CAPITAL MARKETS RESEARCH

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Daily Points

— Tracking the Numbers

On Deck for Monday, August 8

No Canadian or US releases today.

KEY POINTS:

- Six questions relating to S&P's downgrade of the US
- ECB bond buying offset by German comments against expanding the EFSF
- Clean global indicator slate today
- China is a risk tonight

UNITED STATES

Treasuries are rallying as the risk trade gets hit by Friday evening's decision to downgrade the US from AAA to AA+. As we argued in "What To Watch In The Markets During the U.S. Debt Crisis," Global Views, July 29th pp.4-6, the reaction in Treasuries was likely to be insulated in part by concerns over the risk trade as the US plays a safe haven role during times of market duress.

We offer a few quick points drawn partly from the note we sent to clients on Friday night after word of the downgrade, and with input from Scotia's Mary Webb along with other additional reasoning:

1. Why did S&P downgrade? Forget Treasury's $2 trillion smear campaign. That's the side issue driven by a "You can't downgrade America" mentality from government, media and some elements of the US corporate landscape that were nonetheless unquestioning on this side of the Atlantic toward European downgrades. The fully legitimate concern at S&P relates to the timing and credibility of planned austerity, and the risk of further short-term stimulus. In short, S&P is concerned that the effects of austerity under the just passed *Budget Control Act* of 2011 are too far down the road to matter and are malleable under future sittings of Congress, while short-term fiscal stimulus pressures might deepen in such a manner as to make the net picture worse. The *Act* focuses on mid-term restraint, with only modest near-term cutbacks. From the first-stage discretionary spending caps, the Congressional Budget Office (CBO) estimates a bottom line impact of just US$21 billion for the upcoming fiscal 2012 (FY12, starting October 1, 2012), that does not reach US$100 billion until FY17. The second stage, a restraint package of at least US$1.5 trillion developed by the bipartisan Joint Congressional Committee or automatic spending reductions of US$1.2 trillion is more than a year away. For the immediate future, however, the President is urging the extension of at least some of the economic supports, such as the Social Security tax reduction adopted for 2011 with a 2012 revenue cost five times the FY12 saving from the discretionary spending caps. Extending the Bush era marginal tax rate reductions and jobless benefit extensions would add to near-term fiscal pressures. To this effect, this Fall, Congress faces appropriations for FY12 alongside details of how the first discretionary spending cap will be met. Failure of the proposed 12-member bipartisan panel to agree on

BoC Events

BoC Overnight Lending Rate
Current Rate: 1.0%
Next Move: Sept. 7 @ 1.0%
Bias: Neutral

Fed Events

Fed Funds Target Rate
Current Rate: 0-0.25%
Next Move: August 9 @ 0-0.25%
Bias: Dovish

Key International Events

BoJ
Current Rate: 0.10%
Next Move: September 7 @ 0.10%
Bias: Dovish

BoE
Current Rate: 0.50%
Next Move: September 8 @ 0.50%
Bias: Dovish

ECB
Current Rate: 1.50%
Next Move: September 8 @ 1.50%
Bias: hawkish

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an additional US$1.5 trillion package of budget restraint through FY21, or Congress's failure to pass such a package, triggers automatic cuts, that become the focus of the November 2012 election campaign alongside the extension of the Bush tax cuts after 2012 and a further increase in the debt ceiling, likely required early in 2013. Each Party during the election run-up will champion their own solutions with little required effort on compromise. Also revealing Washington's deep political divisions will be the Congressional vote, required by the *Act* before January 2012, on a joint resolution for a balanced budget amendment to the Constitution.

2. Are there other downgrades to follow? Yes, this may well be the first downgrade to sweep through US credit markets and we're not even talking of the risk of another downgrade to the US government itself as per S&P's negative outlook. As Scotia's credit analyst Stephen Dafoe points out, S&P said it would release its views on the impact of the US downgrade on banks, insurers and other financial institutions, government related enterprises and agencies, structured finance and other affected sectors. If S&P follows the pattern of many sovereign downgrades over time, then sub-sovereign issues are next including Fannie Mae, Freddie Mac, numerous state and local governments, and perhaps into elements of the corporate space. What may mitigate this impact is that S&P maintains that sub-sovereign ratings can be higher than the sovereign rating, though this likely just contains the number of other downgrades to come without eliminating them as a pool.

3. Are there knock on effects to follow? Another wave of deleveraging could well be one of them. What those who are dismissing the punitive role of a downgrade are forgetting is that Treasuries are at the root of many leveraged transactions in the global financial system. I'm concerned about the deleveraging consequences (ie: the knock on effects on leveraged transactions) that could compound challenges facing the risk trade to start the week. The piece we did (cited earlier) delved into this through examples such as the repo market which may well now require higher collateral requirements in pledging Treasuries for cash on heightened Treasury volatility and hence risks in accepting them as collateral. If so, then this is just one example of how a downgrade could reverberate through markets via its impact upon many leveraged transactions.

More fundamentally, the US is now going down Europe's path. The cycle of downgrade risk and debt ceiling drama will be ongoing throughout 2012 and beyond with rating pressures lurking in the background throughout.

4. Could the long-run impact on Treasury yields prove different? A downgrade alone may have probably meant a hike over time of up to around a half point in Washington's 10yr bond funding costs and hence that of most other borrowers. The negative impact upon the risk trade may, however, temper this immediate response. Over time, however, Washington's borrowing costs will rise materially and further aggravate the need for additional austerity via the crowding out impact of higher borrowing costs, and either bond holders will eventually come to pay the full price and/or the US economy will through heavier austerity. S&P's decision reflects its sour take on US politics and the bias against any revenue raising measures in the House which may raise the odds of stimulus extension for the payroll tax cut, Bush era cuts to marginal rates, and jobless benefit extensions. In that interim period, bonds will eventually pay the price before possible post-election austerity offers relief at the expense of the economy under a new mandate.

5. Could there be a feedback loop on growth? Probably yes, as one can only imagine a negative confidence impact on corporations and households through the curtailment of risk and the impact of volatility in cycle planning. Some of this effect will be mitigated by the additional safe haven flows into government bonds that will keep borrowing and refinancing costs low for now. Then again, low rates have done little for US growth thus far given inelastic demand for money that has borrowers reluctant to take on additional debts.

6. Could there be a silver lining? Never leave your reader totally on a negative when in uncharted waters, so we'll go out on a limb here. Congress could outperform on its responsibilities over the next six months, and begin the process of restoring household, business and investor confidence including through efforts aimed at meaningful fiscal repair. If this does not occur, however, then elements of S&P's revised downside scenario that could lead to a further downgrade over the next couple of years are not that farfetched. Beyond the risk of weaker-than-promised fiscal repair, annual U.S. real GDP growth could well average 2½% this decade, not 3% plus and yearly increases in the GDP deflator could be significantly less than 2%.

INTERNATIONAL

The **ECB** has stepped in and started to buy both Italian and Spanish bonds in order to put downward pressure on yields this morning after remaining out of both markets last week when the ECB began its bond-buying program once again last Thursday. Here is the ECB's press statement: http://www.ecb.int/press/pr/date/2011/html/pr110807.en.html.

The impact has been substantial with Spanish and Italian yields down across the curve but especially in the short end and with the most buying in the 5-year segment where Italian yields have plunged 86 bps. Two year Italian yields are now down 71 bps to 3.8% while 10-year yields are down 73 bps to 5.35%. Spanish bonds have rallied even further with two year yields

down more than 1% to 3.34% while 10-year yields have fallen almost 80 bps to 5.25%. The ECB also increased pressure on Euro-area governments to pass the changes agreed upon at the July 21 EU Summit which will augment the powers of the European Financial Stability Facility (EFSF), allowing it to buy bonds on the secondary market. Indeed, equity markets actually were flat to up at the open of the European session but then took a turn for the worse after Klaus-Peter Flosbach, the financial policy spokesman for Germany's government, stepped in and rejected the idea of boosting the size of the EFSF arguing the Germany would "suffer the same fate as Italy, Spain or the U.S." if the EFSF was increased to a size that would help two of Europe's largest economies. Germany is already paying for Europe's fiscal problems and this morning's bond-buying by the ECB has compounded that problem as German bunds sell-off across the curve. The concern is that an expanded EFSF would represent far larger contingence liabilities for the backer states like Germany and France, and thus put their own finances in potential long-run jeopardy. This is relevant because the ECB has been reluctant to take on credit risk, hence its requirement that the euro-area guarantee Greek bonds in default rating while the ECB accepts them at the window. Thus, if the EFSF will not be expanded and the ECB is reluctant to buy government bonds in the first place, this could put a cap on the size and extent of ECB involvement in the market for fear that governments will not mitigate any negative impact upon the ECB's own balance sheet.

G7 Finance Ministers and Central Bank Governors affirmed their commitment to the financial markets in a statement released last night, backing the recent US debt ceiling decision and the July 21 EU Summit package which will increase the flexibility of the EFSF although all governments must ratify that point before implementation. The full statement can be obtained at http://www.fin.gc.ca/n11/11-064-eng.asp. One might argue against its assertions that "no change in fundamentals warrants the recent financial tensions faced by Spain and Italy." That always depends upon how one defines the fundamentals and we hope they're not relying upon backward looking indicators (for example, what about accelerating concerns about cross-country holdings of government debt by banks?). But in some sense this is true; the slow motion train wreck has been in place for a very long time, but the tell tale sign of all financial crises is that one can rarely fully predict exactly when concerns will come to a head as they are now. A long simmering crisis often lies at odds with short-term selective readings of the fundamentals. Ask Asia about the late 1990s.

China releases its monthly round of key indicators this morning including CPI, industrial production, and retail sales with consensus expecting a top in inflation pressures and solid growth fundamentals that could allay some concerns about the Chinese economy.

Fixed Income	Government Yield Curves (%):											
	2-YEAR			5-YEAR			10-YEAR			30-YEAR		
	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk	Last	1-day	1-wk
US	0.26	0.29	0.37	1.16	1.25	1.32	2.47	2.56	2.75	3.78	3.85	4.08
CANADA	0.96	1.07	1.38	1.66	1.79	2.03	2.53	2.64	2.77	3.14	3.22	3.28
GERMANY	0.77	0.77	1.10	1.48	1.45	1.62	2.37	2.35	2.45	3.11	3.09	3.23
JAPAN	0.14	0.14	0.16	0.33	0.34	0.37	1.01	1.01	1.08	1.93	1.90	2.00
UK	0.58	0.55	0.62	1.41	1.42	1.54	2.68	2.69	2.80	3.88	3.87	4.00
	Foreign - US Spreads (bps):											
CANADA	70	78	101	50	54	71	6	7	2	-64	-63	-80
GERMANY	52	48	73	32	20	30	-10	-21	-29	-67	-76	-85
JAPAN	-12	-15	-21	-82	-91	-95	-146	-155	-167	-185	-194	-208
UK	33	26	25	25	17	22	20	13	6	10	2	-8

Equities			% change:			
	Last	Change	1 Day	1-wk	1-mo	1-yr
S&P/TSX	12162.17	-217.96	-1.8	-6.8	-9.0	3.1
Dow 30	11444.61	60.93	0.5	-5.8	-9.6	7.4
S&P 500	1199.38	-0.69	-0.1	-7.2	-10.7	6.9
Nasdaq	2532.41	-23.98	-0.9	-8.1	-11.4	10.7
DAX	5153.80	-93.19	-1.8	-10.7	-14.0	-3.3
FTSE	6089.69	-146.47	-2.3	-12.4	-17.7	-2.7
Nikkei	9097.56	-202.32	-2.2	-8.7	-10.3	-5.6
Hang Seng	20490.57	-455.57	-2.2	-9.6	-9.8	-5.5
CAC	3223.47	-55.09	-1.7	-10.2	-17.6	-13.3
Commodities			% change:			
WTI Crude	83.60	-3.28	-3.8	-11.9	-13.1	3.6
Natural Gas	3.88	-0.06	-1.5	-7.3	-7.7	-13.1
Gold	1658.75	-20.75	-1.2	1.9	9.9	39.1
Silver	39.86	0.62	1.6	1.4	9.9	117.8
CRB Index	326.80	-1.17	-0.4	-4.5	-4.9	19.0
Currencies			% change:			
USDCAD	0.9878	0.0058	0.6	3.2	2.6	-3.8
EURUSD	1.4211	-0.0071	-0.5	-0.3	-0.4	7.5
USDJPY	77.8500	-0.5500	-0.7	0.8	-3.5	-9.4
AUDUSD	1.0348	-0.0094	-0.9	-5.7	-3.8	12.9
GBPUSD	1.6376	-0.0015	-0.1	0.5	2.0	3.0
USDCHF	0.7630	-0.0044	-0.6	-2.6	-8.8	-27.3

Source: Bloomberg. All quotes reflect Bloomberg data as at the time of publishing.
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