

## **State Street Global Advisors' Statement on the Markets Following S&P US Long Term Debt Downgrade**

State Street Global Advisors (State Street) believes that so far, Standard & Poor's downgrade of the long term US debt has been greeted in a pragmatic way by investors, regulators, clients, and central banks. Many analysts and investors have claimed to have expected it for some time, and State Street's investment concern is less the downgrade as a per se indicator, but rather the diminishing set of choices available to boost US economic growth, and set federal finances onto a non-inflationary path.

As the markets face volatility on a global basis, our investment team has been carefully scrutinizing the risks and opportunities in financial markets. A summary of our current views follows:

### ***US Growth***

Revisions of prior economic growth, relatively weak current activity, and data supporting weakening confidence point to slow future growth for the remainder of 2011. This maybe reinforced by business and consumer nervousness that resulted from the political wrangling that took place over increasing the debt ceiling limit. We anticipate an environment that points to a combination of weak near term growth, but rising long-term inflationary expectations such that:

- Weak growth will take place over the remainder of 2011 (recent data suggest the chances of the economy contracting have increased slightly);
- Outright deflation is not imminent;
- The stabilization of markets and pre-emption of credit contraction may require additional quantitative easing.

### ***Europe***

Recent developments in Europe should not be overlooked by investors and policymakers. Compared to the lack of effectiveness of US policymaking, Europe looks to be even more pedestrian in its ability to keep up with, or get ahead of, current events. Markets have forced the European leaders and the European Central Bank to take action by driving yields on Spanish and Italian bonds higher. We note the following:

- Sovereign bond risk and bank capital risk have become entangled in such a way that questions about liquidity and the solvency under stress of many European banks, especially in the periphery, have increased.
- To restore stability, a more substantial commitment to Italy and Spain has been sought by fledgling markets. Recently, there have been moves toward a more radical policy, with purchases of bonds in the secondary market driving Italian and Spanish yields lower. Should this policy fail, the contagion risk across the banking system would be a more substantial risk than either a period of weak US economic growth, or further downgrades of the US long term debt by other rating agencies.
- The European Central Bank sees the funding strain on all European banks but the risk has not yet been made clear enough to voters in parts of Europe who would resist support to those nations that they judged to have failed to keep their house in order.

## **Asia Pacific**

The recent volatility in the global markets caused by S&P's downgrade of US long-term credit and the European sovereign crisis have spread to Asia Pacific, stunting growth expectations in the region. Many Asian economies were already expected to see a moderation of growth, prior to the US downgrade announcement, on the back of policy tightening measures by the Asian central banks in response to higher inflation and statistical basis effect from very strong growth in 2010. Going forward:

- Uncertainty on global growth outlook may lead to lower economic sentiment in Asia as exports growth and domestic consumption slow further.
- However, overall Asian economic growth should still be moderately robust as Asian economic fundamentals are still strong.
- The investment outlook on Asian markets remains relatively positive and expected fund flows still favour Asian markets once the knee-jerk reaction of risk reduction subsides.

## **Conclusion**

Whilst US economic growth remains a concern and the downgrade of long term US debt rating by Standard and Poor's is more than simply symbolic, our concern remains the resolution of the European sovereign crisis and whether this can take place quickly enough to prevent a damaging contagion through the financial system. The flight to safety - which inevitably if not ironically includes US Treasury bonds - has thrown in some potentially attractive valuations. A greater degree of clarity about the path to resolving these major risks is needed before deploying substantially more risk, but we have identified this moment as one where risk aversion is creating opportunity.

Should there be any queries concerning the above, please call +61 2 9240 7600 or email [info@spdrs.com.au](mailto:info@spdrs.com.au).

## **Important Risk Information**

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