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FINANCIAL REACTION TO U.S. CREDIT DOWNGRADE

Yesterday morning financial markets appeared to be set for a moderate correction in the wake of the S&P downgrade to the U.S. sovereign debt rating. Asian, European and North American equity markets were generally down 2-3% when we wrote our note on the financial reaction to the downgrade. However, the initial North American sell-off became a rout over the course of the afternoon that reeked of fear.

In our commentary, we stressed that in, and of itself, there was no rational reason for the lower credit rating to provoke panic selling. The US government is solvent and the risk of default remains negligible. Indeed, the probability of default associated with an AAA rating versus a AA+ rating is miniscule. Moreover, the fact that other credit agencies did not follow suit limited the financial consequences of the downgrade.

Accordingly, the market reaction yesterday can only be interpreted as a crisis in confidence. It was a vote of non-confidence in the ability of governments to deal with their fiscal problems. It was also a vote of non-confidence in the sustainability of the economic recovery. This was the worst possible outcome at the worst possible time.

The U.S. economy is extremely fragile. This can be seen by the fact that the combination of $4 per gallon gasoline, a supply chain shock from Japan and bad weather in the Winter and Spring were capable of stalling U.S. economic growth in the first half of the year. The expectation was that the waning of these factors would lead to markedly stronger economic growth in the second half of 2011. However, the financial rout has put this improvement in peril.

The issue is once again about confidence. The financial turmoil runs the risk of negatively impacting the psyche of consumers and businesses. If consumers and businesses cut back their spending because of worries about a renewed recession, it can easily result in the precise outcome that they are fretting about. It could also aggravate the correction in US housing, lead financial institutions to cut back on their willingness to lend, and worsen the US fiscal situation -- in other words, add to the various structural headwinds on the economy.

The traditional response to bolster confidence is verbal support from policymakers or, if that doesn't work, an easing in fiscal or monetary policy. Given that there has been a loss of confidence in the ability of governments to address their problems, verbal support has had little impact so far. Both the G-7 statement on Sunday and Obama's speech on Monday were entirely ineffective. This leads to the matter of policy actions. The bad news in America is that the scope for additional monetary stimulus is limited and fiscal stimulus is not likely feasible in the current political environment.

The bottom line is that the rout in financial markets has materially increased the risks of a renewed US economic downturn, which would have global ramifications. The sad truth is that it doesn't have to be this way. The current environment harkens back to FDR's speech in the 1930s that, "the only thing we have to fear is fear itself—nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance". The US government is not insolvent. There is time to deal with the fiscal challenges. And, the message from S&P and financial markets that greater fiscal progress is required will not be lost on policymakers. Given today's Federal Reserve decision, the immediate question is whether Bernanke can restore some of the lost confidence. The main message to investors, consumers and businesses is don't panic, try to have a bit of faith, and remember that you can be your own worst enemy.

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