

## Implications of Moody's Downgrades

### Ratings Adjusted on European Sovereigns

- More Sovereign Downgrades:** On Monday 13 February, Moody's downgraded Italy (by one notch to A3), Spain (by two notches to A3) and Portugal (by one notch to Ba3). The UK, France and Austria remain Aaa but have been put on Negative Outlook.
- Muted Market Reaction:** The ongoing deterioration in Europe's credit quality is nothing new and markets had already moved to discount such a re-appraisal by Moody's, in our view. This can be seen by the broadly muted secondary market reaction this morning and by Italy's successful BTP auction, which was met with healthy demand.
- Inflation Indices:** For the BTPei market, the one-notch downgrade means that BTPei will remain in a widely followed inflation index. However, we doubt that it will bring any lasting support for BTPei. Our concern is that the prolonged uncertainty of index exclusion (which will be triggered by another downgrade from Moody's) will weigh on market liquidity in the months ahead.
- Long-Term Outlooks:** Moody's has put several EMU sovereigns on Negative Outlook, typically indicating a 1/3 chance of a ratings change over the next 18 months. In our view, this highlights the broader question of the ability of the current policy mix to deal with funding pressures and economic deterioration. Without the correct policy responses, further downgrades are likely.

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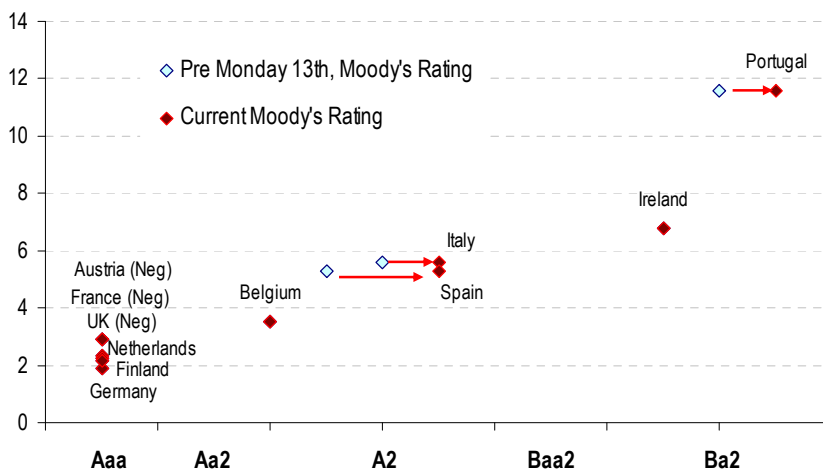
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Figure 1. Moody's Rating Changes for Select European Sovereigns vs 10yr Yield (%)



Source: CIRA, Bloomberg, Moody's

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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# Implications of Moody's Downgrades

## Muted market reaction and few surprises

On Monday 13 February, Moody's adjusted its ratings assessment for 9 European sovereigns. In our view, the majority of the moves should not come as a surprise. Note this review was part of a broader assessment by Moody's which had signaled Europe's deteriorating credit worthiness in November last year<sup>1</sup>. In general, downgrades and negative outlooks were a function of three broad drivers varying in degree by sovereign:

### Factors behind the downgrades

- Prospects for institutional reform / available resources to confront the debt crisis
- Worsening macroeconomic prospects including growing implementation risks
- Variability in market confidence as result with implications for market funding

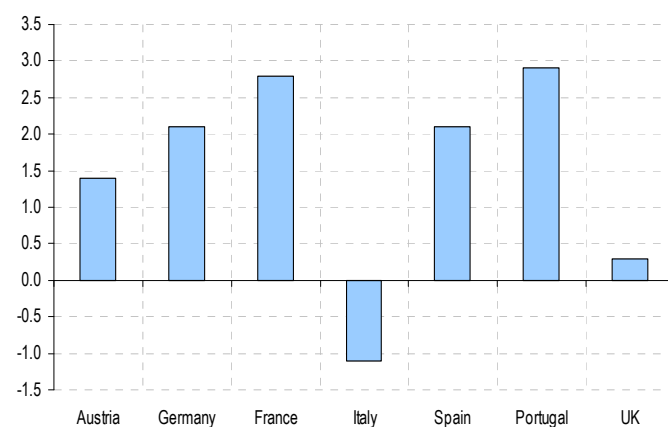
Furthermore, many had anticipated such moves and Citi's views can be found in January's edition of our [Sovereign Ratings Outlook - January 2012](#). For instance, we had forecast a Negative Outlook for France, Austria and the UK (over the longer term) and downgrades for Italy and Spain (albeit we had one notch for Spain and two for Italy). Further details can be found here: [Sovereign Debt Crisis Update](#).

Figure 2. Moody's Rating Actions on Select European Sovereigns

	As at 12th Feb 2012		Post 13th Feb Statement	
	Rating	Outlook/Watch	Rating	Outlook/Watch
Austria	Aaa	Stable	Aaa	Neg Outlook ↓
Belgium	Aa3	Neg Outlook	Aa3	Neg Outlook
Finland	Aaa	Stable	Aaa	Stable
France	Aaa	Stable	Aaa	Neg Outlook ↓
Germany	Aaa	Stable	Aaa	Stable
Greece	Ca	Developing	Ca	Developing
Ireland	Ba1	Neg Outlook	Ba1	Neg Outlook
Italy	A2	Neg Outlook	A3 ↓	Neg Outlook ↓
Netherlands	Aaa	Stable	Aaa	Stable
Portugal	Ba2	Neg Outlook	Ba3 ↓	Neg Outlook ↓
Spain	A1	Neg Outlook	A3 ↓↓	Neg Outlook ↓
UK	Aaa	Stable	Aaa	Neg Outlook ↓

Source: Moody's, CIRA

Figure 3. Morning Change in 10yr Yields, Tuesday 14<sup>th</sup> Feb (bp)



Source: Bloomberg, CIRA

### Rating changes largely discounted by the market

In our view, the rating changes were largely discounted in market prices and also act as a normalisation with the S&P rating changes of 13<sup>th</sup> January. This can be seen in the relatively muted change in yields on Tuesday morning (Figure 3).

### The salient points for bond markets in our view are as follows:

**(1) Gilts:** We believe that the credibility of the UK's willingness and ability to engage in a fiscal consolidation programme remains intact. In this sense, the UK's attractiveness is independent of its Aaa status as is the MPC's QE programme. We do not expect this announcement by itself to trigger a significant fiscal or monetary policy response ([UK – Moody's Put UK on Negative Outlook](#)) – if anything, it could affirm the Chancellor's economic strategy. There was no significant sell-off in gilts in response as we would expect and we remain constructive on the gilt curve over the medium term ([UK Rates Strategy](#)). Indeed, the broader negative assessment across Europe could, at the margin, enhance gilts' appeal.

<sup>1</sup> Moody's Investor Services 28<sup>th</sup> November: *Rising Severity of Euro Area Sovereign Crisis Threatens Credit Standings of All EU Sovereigns*.

Figure 4. Current S&P and Moody's Ratings

Country	S&P		Moody's	
	Current	Outlook	Current	Outlook
Germany	AAA	Stable	Aaa	Stable
France	AA+	Neg	Aaa	Neg ↓
Italy	BBB+	Neg	A3 ↓	Neg
Spain	A	Neg	A3 ↓↓	Neg
Austria	AA+	Neg	Aaa	Neg ↓
Belgium	AA	Neg	Aa3	Neg
Finland	AAA	Neg	Aaa	Stable
Greece	CC	Neg	Ca	Developing
Ireland	BBB+	Neg	Ba1	Neg
Netherlands	AAA	Neg	Aaa	Stable
Portugal	BB	Neg	Ba3 ↓	Neg
UK	AAA	Stable	Aaa	Neg ↓
Swiss	AAA	Stable	Aaa	Stable
Sweden	AAA	Stable	Aaa	Stable
Denmark	AAA	Stable	Aaa	Stable
Norway	AAA	Stable	Aaa	Stable
EFSF	AA+	Developing	Aaa	Stable

Source: S&P, Moody's, Citi.

**(2) BTANs, OATs, RAGBs:** The Negative Outlook placed on France and Austria should not come as a surprise. S&P actually downgraded both sovereigns to AA+ on 13<sup>th</sup> January. What happens next is partly a function of the broader economic malaise across EMU but also dependent on idiosyncratic factors. Specifically, Austria has to contend with its weakening banking sector and its "substantial exposure to the more volatile economies in Central and Eastern Europe<sup>2</sup>". On the other hand for France, Moody's highlights that "an unsuccessful implementation of economic and fiscal policy measures" generating further debt weakness could add to further ratings pressure. Citi's view, as published in the [Sovereign Ratings Outlook - January 2012](#) is that both sovereigns are likely to move one notch lower over the long term from their current ratings by both S&P and Moody's.

**(3) BTP/BTPei:** Citi had originally forecast a two notch downgrade for Italy within this Moody's review from A2 to Baa1. The move lower by one notch to A3 is still above S&P's current BBB+ (Figure 4). Such rating assessments are largely discounted by the market in our view. Yields hardly reacted and Italy successfully auctioned bonds in the 3yr-5yr sector on the same day with reasonable demand ([Auction Assessment: 3- and 5-year BTP](#)). For inflation markets, the one notch downgrade means BTPei remain eligible for a widely followed inflation index. A two notch downgrade would have triggered exclusion. Our key concern now is that the prolonged uncertainty of index exclusion will weigh on market liquidity in the months ahead. See [BTPei Update: Implications of the Moody's Downgrade](#) for more details. Going forward, Citi expects further downgrades over the longer term possibly to BBB- (S&P) and Baa3 (Moody's) predicated on further economic weakness.

**(4) Bonos:** Moody's downgrade by two notches to A3 was more severe than Citi's expectation of a one notch downgrade. However, as with the majority of the rating adjustments, the deterioration in Spanish creditworthiness is hardly new. Going forward, Citi expects further ratings pressure, possibly to BBB+ (S&P) and Baa1 (Moody's) given ongoing economic weakness. What is perhaps more important for the secondary market will be upcoming auctions. To date, Spain has had considerable success in issuing 24% of its 2012 pipeline with auction amounts often exceeding target sizes. Issuance comes on 16<sup>th</sup> February.

**(5) EFSF:** The EFSF remains on Aaa Stable given the irrevocable and unconditional guarantees of the participating EMU Member States. Moody's highlights that the EFSF could be put on Negative Outlook or be downgraded if there were a deterioration in the creditworthiness of the participating euro area member states (as reflected by a change in Moody's ratings for these states)". As Citi expects underlying ratings to edge lower, the EFSF's rating could therefore come under renewed pressure over the longer term

## Conclusion

The significance of the Aaa standard for European sovereigns has clearly been damaged. However, much of today's ratings action has been well flagged by Moody's and spreads and yields had already moved to take such considerations into account. What will likely govern the broader trajectory of EMU spreads in coming months (and weeks) will be the evolution of the policy response to the wider crisis. A failure on the part of policy makers to make significant headway to reduce debt burdens will likely lead to further ratings actions over the longer term, but market spreads are likely to lead the way rather than wait for the rating agencies themselves, as argued in [Euro Rates Strategy - The Implications of S&P's Sovereign Downgrades](#).

<sup>2</sup> Moody's Investor Service: *Rating Action: Moody's adjusts ratings of 9 European sovereigns to capture downside risks (13<sup>th</sup> February 2012)*

EMU spreads likely to lead the way rather than wait for the rating agencies themselves

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## Implications of Moody's Downgrades

14 February 2012

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