



Flight to “Quality” or Force of Habit?

At the time of writing, US Treasury Bills were yielding BELOW 1% for tenors 6 months or less. The three month went from yielding 1.57% on 11 September to 0.05% on 19 September. In the same timeframe, the 1 month dropped from to 1.5% to 0.25%, while the 6 month slid from 1.45% to 0.61%. You can see the movement for the 4 week and 3 month Treasury Bills graphically in Charts 1 and 2.

Chart 1 – 4 week



Source: Bloomberg

Chart 2 – 3 month



Source: Bloomberg

What might cause such a dramatic drop in US treasury yields – to levels where the real rate of return would be in the vicinity of -5% given a year-on-year CPI of 5.4%? What would prompt investors to pull funds in what can only be described as a mass exodus from almost every asset class including commodities, equities and bonds, to place these funds in US government securities yielding less than 1%? Why would investors opt to earn less than they could if they placed their funds in a typical bank account?

The answer – a dirty four letter “F” word – FEAR.

One of the known effects of fear on the brain is that it creates distortions to one’s perception of reality, which could then lead to a reaction which is exaggerated, inappropriate, or irrational.

Any major market upset is followed by the usual “flight to quality” where investors remove their funds from investments which could possibly be affected by this event, and park said funds in the so deemed risk-free, safe-haven that US treasuries represent. I would argue that this unprecedented level of demand seen for US treasuries is a knee-jerk response or a force of habit – one that probably would not have taken place, or would have been of a smaller magnitude, had more careful consideration been given to some of the facts I would now attempt to explain in detail. The belief that US treasuries are the safest of instruments stems from the underlying assumption that the probability or risk of default is zero. But how safe is it to make this assumption under the current scenario?

The root of the assumption that there is zero risk of default stems from the notion that the US can print an infinite amount of US dollars to service any amount of debt, and the rest of the world will accept these dollars without question. Standard and Poor's seems to consider this factor most significant in its assessment of the credit rating of the sovereign. On 2nd September, Standard and Poor's reaffirmed their credit rating of the US at AAA with a stable outlook, based on the following assessment quoted from their report: "The ratings on the U.S. rest on its high-income, highly diversified, and exceptionally flexible economy.

The ratings also reflect the U.S. public sector's fiscal flexibility and the **unique advantages coming from the dollar's preeminent place among currencies**. These strengths outweigh growing risks in its financial sector, longer term challenges of its entitlement programs, and the nation's weak external position. The U.S. has arguably the most flexible economy of any high-income nation, with both exceptionally adaptable labor markets and a long track record of openness to capital flows, as well as minimal government intervention. In addition, the public sector uses a far smaller share of national income than in the U.K., France, or Germany (all AAA/Stable/A-1+), implying greater revenue flexibility; and **the U.S. dollar is by far the world's most used currency. The latter characteristic provides unique external flexibility: The vast majority of U.S. trade flows and external liabilities are denominated in its own dollars. We do not expect that this privileged position will diminish in the medium term...**"

Notice they said "Medium term". Historically the US Dollar has been the universally accepted currency, but we have witnessed the winds of change manifesting itself in subtle as well as significant moves – Kuwait removed its currency peg from the USD, dollars no longer being accepted to enter the Taj Mahal and other tourist attractions, various US rap artistes displaying their wealth in Euros in their music videos and supermodels demanding payment in Euros. This trend is bound to spread and gain severity in impact as time progresses, and as weakness in the financial system transfers to the real economy.

But what about the other factors that analysts and credit rating agencies usually focus on to gauge the creditworthiness of a sovereign?

The level of political risk, economic structure and growth prospects, level of debt, fiscal flexibility, monetary flexibility and external liquidity are the major categories typically examined.

On the political front, the US general elections to be held in November most likely poses very little threat to policy continuity, except as it relates to foreign policy and national security. All else should remain relatively unaffected. But foreign policy and more importantly the use of military force overseas in particular can potentially have a significant impact on national security via foreigners' perception of and reaction to said policies. Obama seems to be more willing to engage in dialogue and negotiation and use military force less readily than the more trigger-happy Vietnam veteran McCain. Overall, the outcome shouldn't materially affect US creditworthiness.

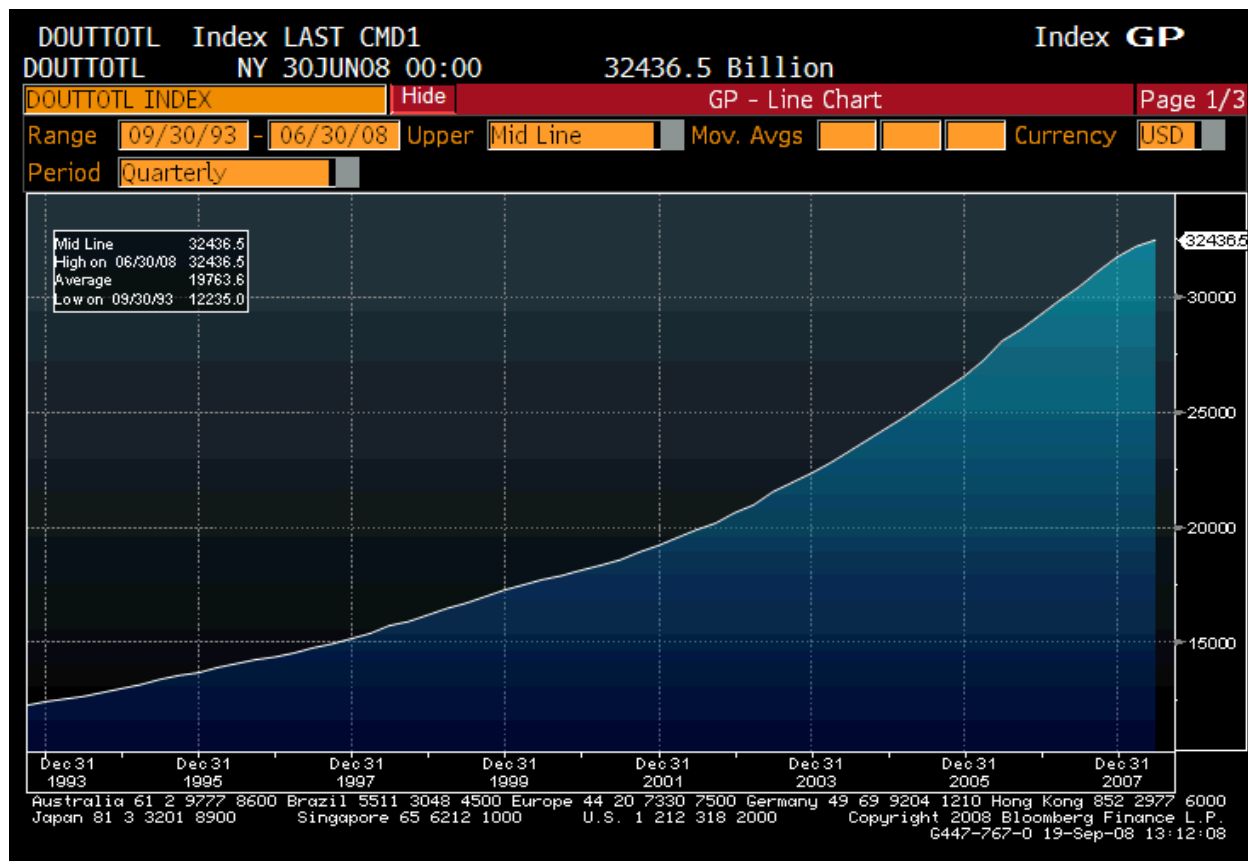
With respect to economic structure and growth prospects, we know that the US economic structure is based heavily on domestic consumer spending. Consumer spending in the US is largely credit driven and confidence induced – and we know that both the availability of credit and the level of consumer and investor confidence have taken a severe beating in

the past year. Another factor in the spending equation is employment and wage levels. Unemployment in the US is running at 6.1%, and like consumer confidence, growth in hourly earnings and growth in personal consumption growth, these are levels that have not been seen since the last recession more than 5 years ago.

Economic growth as measured by the quarter-on-quarter annualized GDP growth rate stood at 3.3% for Q208 after having dipped briefly into negative territory at -0.2% for Q407. Growth has been propped up by export demand which was buoyed by the weak USD against other major currencies. Given that the USD has posted a rally over the past quarter, one would expect to see export growth soften, particularly as other economies tighten their belts in anticipation of a recession and in the face of diminished consumer confidence. Overall, one would expect economic growth to continue to slow in the US, which does not bode well for creditworthiness.

Debt levels in the US are astounding. Total debt outstanding stood at USD32.4 trillion as at 30 June, 2008. Chart 3 shows how this figure has moved since 1993. Given that nominal GDP stood at USD14.3 trillion as at the same date, this gives a total debt to GDP ratio of 226.6%. Given that this ratio is set to rise due to increased debt issuance and falling GDP growth, despite the US's ability to print an infinite number of US dollars, this level of indebtedness must affect primary fiscal balances, fiscal flexibility and ultimately, ability to repay. There must be an element of risk at these levels. This to me does not inspire confidence or reflect a well managed economy.

Chart 3 – Total Debt Outstanding



Source: Bloomberg

On the issue of fiscal flexibility, the fiscal balance has been in deficit since the middle of 2001, hitting a low for the FYE 2004 of -USD412.84 billion, recovering somewhat to FYE 2007 of -USD162.83. Interest burden has reached an all time high of USD25.142 billion for the month of August 2008 to total for the year to date USD171 billion. When added to entitlements and other mandatory spending of USD1.45 trillion for the year ended December 2007 (conservatively assuming no growth to this consistently upward trending figure, for simplicity) amounts to an estimated total non-discretionary spending level of USD1.620 trillion for 2008. Compared to total revenue of USD2.567 trillion in 2007 (again assuming no change for the sake of simplicity) this means that 63% of the government's fiscal spending is NON-DISCRETIONARY which means that fiscal flexibility is severely handicapped. How can this not be interpreted as a risk in terms of creditworthiness?

In light of recent events where Fannie Mae, Freddie Mac and AIG have in effect been nationalized, and we may see more events of this nature, the level of debt issued may spike. Standard and Poor's estimates bailing out that Fannie Mae and Freddie Mac could translate into an upfront worst-case scenario cost to the Government 2.5% of GDP. Added to AIG which cost USD85 billion, the total outlay for the Government in bailouts alone for the past month has reached an estimated 2.6% of GDP!

With respect to external liquidity, the US's current account deficit stands at USD183 billion, and in relation to GDP, stands at 5.1%. This figure has recovered however from the peak of 6.4% in Q306 at USD210 billion. As stated previously, the USD rally will adversely affect exports but imports should become cheaper as well. This ratio, although relatively high for a developed country, does not appear to pose a significant challenge to the sovereign's ability to repay debt, since they do not depend on foreign inflows of USD to repay debt in USD.

All things considered, it would appear that there are risks to the US's ability to service its ever increasing unsustainable level of debt. This pessimistic view is of course reinforced by the recent turmoil in the financial sector which has cost the US governments a tidy sum directly, and who knows how much more indirectly. US treasuries should not be considered risk-free, and as such, the yields available on these instruments should not be considered the risk-free rate of return. Furthermore, the yields displayed in charts 1 and 2 do not compensate the investor for the risk of holding these instruments, and maybe investors would be better off, risk-return wise, holding cash.

FINANCIAL & ECONOMIC INDICATORS

As at 18 September, 2008

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	105.44	107.17
Euro	1.43	1.40
Jamaica	72.30	72.19
Guyana	205.20	204.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	97.88	100.87
Natural Gas (US\$/mmbtu)	8.11	7.83
Gold (US\$/Troy Ounce)	850.84	746.47

Eurobond Indices (Return % YTD, as of 11-September-08)

Lehman Brothers Global Aggregate Index	1.40
JP Morgan EMBI+ (percentage change)	60.00
CMMB Eurobond Index	n/d

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0.25	2.00
Euro Zone	4.25	4.25
Japan	0.55	0.50
Brazil	13.75	13.75
Trinidad	8.50	8.50
Jamaica	13.50	13.50
Barbados	4.50	4.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.08	1.59
US 10-Yr Treasury	3.55	3.64
3-month UK Libor	5.98	5.71
Japan 90-day T-Bill	0.53	0.53
Brazil 90-day T-Bill	13.90	13.80
TT 90-day T-Bill	7.30	7.30
Jamaica 90-day T-Bill	14.81	14.58
Barbados 90-day T-Bill	3.63	3.77

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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