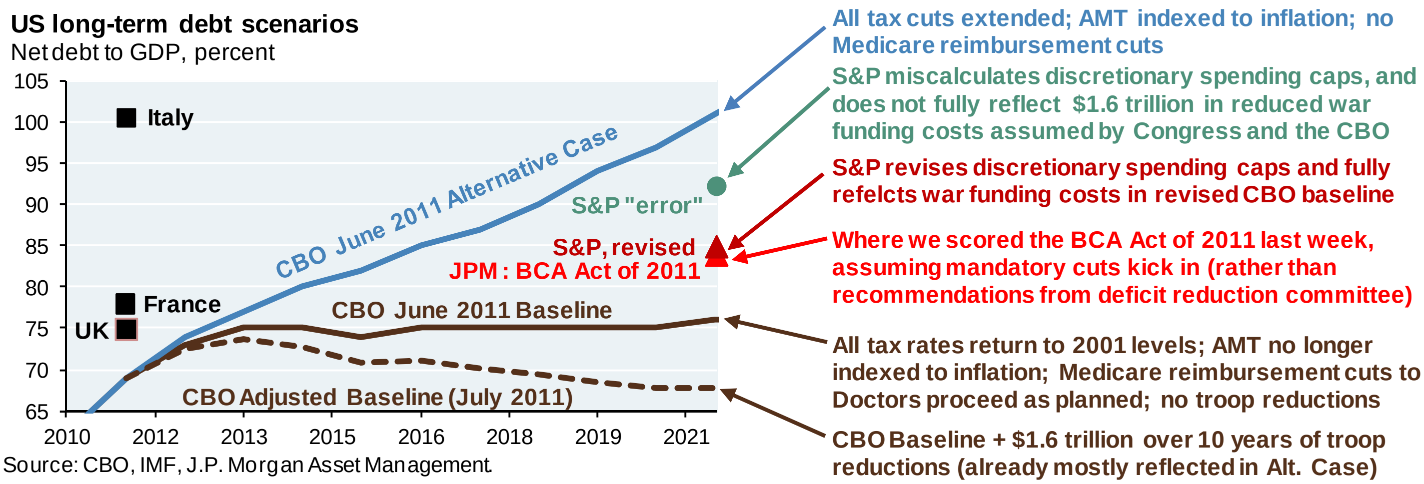
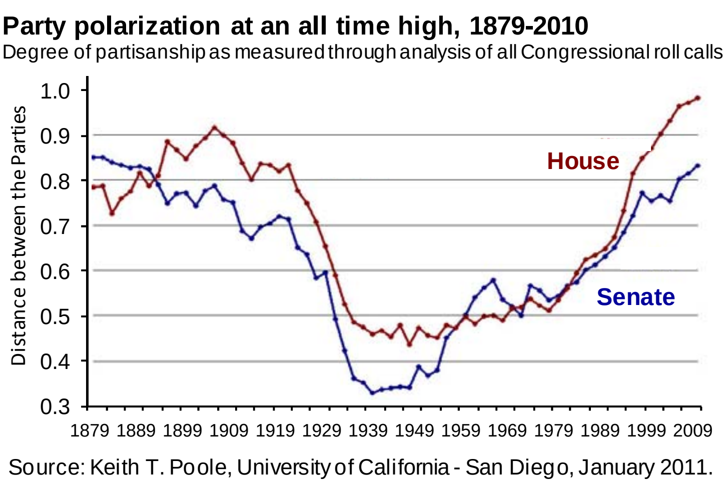
Centennials: S&P downgrades the United States of America, and pressure on Europe to save Italy

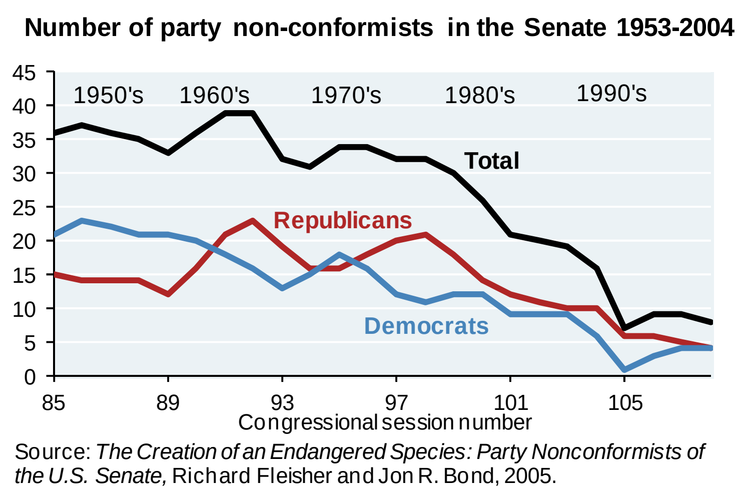
Almost 100 years ago, the United States received its first AAA rating, from Moody's. Yesterday, this highest rating was withdrawn, by S&P. Italy also faces a downgrade, as its public debt approaches the highest levels in almost 100 years, and with the exception of world wars, the highest since unification. Large-scale purchases of Italian debt by the European Central Bank look like the last line of defense by policymakers, absent an abrupt acceptance of Federalism. To prevent further escalation of sovereign debt, both Italy and the US face austerity conditions that will impede growth.

Let's start by looking at why S&P acted. Compounding everyone's confusion is the startling assertion Friday night by the Administration that S&P made a "$2 trillion mistake". This is partially true; S&P miscalculated discretionary spending caps in the Budget Control Act (BCA). However, another factor affecting the "mistake" appears to result from S&P not incorporating the CBO and Congressional decision to assume that $1.6 trillion in war funding costs simply *disappear* from the budget outlook (e.g., the Revised July 2011 Baseline against which the BCA was scored). This reduction in war funding is neither legislated nor binding, and as such, renders the Administration's claim somewhat disingenuous. S&P has now incorporated the discretionary spending cap specifics, and the Congressional definition of the baseline case. Interestingly, S&P's revised estimate that the Budget Control Act results in a debt/GDP ratio of 85% in 2021 is exactly where we scored the bill last week[1]:



We were surprised by the speed of S&P's action, but they do not see a cresting of US federal debt ratio by 2015, or by 2021, unlike their projections for countries like Germany, France and the UK. S&P spent a lot of time in their press release on the fractious politics of the US, and the difficulties it presents in making tough choices on revenue increases and entitlement cuts, which they note are mostly absent from the Budget Control Act. We use these two charts to put numbers around a polarized legislature, reflecting a polarized electorate (btw, the Senate hasn't gotten less partisan since 2004).





[1] We made the right adjustments for the discretionary spending caps, and accepted (reluctantly) the Congressional definition assumption on reduced war costs. *Cap* is the wrong word: discretionary spending is projected to decrease and then grow at a slower rate than previously assumed (around 1.8% per year over the next decade).

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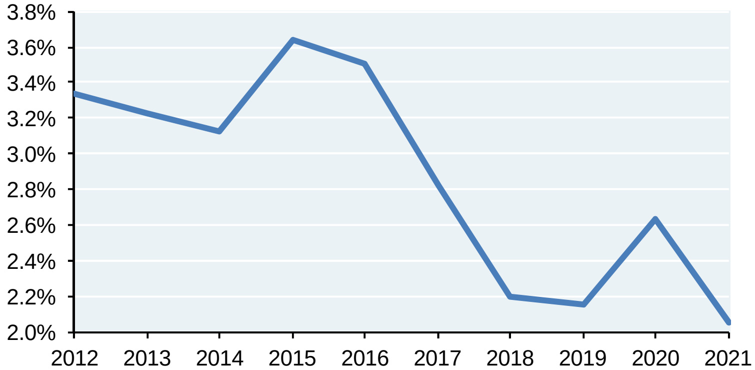
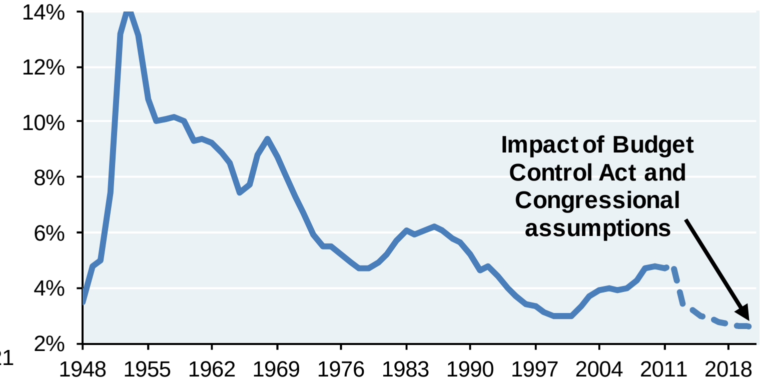
IMPLICATIONS: we are less concerned about credit and fixed income markets than we are, in the near term, for equities (see table below for details). Should the downgrade contribute to continued lackluster job growth[2] or consumer spending, that would obviously be a problem for growth at a time when there isn't much of it. By the way: as shown below, CBO assumes growth for the US of 3.0% - 3.6% in the next few years, tapering off to 2% by 2021. If GDP growth averaged 2% during the entire decade, the projected US debt to GDP ratio would rise over 90% (close to S&P's original "erroneous" assessment). Another consequence of the CBO spending projections, if they actually come to pass**: questions about the role of the United States in the world, given what looks to us like the lowest military spending levels since the US became a global power**[3]. That's what prompted Secretary of Defense Leon Panetta's objections to the deal last week.

CBO's real GDP growth assumptions
Percent YoY



Source: CBO.

US military spending since 1940
Percent of GDP



Source: CBO, OMB, J.P. Morgan Private Bank.

The details on fixed income markets of a downgrade, from our July 29 EoTM (Capitol Grill).

- Most Treasury collateral agreements appear to have leeway to avoid immediate liquidation of the collateral in case of a downgrade. Furthermore, for now, Moody's and Fitch still rate the US as AAA.
- Money market funds that are subject to 2a7 legislation even have the ability to hold *defaulted* collateral if selling would be disruptive and not in the fund's shareholder interest, so a downgrade should not force any specific action
- There is nothing in ERISA language governing pension funds that would trigger a sale in case of a downgrade; it would be up to individual account guidelines as to whether there was flexibility on collateral rules.
- In a joint statement last night, several regulatory bodies (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency) confirmed the riskless nature of Treasuries and government agencies for risk-based capital purposes.
- We do not see an impact on Treasuries as eligible collateral in repo transactions. Haircuts applied to Treasury collateral in repo transactions are typically 2%; the downgrade could increase this by 1% or so, but there is no reason to think this will happen automatically. It will depend on the volatility of the Treasury markets in the interim
- The downgrade may trigger a matching downgrade of Fannie Mae and Freddie Mac, GNMA, municipal bonds backed by Treasury bonds, the Federal Home Loan Bank, Federal Farm Credit Bank and other government-backed securities.
- There may be downgrades of highly rated bank subsidiaries and holding companies due to "sovereign ceiling" issues, and insurance companies, due to their high concentration of Treasury holdings. Other potential downgrades: states with high levels of government dependency. As an example, Moody's had put South Carolina, Tennessee, Maryland, Virginia and New Mexico on negative outlook due to exposure to Federal employment, procurement contracts and Medicaid transfers.
- Finally, we do not expect material change in demand for Treasuries and quasi-sovereign paper by central banks reinvesting their current account or petrodollar surpluses. Well more than half of all AAA securities in the world are US Treasuries, Agencies and Agency-backed securities, leaving few and highly fragmented immediate options for central banks, insurance companies and other AAA buyers (soon to be AA buyers?). An end to central bank reserve accumulation (perhaps out of concern for inflation) appears a bigger risk for Treasuries than central bank reserve diversification.

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[2] Last Friday, private sector payroll growth exceeded expectations, but the labor participation rate, the employment to population ratio and the average length of unemployment worsened yet again, some to low points for the cycle.
[3] Our estimate of future military spending as a percentage of GDP assumes the $1.2 trillion of mandatory cuts (rather than the $1.5 trillion from the Deficit Reduction Committee); the split between defense and non-defense spending is specified in the Budget Control Act.

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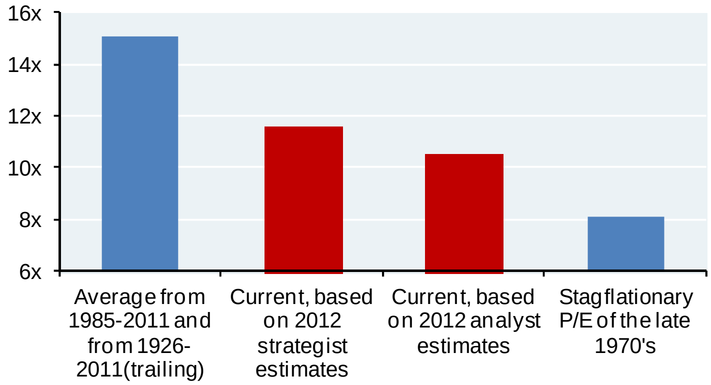
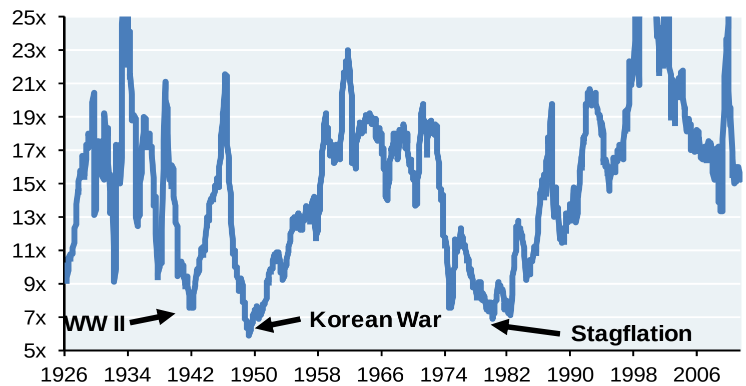
Something to be mindful of is that US equity markets are already pricing in a lot of bad news, and a rising likelihood of a recession. While earnings would be dragged down by weaker global growth, as things stand now, P/E multiples computed based on earnings estimates for 2012 are 10x - 12x based on Friday's closing levels. How low could multiples go? As shown in the chart below, current trailing P/E multiples of 13x are low in the context of the last 80 years, with two notable exceptions: the stagflationary period of the late 1970's, and the periods of peak debt levels following WWII and the Korean War. What makes the latter comparisons relevant is the current wartime level of US public debt. Markets may well open up weaker on Monday, when they have the first chance to digest the S&P downgrade news. However, selling equities at this point appears to assume the certainty of a US recession, and/or a near-term disintegration of the European Monetary Union. **Our view is that the financial markets will be more sensitive to ongoing events in Europe, and specifically Italy, than S&P's downgrade of the US. On Italy, see below.**

P/E ratios on the S&P 500
Forward P/E multiple



Source: Standard & Poor's, I/B/E/S, Empirical Research Partners.

Super low P/E ratios: Wars and stagflation
Trailing P/E mulitple on the S&P 500



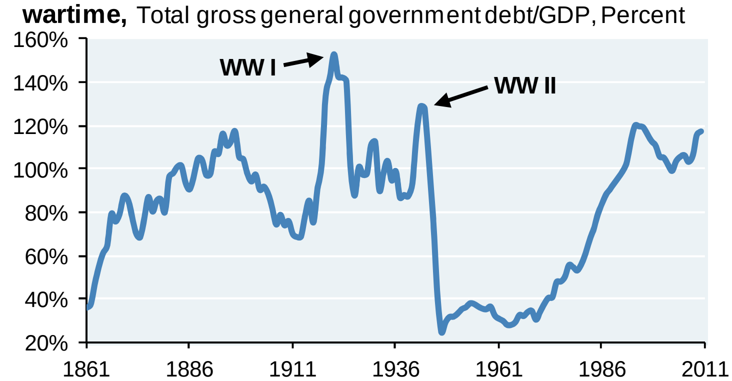
Source: Empirical Research Partners.

<u>**Italian public debt: another unhappy Centennial, and the latest Achilles heel of the European Monetary Union**</u>

EU policymakers are being forced to defend the European Monetary Union, as investors reduce exposure to Italian sovereign bonds, credit and bank shares. Last week, Italian regulators reportedly seized documents at Moody's regarding declines in Italian bank stocks and concerns that Moody's research reports were somehow involved. As mentioned a week ago, this is an indication of the pressure the system is under, and the possible search for scapegoats.

Italy has around the same amount of public debt outstanding as Germany, but is a country whose GDP is 2/3 the size. As shown in the chart, Italy's debt levels are stubbornly high, despite having adhered to substantial fiscal discipline for the last 20 years. Since 1992, Italy has run a budget surplus (ex-interest) in almost every year. But with high debt levels, low growth and low productivity, Italy has not been able to make much progress in bringing down its debt. **Italy faces its highest debt levels in almost 100 years, and practically the highest since Italian unification (1870).**

Italy's debt/GDP: highest since unification other than wartime, Total gross general government debt/GDP, Percent



Source: Reinhart, Camen M. and Kenneth S. Rogoff, "From Financial Crash to Debt Crisis," NBER Working Paper 15795, March 2010.

The politics of this are getting messier. EU Commission President Barroso berated policymakers last week for "*undisciplined communication and the complexity and incompleteness of the 21st July package*". Could the EFSF be expanded from 440 billion Euros to 1.5 to 2.0 trillion Euros, which is what would be required to fund Spain and Italy if they can't access debt markets? Probably not in the near term; it could take weeks or months for national parliaments simply to approve what they agreed to on July 21. As a result, **we expect intense pressure on the ECB to buy Italian government bonds. Whether small purchases can convince markets of anything is unclear (small purchases in other countries hasn't prevented yields from sky-rocketing).** We have had concerns about the sustainability of the European Monetary Union since November 2009. Our recommended approach has been to hold substantial underweight positions in Europe (ex-Germany) until a path to growth and debt sustainability is clear.

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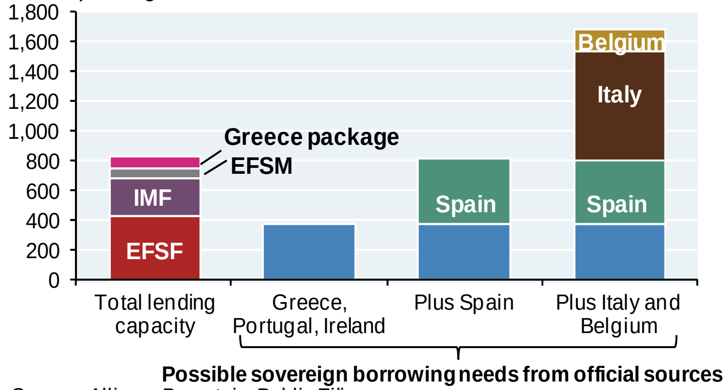
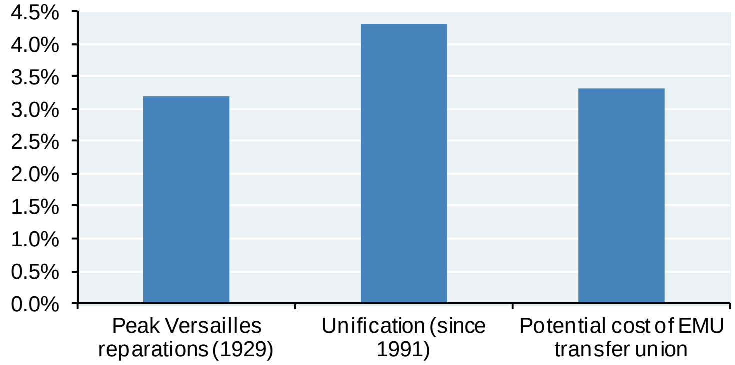
Limited capacity at the European Liquidity Hospital
Official sector lending capacity vs sovereign funding needs (including deficits) through 2013 - Billions, EUR



Source: AllianceBernstein, Public Filings.

Cost to German taxpayers of major events
Percent of GDP, annual



Source: Carl-Ludwig Holtfrerich, Halle Institute for Economic Research, Zentrum fur Europaische Politik (Freiburg), J.P. Morgan Private Bank.

Watching European and US governments grapple with their respective sovereign debt problems is like watching that 1940's video of the collapse of the Tacoma Narrows Bridge. A small gust of wind sets in motion a series of events that builds in intensity until a moment of reckoning. The difference here is that, particularly in the US, the tools to stop the gyrations do exist; they just require substantial collective sacrifice to do it. Sacrifices include enormous downward wage adjustments in peripheral Europe to restore competitiveness (given the absence of an exchange rate adjustment); and restructuring of public sector finances that in the US, threaten to rob future generations of the benefits enjoyed by current entitlement recipients. The US Federal Reserve and European authorities won't go down without a fight, and we expect additional measures to try and mitigate the effect of these adjustments. However, there's not much they can do to prevent them from happening, and I'm not sure adjustments needed in southern Europe (like Italy's zero-deficit plan) are feasible without perpetual transfers from Germany[4] (perhaps via jointly and severally guaranteed Eurobonds). **We have documented these adjustments extensively over the last couple of years; understanding the need for them has moderated our risk-taking at a time of almost unparalleled strength in corporate profits.** With each passing day, the price for those profits get cheaper.

Michael Cembalest
Chief Investment Officer

CBO = Congressional Budget Office; EFSF = European Financial Stability Facility

[4] According to a Der Speigel article today, some German officials are quoted saying that: the German government isn't even sure tripling the EFSF fund would help; that the EFSF should be used primarily for smaller countries; that trying to save Italy could jeopardize German finances; and that **Italy needs to rely on its own structural reforms to sustain access to public debt markets.**