

Tanks in Cairo hit markets in New York

Japanese debt downgrade gets second billing

January 28, 2011 – In another era, perhaps, a sovereign debt downgrade of one of the top three largest economies in the world would be cause for some concern. Yet last week’s downgrade of Japan’s debt by rating agency Standard & Poor’s caused barely a ripple in global stock or bond markets. That’s no longer surprising, given that sovereign debt downgrades have become commonplace, and in fact almost routine. But put a tank or two in Cairo, and watch out!

S&P chopped Japan’s rating to AA–, its fourth-highest rating, citing political and fiscal disarray, deflation, and an aging population. Japan’s national debt stands at more than 100% of economic output. That’s higher than the basket cases of Greece and Ireland, whose debt has been rated at junk status by all the major rating agencies. Much of Japan’s debt (about 93%) is held domestically, and the country has the world’s second-largest foreign reserve holdings (more than US\$1 trillion), both of which provide stability to Japanese bonds and keep a lid on volatility.

So while the Japanese yen took a hit in currency trading, the Nikkei 225 index ended the week higher than the previous week’s close, even after a dip late in the week. The ability of Japan’s domestic institutional market to absorb ever more debt hasn’t been tested to its limits just yet, a day of reckoning is bound to arrive, driven simply by the implacable calculus of an aging demographic.

Global markets didn’t go into the proverbial tailspin or meltdown over the Japanese debt downgrade, but the ripples of deteriorating sovereign debt fundamentals from eurozone peripheral nations are beginning to wash up on the shores of the so-called “core” economies. So much so that some analysts have started wondering whether America’s prized AAA debt rating could be in jeopardy, given its enormous debt load and its staggering fiscal budget deficit, calculated now at a record US\$1.5 trillion for 2011.

Yet the U.S. is a far different case than Japan and is nowhere near the “basket” status of cases like Ireland, Greece, or Portugal. Fourth-quarter gross domestic product expanded at an annual 3.2%, for a growth rate of 2.9% for all of 2010. That all-important consumer spending provided a big push, growing 4.4% from the third quarter, the fastest pace since early in 2006.

Put an exclamation mark on that last point. The initial fear, and still lingering concern, was whether consumer spending would come back with enough substance to drive growth. US consumers typically contribute 70% to US GDP.

The “lingering concern” tag line comes from analysts who question whether government stimulus – either through direct government spending programs or US Federal Reserve interest rate policy – is providing a crutch to consumers that will lead to higher debt levels, and yet another bubble.

The Federal Reserve Board’s Open Market Committee – the group that sets monetary policy – has made it clear that it will hold its target federal funds rate unchanged (at between 0% and 0.25%) “for an extended period,” as long as the economy remains sluggish and unemployment stays high.

In addition, the FOMC reiterated its pledge to buy US\$600 billion of Treasury securities by the end of June, a process called “quantitative easing” (or “QE2,” following a similar process in 2009) by some, “money printing” by others.

Forcing a torrent of liquidity into the US economy is buoying the stock market and stabilizing real estate prices. Two pillars that support the wealth effect and kick start credit quality. Are we all following the bouncing ball? Better credit leads to more lending, which underpins the US consumer.

But this strategy has consequences. It is a source of consternation in emerging markets, where waves of liquidity in the form of cheap US dollars are pushing up local currencies, creating asset bubbles, and contributing to inflation. And make no mistake, emerging markets are simply at the front of what may become a global problem.

Another unintended, consequence of QE2 is a steepening of the Treasury yield curve – the difference between short-term and long-term US Treasury debt yields. Last week, the spread between US two-year Treasury notes and 30-year bonds widened to a record four percentage points. In past economic recoveries, the spread has narrowed and the curve has flattened as growth gathers momentum. Not this time. And it has some analysts worried that by demanding higher yields on longer terms, the market is anticipating that the Fed will keep rates low even in the face of a more inflationary environment.

For now, though, forecasts for economic growth are becoming slightly more optimistic. The International Monetary Fund raised its estimate for global growth to 4.4% in 2011, up slightly from its 4.2% forecast last fall. Export Development Canada, a government agency, was more optimistic than either the IMF or the Bank of Canada in projecting Canadian GDP growth of 2.9% for Canada in 2011, with a 5.8% increase in exports expected to contribute significantly. And almost everyone expects a continuing uptrend in US growth.

While the debt downgrade of the world’s third-largest economy wasn’t enough to shake up markets last week, tanks in Cairo were. The generally positive tone of the economic

datastream wasn't enough to overcome some serious anxiety in the markets over the deteriorating political situation in Egypt, as the Egyptian government sought to quell increasing civil unrest by sending troops and tanks into the streets.

We have all seen this movie and we all know the outcome. Egypt's President Mubarak has already lost power, and will leave office voluntarily or by force. The concern is whether this could lead to a shutdown of the Suez Canal, which is a major shipping transit channel for oil. That fact hit US indexes hard in Friday's trading session, leaving them in the red for the week.

Conversely, of course, Toronto's benchmark rose, for the very same reason. Energy issues helped push the S&P/TSX Composite Index to a 1.4% week-over-week gain, as shares of Canada's large oil and gas producers got a lift from the Egyptian crisis.

The Dow Jones Industrial Average retreated 0.4% on the week, dropping 166 points on Friday alone, bringing to an end eight straight weeks of gains. Similarly, the S&P 500 Composite Index fell 0.6% on the week, as fears of a widening Egyptian crisis had investors seeking safer harbours.

One of those safer harbours was the US dollar, which strengthened on Friday. Another was gold, which jumped about US\$20 in Friday's trading, to around US\$1,335 per ounce, the correlation between gold in the market and tanks in the street being undeniable.■

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