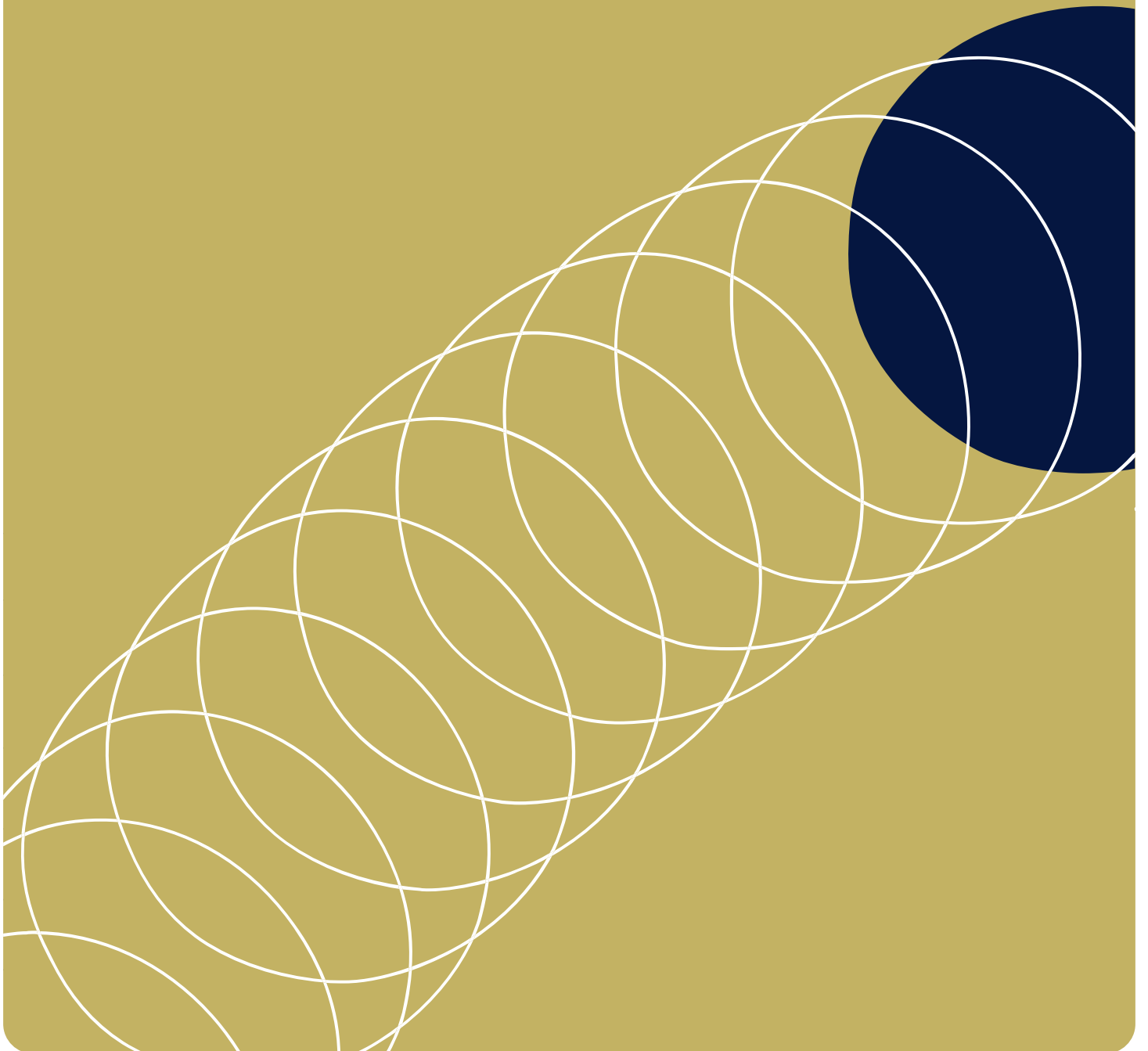


S&P decision mainly hurts Italy

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Last Friday evening, Standard & Poor's (S&P) added fuel to the fire in Europe. Italy will presumably pay the highest price, while German government bonds benefit. For investors, the rule still applies: avoid peripheral bonds.

American rating agency S&P on Friday lowered the creditworthiness of nine euro zone member states: France, Italy, Malta, Austria, Portugal, Slovakia, Slovenia, Spain and Cyprus. Germany, Finland, Luxembourg and the Netherlands are the sole remaining euro states to carry the highest rating from all three major agencies, and of those countries only Germany still has a "Stable" outlook. All the others (with the exception of Slovakia) were accorded a "Negative" outlook. This means that there is a 1-in-3 chance of a (further) downgrade in the next two years.

Overview of ratings

	Moody's	S&P	Fitch
Austria	Aaa	AA+ ↓	AAA
Belgium	Aa3	AA	AA+
Finland	Aaa	AAA	AAA
France	Aaa	AA+ ↓	AAA
Germany	Aaa	AAA	AAA
Greece	Ca	CC	CCC
Ireland	Ba1	BBB+	BBB+
Italy	A2	BBB+ ↓	A+
Luxembourg	Aaa	AAA	AAA
Malta	A2	A- ↓	A+
Netherlands	Aaa	AAA	AAA
Portugal	Ba2	BB ↓	BB+
Slovakia	A1	A ↓	A+
Slovenia	A1	A+ ↓	AA-
Spain	A1	A ↓	AA-
Cyprus	Baa3	BB+ ↓	BBB

Source: VP Bank, Bloomberg

At the political level, it was mainly the downgrading of France that provoked the most comments over the weekend. Elections lie just three months ahead in France, so the decision will likely be politically exploited, with the fringe parties gaining ground. In general, S&P finds justification for its downgrades in the high levels of national indebtedness coupled with slow growth, as well as the political disunity on the proper strategy for resolving the crisis. Add to that the banking sector's exposure to the periphery (France) and Eastern Europe (Austria), the high interest rates for refinancing government debt, and the hesitancy in introducing structural reforms (Italy, Portugal, Spain).

Italy: the "true" victim

From an economic standpoint, this altered situation will have the greatest impact on Italy. With its new BBB+ rating, Italy has fallen below the minimum level (A) that many institutional investors are statutorily obliged to maintain with their investments. And not only if Moody's and Fitch follow suit is it likely that many institutional investors will pare down their Italy portfolios further: some of their investment rules stipulate that the lowest rating alone is decisive. Hence yields can be expected to rise again and in turn force the European Central Bank (ECB) to purchase even more bonds. Incidentally, in its report, S&P praised the ECB's crisis management efforts.

Effects on banks and supranational borrowers

A number of European banks, above all in the affected countries, will probably be downgraded as well in the coming weeks. The spiral of progressively increasing indebtedness, higher refinancing costs, slower growth and the shrinkage of banks' balance sheets will continue for the time being. We are also reckoning with a downgrade of the EFSF rescue umbrella as well as the ratings of various supranational organisations. As to the EFSF, this can only be avoided if the remaining four AAA countries increase their guarantees or lower the amount earmarked for financing state deficits. That first approach will be a political hot potato especially in Germany and Finland. Although the market has already been demanding a yield in the AA range lately for EFSF bonds, the funding process would become even more difficult in the event of a downgrade. The contemplated leveraging of the EFSF has receded into the dim distance. So the focus is likely to shift increasingly towards the permanent ESM crisis mechanism that has now been brought forward to the middle of this year; this because the new structure envisages capital backing that is prepaid.

Germany: "tertius gaudens"

To a certain extent, these latest downgrades have already been reflected in yield levels for quite some time, so major yield fluctuations are unlikely for the time being. Nonetheless, German government bonds should be the beneficiaries of this new lay of the land:

- The rating decision of S&P was somewhat harsher than generally expected. In particular, the market did not anticipate that there would be such a clear differentiation between the various countries.

- The lower the ratings of euro states and their banks and institutions fall, the greater the (relative) attractiveness of German government bonds will become as a safe haven.
- Only the assessment of Germany stays largely unchanged now that S&P has accorded a "Negative" outlook to the other three remaining AAA countries.

Germany's lead over the other euro states will therefore widen. The yield gap will undoubtedly follow. Thus the already low real returns in Germany are likely to decline further (into negative territory). In terms of the convergence of the euro states, this is not a favourable development.

Yields on German government bonds



Source: VP Bank, Bloomberg

Political implications

S&P's rating decision probably also had a political component. Given the combination of a top rating and stable outlook, Germany's position at the negotiating table is now stronger. The pressure for more sanctions and greater fiscal policy integration is likely to increase, while the introduction of Eurobonds has become even more improbable. Also, Germany continues to reject the idea of the ECB playing an explicit role in combatting the crisis. The rhetoric in advance of the next euro zone summit in late January could already reveal the heftier weight of Germany. But by staying on the same path as today, the euro crisis will continue to smoulder for quite some time.

The bottom line:

S&P has intensified the European debt and confidence crisis. However, the general reaction in the bond markets should be muted at least for now. On the whole, the downgrades were expected, but further cuts would catch bond investors by surprise. No such move has been priced-in at this point. The "Negative" S&P outlooks therefore constitute an ongoing source of uncertainty and volatility. German government bonds are playing an even more important role as a safe haven and are benefiting from the rating revisions, while those changes could have the most negative consequences for Italy.

In the financial markets, EUR suffered the most from the downgrades. For the first time since 2010, the common currency traded below the 1.27 mark versus USD. Further losses in EUR cannot be ruled out over the short term. However, the high net short position in the futures markets sounds a note of caution: the correction potential against USD is by no means inconsiderable.

Bond investors should continue to focus on the core euro zone countries, including France. We also consider the supranational institutions to be sufficiently guaranteed. In terms of the search for yield at a reasonable risk, we recommend the corporate bond sector (excluding banks within Europe, but increasingly so outside the Continent). If you have bulk risks in your bond portfolio, we urge you to consult our Client Advisors in effort to diversify those positions as best as possible.



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