism, because a steepening yield curve (that is, the difference, or spread, between 2-year notes and 10-year notes) very often precedes the end of a recession and a recovery, just as a negative yield curve precedes the onset of an economic downturn. (The negative yield curve in 2008, as we pointed out at the time, was a classic textbook example.)

US YIELD CURVE, AT MAY 22, 2008



Courtesy Bloomberg LP

The danger, of course, is that the 10-year yield could climb beyond its recent 3.5%, as investors drive up the yield on fears of higher inflation and steeper financing costs for the US government down the road. The 10-year yield is critical for the government's recovery plan, because it benchmarks longer-term borrowing rates, of which mortgages are a key component. So watch for the US Federal Reserve Board to keep the 10-year rates capped at current levels, to prevent the nascent recovery from stalling.

Any significant indication that the worst of the financial crisis has passed and that a recovery may be imminent is the shrinking of the 3-month London interbank offered rate (Libor) to a recent 0.66 from a high of over 4.7 last November. Similarly, the TED spread (see chart below), which is the difference between 3-month Libor and 3-month US Treasuries, has narrowed to a recent 0.86 from 2.6 last November.

The more normal yields are a signal that central banks' efforts to thaw out credit markets and restore confidence have succeeded, insofar as the exaggerated risk premium that plagued interbank lending for so many months has deflated as government loan guarantees, bailouts, and asset purchases kicked in.

TED SPREAD, 3-MONTH AT MAY 22, 2009



Courtesy Bloomberg LP

As go credit markets, so go stock markets, and the inverse correlation between the TED Spread and the S&P 500 since the beginning of March has been striking as seen in this chart:

TED SPREAD VS. S&P 500, 1-YEAR AT MAY 22, 2009



Courtesy Bloomberg LP

Another key indicator of market sentiment, the CBOE Volatility Index, or VIX, dipped below 30 last week for the first time since last September, down from a high of more than 80 last October and November. The VIX, which tracks options prices on the S&P 500, is a widely used measure of stock market implied volatility, and generally posts higher readings when stocks are falling and lower readings when stocks are rising.

North America's major market indexes maintained their gains for the week, despite setbacks on Thursday and Friday inspired by action in the credit markets. On Thursday it was the potential UK debt downgrade. On Friday, it was a bump in 10-year Treasury yields ahead of a surge in US debt issuance next week.

Still, the S&P/TSX Composite Index closed Friday with a week-over-week gain of 0.2%, while both the Dow Jones Industrial Average and the S&P 500 Composite Index advanced 0.5% on the week.

As indexes close in on or exceed their year-to-date highs, some resistance and consolidation is to be expected. We've been singing that tune for a few weeks now, and we see no reason to change either the key or the melody at this point. ■

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