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Graham Kitchen

Reaction to S&P US downgrade

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Late on Friday evening, we saw the S&P downgrade its rating on long-term US Government debt. Whilst this has had a negative impact on markets, it's important to remember that two of the major agencies have maintained AAA status for the US. As such, we don't expect it to have any major pricing implications for US treasuries. What it does highlight is the need for the US to adopt policies to put the federal budget on a more sustainable path over the medium-term.

It has also increased the pressure on the euro zone where, arguably, the long-term debt problems are far more severe. And, in fact, overnight, we've seen the ECB extend their buying programme of bonds to include both Italy and Spain. While this is to be welcomed, it really is only going to provide short-term breathing space; what is required is a coherent long-term strategy, agreed by politicians and on central banks to address the long-term debt issue in Europe.

The one positive that actually may come from the S&P downgrade is that it will hasten these policies to control the long-term debt issue. The challenge for policy makers will be both to address these long-term debt issues whilst, at the same time, maintaining a reasonable growth path, and therefore we would expect any long-term policies to be accompanied both in Europe and in the US by short-term stimulus packages.

So, where does this leave equity investors? Well, clearly volatility is likely to remain. Why will markets remain in a state of flux? Investors simply don't believe that central bankers and politicians have the will or the capability to address these issues. As mentioned, what may well happen is the S&P downgrade hastens these policies. For equity investors, when we look at the equity market, valuations remain extremely low; there is considerable value within equities. Furthermore, throughout the world, corporate balance sheets remain relatively robust. So, therefore, whilst GDP growth is likely to slow and there will be pressure on earnings, this is likely to be offset by a very low

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valuation, strong balance sheets and good dividend growth throughout many areas. Therefore, there are still considerable opportunities, within Asian markets and within European markets, particularly with companies with robust balance sheets, strong dividend growth and high dividend yields. In fact, whilst the S&P downgrade is clearly a negative for markets, and markets will remain volatile, what we may well look back on with hindsight is that actually this was an ideal opportunity to buy into equities because considerable value remains within the equity market.

Graham Kitchen, 8 August 2011