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Shaking the Status Quo: S&P Downgrades US Sovereign Credit Rating for the First Time in History

Please find below our views on the likely implications on local financial assets of Standard & Poor's (S&P) downgrade of the US long-term sovereign credit rating to AA+ from AAA along with a "negative" rating outlook.

We wish to stress that the move was not unexpected; a smaller US- based ratings agency, Egan Jones along with China's Dagong Global Credit Rating Co. were first to downgrade the US sovereign credit by a notch lower.

In our own Research Note / Market Commentary released on July 29, 2011 entitled "A US Default or Downgrade? What if? Evidence from the Past, and Signs from the Present" we mentioned that the downgrade of the US to AA+ will be a likely scenario. Our view is that US Treasury prices may encounter a mild sell-off in the medium term especially if another agency downgrades them along with S&P to AA+ and AA, respectively. For now though, we are on the view that interest rates will not rise dramatically to AA+ levels such as those of Belgium and New Zealand, other AA+ rated countries by S&P as US Treasuries are still highly favored for its liquidity (so far) and for lack of other alternatives. Just this morning, Credit Suisse was quoted saying that less than 2% of global bond funds have triple-A rating mandates (i.e. there will be only contained forced selling). Moreover, major buyers of US Treasuries, which have huge liquidity requirements, would have no other option to park their funds. In fact, Japan, the second-largest holder of outstanding US Treasuries commented that they will continue to buy US paper as part of their international reserves program. The only other alternative to the US dollar as a reserve currency is the euro, but the region is also hounded by its own structural challenges, which many believe are far worse than that of the US. Very few bond markets can match the depth and liquidity of the Treasury market, which has almost US$10 trillion in outstanding debt.

In terms of specifics, we summarize the possible reaction/implications on the local fixed income and equities markets:

Local Fixed Income:

- We see immediate pressure on ROP bonds, as investors try to reduce duration amid increased risk aversion and rising US Treasury yields.
- ROP bond prices lost 1.25 percentage points for maturities greater than 10 years in today's session, on top of the almost 1 percentage point decline last Friday.
- We expect intermediate securities, those with maturities of less than ten years, to be supported as fundamental factors in the Philippines remain sound.
- We see less pressure on peso-denominated bonds which are supported by strong local data on the inflation and fiscal front, though not entirely immune to some risk-reduction as local financial institutions try to incrementally lower risk.
- Inflation averaged at 4.81% year-to-date, still below the Bangko Sentral ng Pilipinas' (BSP) target of 3-5%. The country's gross international reserve (GIR) stood at US$71.0 billion as of end-June 2011, a fresh high, and is up 13.83% year-to-date. This translates to around 10.5 times the country's short-term external debt. The country's path towards fiscal consolidation has shown a stark improvement through the years. The budget deficit amounted to Php17.2 billion in the first half, lower than the Php152.1 billion recorded in the first semester of 2010. As of end-March, the country's debt-to-GDP level stood at 51.2% from a peak of 74.4% in 2004.

Local Equities:

- The sell-off so far has been more of a knee-jerk reaction.
- Sell-offs at the open have been met with buying later in the day that helped arrest declines: a good sign of local support and local conviction. The market shed 3.78% in the last two trading days with the index falling by as much as 152.71 points on Friday, and 105.04 points today. Buying recovered before the close of both days with the index eventually giving up just 57.22 and 94.38 points, respectively, from the open. Despite net foreign selling today

amounting to Php1.633 billion, the biggest since May 25, locals stepped up their game and dominated the market by grabbing 71.23% of the total traded value. Local purchases usually account for 61% of total trades.

- We believe that the slide in equity prices is temporary as the market has been anticipating the downgrade beforehand.
- Consensus is that the US will still be able to maintain some growth albeit at a slower-than-initially forecasted, and that global growth would still be led by emerging markets.
- The bottom line is that, local stocks should be well supported by healthy economic and corporate fundamentals. For one, the Philippine banking system remains stable as the average capital adequacy ratios (CAR) across the industry continues to exceed the BSP's minimum ratio of 10%, registering at 16.02% as of December 2010 on a solo basis and 16.97% on a consolidated basis. Similarly, the Tier 1 (T1) capital ratios of the banking system remained high at 13.64% and 13.69% on solo and consolidated bases, respectively. As of end-May 2011, the average non-performing loans (NPL) ratios of universal and commercial banks (U/KBs) improved to 2.80%, lower by 0.15 percentage points from last month's 2.95% and lower by 0.51 percentage points from last year’s 3.31%. This is the fourth consecutive month that the average NPL ratio has been below 3.00%. Growth in outstanding loans of commercial banks, net of banks' reverse repurchase (RRP) placements with the BSP, accelerated in May to 18.8% from the previous month's expansion of 14.2%. The increase is the highest rate recorded since April 2009.
- Long-term, we remain bullish, but guarded on the short-term due to a confluence of external risks coming mostly from the US and Europe. Our strategy remains buying cheap, buying gradually into dips, and buying for the long-term.
- From a valuation perspective, despite price-earnings (P/E) multiples tracking higher than the region's average of 12.74x forecasted P/E for 2011 and 11.14x forecasted P/E for 2012, the local bourse is still trading below its historical mean of 15.0x, implying further upside. With the recent mass exodus out of equities, the index is currently trading at around 13.29x forecasted P/E for 2011 and 12.09x forecasted P/E for 2012, with prices dipping to attractive levels. Earnings for the second quarter continue to trend in line or above consensus forecasts, signifying greater interest for local equities. According to data on hand, 5 out of 9 index members have already reported earnings which blew past estimates in the second quarter.