



Sovereign woes dominate both sides of the Atlantic

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- **We began reviewing the impact of a downgrade to our fixed income portfolios more than a week ago, and found that it would not have a material direct impact on our funds¹**
- **The sharp fall in equity markets in the last month has brought equity market valuations to historically very attractive levels with many blue-chip companies on single-digit price-earnings multiples and well covered yields of over 5%.**

In the last few days two market developments have been the subject of much comment. First, the downgrade by Standard & Poor's (S&P) of the US government from AAA to AA+, and second the announcement by the European Central Bank (ECB) that it would intervene directly in markets to purchase Italian and Spanish bonds.

US downgrade

The US downgrade by S&P was well telegraphed and should have come as no surprise to market participants. In that sense, its impact at a time of heightened uncertainty is largely symbolic. Indeed at the time of writing, the US 10-year treasury yield has traded in a narrow 10 basis points range and the dollar/euro exchange rate has traded in a range of 1.42 to 1.44. We began reviewing the impact of a downgrade to our fixed income portfolios more than a week ago, and found that it would not have a material direct impact on our funds¹ (meaning no forced selling and no forced buying for collateral raising purposes). It could reshape the way clients design certain mandate parameters in the future, but presently the direct impact is limited. We should expect that there will be announcements of further consequential rating changes as S&P consider the ratings of Agency and other US government-related securities. What is less clear at this stage is whether this is a start of a wider review of country ratings that could lead to a further reduction in the number of AAA-rated countries.

Longer term the S&P move highlights, once again, the difficult fiscal position faced by many Western developed economies. In the longer term there may also be some modest increases in US treasury funding costs which will feed through to other rates in the economy. Worth noting is that Japan, whose rating was downgraded in January to AA-, continues to borrow at close to 1%.

ECB bond purchases

The ECB's move to intervene directly in markets to buy Italian and Spanish bonds is designed to restore calm to markets, which the authorities regard as increasingly dysfunctional. To the extent that the ECB is seen to put an effective ceiling on borrowing rates; this move may be quite helpful in reducing near-term uncertainties. There was a danger that markets could create their own reality by driving bond yields to a level which would threaten a country's solvency. The initial impact has been to drive Italian bond yields down by some 63 basis points and Spanish yields down by 82 basis points to 5.37% and 5.22% respectively. Coupled with moves to speed up fiscal reform, these initiatives have the potential to restore a degree of calm to markets.

¹Current and future fund holdings are subject to risk.



However, at the time of writing equity markets are still under pressure with the Euro Stoxx 50 down a further 1.5%. Meanwhile gold has convincingly broken through \$1,700 and is trading around \$1,710. Underlying market concern is a re-appraisal of medium-term growth prospects for the world economy generally and the Western developed nations in particular. We have long held the belief that economic recovery would be muted and that we faced a protracted period of below-trend growth as economies eventually face the three headwinds of deleveraging, fiscal retrenchment and a normalization of interest rates. However, near-term markets are focusing on the possibility of 'double-dip' at a time when there are few policy levers left. Interest rates are already near zero and fiscal policy has reached its limits, leaving the authorities only with unconventional monetary policy (quantitative easing and other interventions) to combat falling activity levels.

All that said, the sharp fall in equity markets in the last month has brought equity market valuations to historically very attractive levels with many blue-chip companies on single-digit price-earnings multiples and well covered yields of over 5%. Investors who are able to withstand short-term volatility may well consider that these represent attractive buying opportunities.

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