FLASH NEWS REPORT
Monday, August 8th 2011

Standard & Poor's downgraded the United States from "AAA" to "AA+". The unexpected certitude we all feared actually happened. It makes us think of the loss of someone close, whilst we all anticipate such events they shock us when it occurs. And then, the World continues to spin and life resumes its usual routine.
Here, the downgrade after the close of business Friday destroyed our weekend rest, wondering what will be as we listened to dire analysis and interpretations by the usual crop of wise guys on CNBC, CNN, BBC and Bloomberg TV. Sunday morning gave us an early glimpse of Monday, as Middle Eastern Markets (the only ones open on Sundays) fell rather harshly, 4 to 5% across the Gulf and Israel. The latter closed the market early to prevent panic selling. Timothy Geithner, the US Secretary of Treasury slammed the imbecility of the irresponsible, baseless rating change. Sunday night was difficult, all expecting confirmation in the East that the markets will punish investors. They did that, again, 2 to 4% drops across the region.
This morning, after a brief dip, all European markets went to green before slipping back in to the red. The US Futures having pared their losses quite significantly, are now showing losses around 2.50% Not nice, but not the "Black Monday" fears many had harboured.

Yields on US Treasury Bonds and Notes are lower, implying the market is pleased the downgrade was not as bad as might have been feared!? The currencies are surprisingly stable, Euro trading at 1.430 as we write, the Swiss Franc at 0.7600 and the Japanese Yen at 77.70 All within a hair of the "Pre-News-Moment". Another *Huge Non-Event* or is there more to it than meets the market eyes? Gold shot-up through $1'700 and settled back some to trade now at 1'709.

In Europe, our second pole of attention, the ECB has agreed (albeit reluctantly) to commence purchases of Italian and Spanish bonds. This is a stop-gap activity awaiting the establishment of the European Fund which will pursue this later, in essence a Euro-TARP. Perhaps the markets will accept this as more than a band-aide and a harbinger of a European Treasury?
We are reminded of an old Hebrew adage "Me'az yotsé matok" which in its essence states that from hardship sweetness is extracted. Perhaps this wake-up call from Standard & Poor's will help bring back some serious focus to the US Administration? The reaffirmation of France's "AAA" rating may give support to the European realignment?

The risk of a US downgrade has materialized, so uncertainty has been reduced. At Bedrock we view the downgrade as a relief. This could give markets a short-term breather and therefore a likely upwards move in equities, bond prices and possibly even a boost to the US Dollar. Echoes of 2008-9 "less badder" news?

This said, the bare reality is that the US has amassed an unsustainable level of debt and has a serious governance problem. The rating agency may have erred in the details of their analysis but they did hit the nail on head as to the core of the problem.

Opening our eyes wide we can see how the *resolution* of the 2008 financial crash was only a shift of the problem from corporate to sovereign, kicking the can down the road... As GM is reviving, its saviour is wobbling.
As Europe fixes Greece, Italy is shaken. We can be sure that interest rates in the West (and Japan) will not rise for a very, very long time. Real interest rates are likely to be held in negative territory to help debtors (governments) amortize their obligations over time. A ball-park analysis of the USA debt burden implies that each American owes around $500’000. This compares to a median household income of about $50’000. Say average household of 3 people, then each American has about 17K of revenue with which to repay 500K. With interest at zero, this would require 30 years of repayment… Interest rates must be made negative to reduce the time needed to repay.

What should we be doing now? We own bonds and have done well with them. Most of the returns realized are attributable to the gains from the fall in yields but looking forward, these are unlikely to compress much further. We only find value in corporate bonds where the yields remain positive in real terms. Where else may we seek returns? Commodities are falling into expectations of slowing growth (demand), so probably not here either. This gives us reason to expect capital to resume its flow towards global equities which are the only source of real growth. But be warned, the road ahead is likely to be bumpy.
On the currency side, the strength of the commodity countries such as Australia may be ebbing as their revenues may weaken. The haven countries with sane finances such as Switzerland, Norway, Sweden and the like are all too small to absorb the need for safe haven, much like Gold. So these may have had their run, for now. Perhaps, just perhaps, it is time to reconsider the US Dollar? Arguably, the $ has already taken its haircut and may be ready for stability or even a rebound?

We now can appreciate the Chinese curse “May you live in interesting times”…
