On the Ground | 23:30 GMT 26 July 2011

United States – The downgrade scenario

- **As the 2 August debt-ceiling deadline approaches, we explore a US downgrade scenario**
- **It is critical to distinguish between raising the debt ceiling and the 10-year deficit-reduction plan**
- **Investor clients we have surveyed indicate that a UST fire sale is unlikely**
- **S&P downgrade appears likely given high bar of USD 4trn worth of deficit cuts over next decade**

David Semmens, +1 212 667 0452
David.Semmens@sc.com

David Mann, +1 646 845 1279
David.Mann@sc.com

Ned Rumpeltin, +44 207 885 5558
Ned.Rumpeltin@sc.com

Jennifer Kusuma, +65 6596 8250
Jennifer.Kusuma@sc.com

Callum Henderson, +65 6596 8246
Callum.Henderson@sc.com

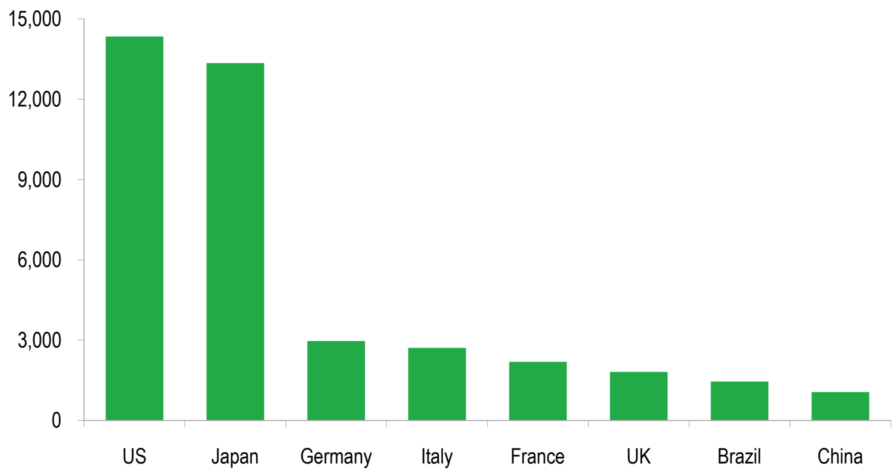
Summary

The US debt-ceiling negotiations in Washington are showing little progress as the 2 August deadline approaches. Based on the latest proposals under discussion, the chances of a debt-ceiling hike which also incorporates USD 4trn worth of deficit cuts over the next decade are slim. This is important, as it means that S&P is likely to downgrade the US sovereign rating from AAA to AA, even if the debt ceiling is raised. Note that in an interview with Dow Jones, one of S&P's credit analysts said that to avoid a downgrade, the US needs to agree to reduce the fiscal deficit by over USD 4trn over the next ten years. This is what S&P sees as the required amount to prevent the total government debt-to-GDP ratio from rising. Therefore, a debt-ceiling deal with deficit cuts falling short of this could mean a downgrade by at least one of the three key rating agencies.

Such a move, which could come as soon as August, would be highly disruptive in the near term. But it does not change our view that there is no better benchmark asset than US Treasury debt (see **On the Ground 23 June 2011, United States – Testing the gold standard of debt**). Also note that other agencies are less likely to follow S&P down this route—at least initially. We see a low probability of no agreement on raising the debt ceiling in time for the 2 August deadline. This may not be enough, however, to prevent more deficit-reduction negotiations from being necessary before the 2012 presidential election. If the debt ceiling is not raised, the drag on GDP growth from a US government shutdown would be far more serious than in the 1990s shutdowns.

Chart 1: Few markets have the potential to be as deep as the US'

General government gross debt (USD bn)



Sources: Bloomberg, Standard Chartered Research

Obama cannot 'go it alone'

In the case of government debt-raising decisions, it is hard to imagine the president acting unilaterally. Without acting through the 14th amendment, or taking action akin to Lincoln's suspension of habeas corpus, there needs to be a majority approval of a unified bill that passes both the Senate and the House of Representatives and is then presented to the president for his signature.

This can all happen relatively fast, but only once a unified bill has been negotiated which would be acceptable enough to push for the vote. As Treasury Secretary Geithner made clear on 24 July, it is not a workable option for a president to invoke constitutional authority that goes around Congress in order to raise the debt ceiling.

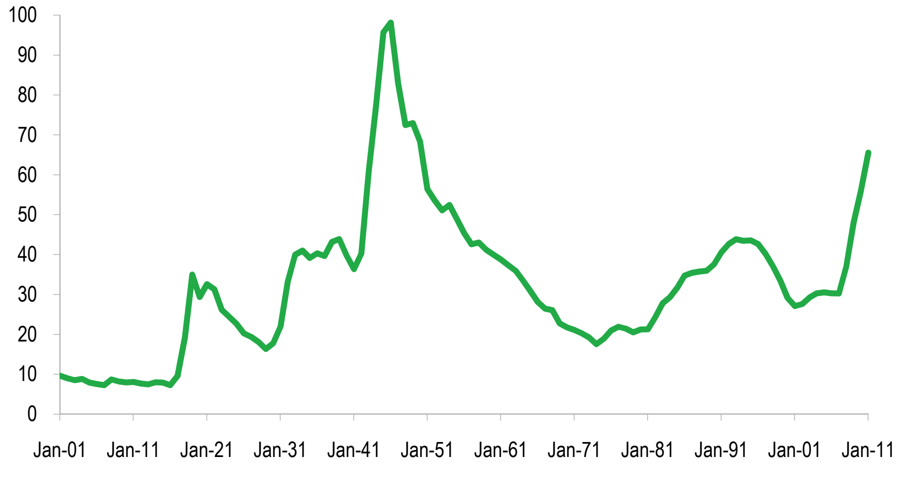
As well as placing the US sovereign-debt rating on negative watch, S&P has put AAA rated clearing houses Fixed Income Clearing Corporation, National Securities Clearing Corporation, Options Clearing Corporation and CSD Depository Trust & Clearing Corporation on negative watch. Those financial institutions with a direct reliance on the government, such as Fannie Mae and Freddie Mac, are also on negative credit watch.

The scale of the potential disruption to the clearing houses could be very significant. The Depository Trust & Clearing Corporation alone provides custody and asset servicing for more than 3.6mn securities issues from the United States and 121 other countries and territories, valued at USD 33.9trn. A sudden shortfall in collateral would be highly disruptive. However, it could mean that even more US Treasuries (UST) would need to be bought to make up for the shortfall in collateral.

Separate to the risks to the financial system of such a shortfall, there is also the question of whether real-money investors with a mandate to only invest in AAA rated securities would have to dump US government paper.

Chart 2: Debt not GDP is showing aggressive growth

US net government debt to GDP (%)



Sources: IMF, Standard Chartered Research

Our survey said…

No sign of panic, yet

We surveyed a selection of market participants with the following question:

If UST lose AAA status, what options do real-money investors have?

(a) Sell immediately
(b) Change investment restrictions to permit ownership at lowered ratings
(c) Press for industry-wide regulatory relief, permitting continued ownership
(d) None of the above

Below is a summary of a selection of the responses:

There are few realistic alternatives to the US government bond market. There is no other market with as much depth or liquidity in the world. Corporate investors may have more stringent guidelines than funds.

What Moody's does will also matter. If it is only S&P, it is unlikely that many funds will be forced to offload those securities.

There is not that much AAA investment out there as an alternative. Most likely, option (b) would be the right course of action. If a fire-sale scenario unfolds, it would make sense to allow continued ownership because of potential losses and a lack of alternative investments.

Funds in Europe and Asia are more likely to have hard AAA constraints in their investment guidelines. US investors are often constrained to AA or better.

If any mandate stipulates we have to have X% in AAA securities, we would adjust the mandate to continue to hold it. What alternative is there?

If anything, some funds may end up buying more, especially as the safe-haven status in terms of the most liquid asset would remain intact.

It is highly unlikely that a UST downgrade will occur. However, if a downgrade does occur, there may be a knee-jerk reaction among the real-money investment community in which investors shed their UST positions. However, in the short-term, real money funds would surely push to amend their mandates so that they can continue to be long USTs. In the long run, it's still a better bet to be long USTs.

We are not convinced that the market will care even if there is a downgrade. This is assuming that other rating agencies (such as Moody's') do not also downgrade.

Rating agencies in action

Green, amber and red

Among the rating agencies, by far the most aggressive stance has come from Standard & Poor's. While Moody's and Fitch have primarily focused on the US federal government's inability to agree to raise the debt ceiling, S&P is showing the greatest concern about the lack of a long-term plan to restore fiscal balance to the world's largest debtor nation. While in April, S&P appeared content that an agreement on the fiscal deficit had to be reached by 2013, now political agreement to trim at least USD 4trn over the coming ten years is required to satisfy S&P that the debt-to-GDP ratio will halt the persistent rise seen since 2006.

At present, the Congressional Budget Office forecasts over the next ten years that the total budget deficit will be a cumulative USD 6.97trn, meaning that net public debt will rise from 69.4% in 2011 to 76.7% by 2021. Barring significant and definite action on both the debt ceiling and budget deficit, S&P would appear ready to downgrade the US to AA, in line with their rating for Spain and Slovenia.

Almost conversely, Moody's has suggested that the US eliminate its debt ceiling in order to lower uncertainty among bondholders and reduce their exposure to event risk. This immediate concern of a technical default was behind their decision to put the US on review for a possible downgrade in July 2011. Moody's is concerned predominantly with debt affordability (the ratio of interest payments to government revenues) and debt reversability (the government's ability to recover from an economic shock). The key risk is that at some point Moody's sees the interest payments to general government revenue reaching beyond the 10-14% 'debt reversibility band'.

Fitch, perhaps the most dovish of all, has yet to alter its outlook for US ratings. This, in our opinion, is because an 11th hour deal may still be formed. Fitch has published an outline of possible paths should the debt ceiling fail to be raised. These range from placing the US on negative watch if the debt ceiling is not raised by 2 August to lowering the rating from 'AAA' to 'restricted default" if a significant portion of Treasuries fail to honour the USD 25bn coupon and principal due on 15 August. It is not clear at this point whether Fitch is close to a downgrade on the grounds of a medium-term unsustainable fiscal projection.

Without a debt-ceiling increase by 2 August or an explicit statement from the Treasury that revenues have been significantly larger than anticipated so as to extend the deadline, we would expect Moody's and S&P to place the US on restricted default on 4 August. We expect that the volatility and disruption in the markets would be significantly magnified if the US were to be downgraded by more than one rating agency.

Lessons from the 1990s

The risk of larger shock

In a very similar situation to today's, the failure of President Clinton and the Republican-controlled Congress to agree a fiscally conservative budget led to Republicans' refusal to raise the debt ceiling in 1995. This led to two government shutdowns occurring in close succession. The first shutdown was between 13 and 19 November 1995, when 800,000 non-essential workers were furloughed without pay for five days. The second shutdown was from 15 December 1995 to 6 January 1996, the longest in history at 22 days, during which 284,000 non-essential workers were furloughed, 368 national parks closed and 3,500 bankruptcy cases were reportedly suspended. Entitlement spending (such as social welfare payments) did continue during this period. If a similar situation to the mid-1990s arose, similar measures would be imposed, though new applications for social welfare could be held up.

Bond yields fell during the last shutdown, which is not surprising given that the Secretary of the Treasury declared a debt-issuance suspension period on 15 November 1995, which meant that no debt subject to the debt ceiling could be issued until the debt ceiling was raised on 29 March 1996. There was no real concern in the market that the US might fully default, but the stock market suffered owing to growth concerns. History shows that even when the decision to raise the debt ceiling goes down to the wire, it does not lead to a default or a change in the perception that the US is the gold standard against which to benchmark other debt. This time around the stakes are higher.

On 2 May, 2011 Treasury Secretary Geithner sent a letter to Congress informing them that the debt ceiling had been reached. A stay of execution was avoided as the Treasury Secretary extended this deadline by employing extraordinary measures to ensure that that the US could meet its obligations until 2 August. While the prior shutdown was for a total of 29 days, it occurred when the deficit was around 2.0% of GDP.

The 12mma trend for the federal deficit has been running at around USD 110bn per month for the past two years. This is equivalent to 8.7% of GDP. Now the US economy is even more reliant on government spending. The clear drag on growth caused by a shutdown would be far greater than before.

USD implications

Another medium-term USD negative

Up to now, we and many market participants have been operating under the assumption that Congress and the Administration will strike a last-minute bargain, involving not just an increase in the debt ceiling, but also a meaningful and credible long-term fiscal consolidation plan, which would avoid a credit-rating downgrade of the US by one or more of the major rating agencies.

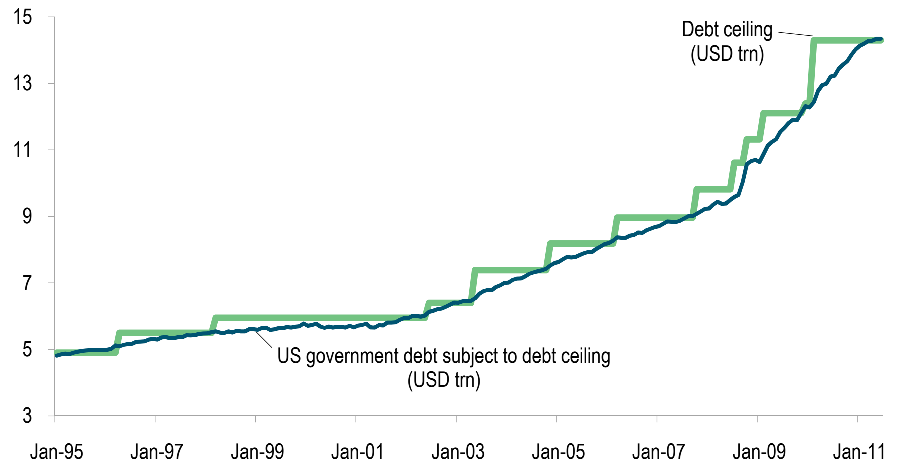
However, the last minute is now rapidly approaching and the apparent lack of compromise on both sides of the debate is starting to unsettle markets, leading to increasingly volatile conditions.

From an FX market perspective, we previously saw our base case scenario of a debt deal/credible fiscal consolidation plan as USD-positive in the same way as in 1995-96, which involved first a debt deal and thereafter a balanced-budget amendment. While the specific dynamics of that event were different in important ways, this example is an important precedent for how a material (and positive) change in US fiscal expectations can give a significant and sustained lift to the USD.

In this context, our base case as of 2 August is that the USD will rebound against G10 currencies, while remaining relatively weak against emerging-market (EM) currencies with much stronger fundamentals.

Chart 3: It is a limit, not a target

General government gross debt (USD bn)



Sources: IMF, Standard Chartered Research

However, in the last two weeks, the USD has come under increasing pressure on the view that, while the US debt ceiling will be raised, any accompanying fiscal consolidation plan is likely to fall short of market expectations. In our view, we think this process has further to run. From here, as we head into the 2 August deadline, we see three possible scenarios:

Scenario 1: The debt ceiling is increased and the White House/Congress succeed at the last minute in reaching a credible fiscal consolidation plan, and avoids a downgrade of the US credit rating.

FX market reaction – This would be broadly USD positive, particularly against G10 currencies. In this scenario, we still think that EM currencies would remain resilient and gradually resume their outperformance against the USD.

Scenario 2: The debt ceiling is increased, but the White House/Congress fail to agree a credible fiscal consolidation plan and only arrive at a short-term compromise. Given recent comments from rating agencies, this would likely result in a downgrade of the US credit rating by one or more rating agencies – though crucially the US would remain investment grade. **Our central scenario is that S&P downgrades US debt, but Moody's and Fitch hold off doing so, for now.**

FX market reaction – The USD would initially benefit from investor risk aversion, particularly against high-yield/high-beta currencies, both in G10 and EM, though not against safe-haven currencies such as the Japanese yen (JPY) and Swiss franc (CHF), which would significantly outperform. Thereafter, as benchmarked investor investment committees and central banks responded to the downgrade of the US within the investment grade category, there would be broad-based USD selling across the board.

Scenario 3: The debt ceiling is not raised and no fiscal consolidation plan is reached. In this event, rating agencies have publicly considered the possibility of slashing the US credit rating to selective default – a cataclysmic event for global markets.

FX market reaction – We see the FX market reaction to such a catastrophe as being largely a function of a total collapse in risk appetite – similar to the Lehman Brothers collapse, only of a much greater magnitude. As such, this would be USD-positive de facto rather than de jure, with all risk assets getting crushed. At some stage, the USD would come under massive and sustained pressure as investment committees sought to reduce their exposure to US assets, but this would only come after an explosive USD rally.

Currently, scenario 2 – a debt deal and a compromise fiscal plan, which would not be enough to avoid a US credit rating downgrade within the investment-grade category, is looking increasingly likely. We see this initially as risk-negative – and thus initially USD-positive against high-beta/high-yield currencies in G10 and EM – before a more sustained wave of USD selling across the board as investment committees and central banks react by reducing USD exposure. The schedule for these two stages would depend on market expectations and positioning heading into such an event, which now appears mildly USD short, suggesting significant market complacency regarding the risk of a US credit-rating downgrade.

Under this scenario, the likes of the Japanese yen (JPY) and the Swiss franc (CHF) would outperform higher-yielding currencies such as the Australian (AUD), New Zealand (NZD), and Canadian (CAD) dollars and EM currencies. Thereafter, we see EM currencies rebounding, benefiting from much stronger fundamentals and broad-based USD selling.

In response, the central banks of EM countries, notably those in Asia ex-Japan (AXJ) and Latin America, may respond first with intervention and thereafter further macro-prudential measures or even some form of capital controls. However, in our view, such measures are only likely to slow the speed of appreciation of EM currencies rather than reverse the trend.

AXJ currencies to outperform

A US credit-rating downgrade may trigger a brief sell-off in AXJ currencies given broader risk aversion and position reduction. The vulnerable currencies in Asia should be the ones in which positioning is most heavy, including the Korean won (KRW), Chinese yuan (CNY), Singapore dollar (SGD) and Indonesian rupiah (IDR) whereas the Indian rupee (INR) Thai baht (THB) and the Philippine peso (PHP), where positioning is lighter, should be less affected. Real-money funds will likely be the big buyers of AXJ currencies, in which the most obvious beneficiaries will be currencies where the government bond market is part of a global benchmark, which includes the IDR, Malaysian ringgit (MYR), Thai baht (THB) and Philippine peso (PHP). The KRW should also benefit, given real money funds' preference to play Korea as an off-index allocation. Risk-sensitive, liquid currencies such as the SGD and INR should gain from broad-based USD weakness.

In contrast, managed currencies such as the CNY, Taiwan dollar (TWD) and Hong Kong dollar (HKD) may underperform regional currencies.

From an FX Strategy point of view, we recommend that real money funds remain *Overweight* on the CNY, KRW, IDR, SGD, THB and PHP, whereas they should maintain *Neutral* positions on the TWD, INR, HKD and MYR.

In the *Standard Chartered FX Trading Portfolio*, we are short USD-THB via 3M forward outright, short USD-CNY via 12M NDF, short USD-TWD via 3M NDF and long PHP 3M NDF versus a 50/50 basket of USD and euro (EUR).

Rates implications

What is the alternative?

We concur with the fund manager survey result, which shows that a US credit rating downgrade is unlikely to trigger a major UST sell-off. However, we expect that a US credit-rating downgrade will speed up the asset-allocation shift out of developed markets and into EM. This should especially benefit inflows to EM with high credit ratings and sound fiscal positions. While we cannot discount the possibility of a near-term "risk-off" sentiment driven by the downgrade, the spread between EM cash bond yields to UST yields would narrow as the EM risk premium over US assets demanded by investors would likely fall.

Strong economic growth and the bullish FX outlook in many AXJ countries should continue to encourage inflows into the cash bond markets. Policy makers in the region still face high inflationary pressures. While headline CPI inflation is peaking, core inflation should continue to rise and is likely to become an even more apparent threat in 2012. We favour AXJ cash bonds to rates as inflows are anchoring bond yields, despite monetary tightening.

In the cash bond markets, we hold a *Neutral* duration stance in Singapore and Hong Kong, but we expect the SGD and HKD government bonds (both having AAA rating from the S&P) to outperform the UST upon a US credit-rating downgrade. We recommend that real-money investors maintain an *Overweight* duration in Indonesia, the Philippines and Malaysia. We favour being long the IDR 20Y bond and PHP 20Y bond, driven by 10/20Y curve steepness and high liquidity in the segment. While we are *Underweight* duration in Thailand, we see value in increasing cash allocation to the THB 1Y T-bill, as we see the recent sell-off in the front-end of the curve as overdone.

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David Mann	23:30 GMT 26 July 2011	23:30 GMT 26 July 2011
Regional Head of Research, the Americas		