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Ratings & Downgrades: Opportunities in a Spooked Market

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The ratings downgrades that are spooking many of the developed economies might hold promise for Asia in the long-term, although some of the region's newer economies will need to get their political houses in order to get a credit rating, says Professor Annie Koh.

The downgrade of the credit ratings for the U.S. and the U.K. was not surprising, Professor Annie Koh, Associate Professor of Finance and Vice President of SMU's Business Development & External Relations office tells Perspectives@SMU. "The markets have been aware of the economic uncertainty of the two countries. A credit rating simply reinforces what the market is already expecting and there are many times when the markets don’t react to news of the downgrade itself because they have already taken their position.”

And credit agencies are usually late in their assessments, she adds.

Tell-tale signs that a ratings downgrade is just around the corner include a budget deficit that exceeds eight percent of a country’s gross domestic product (GDP).

“However I would say, don’t even think about the ratings,” says Koh. “You should look at the bond yields of any new bond issue coming out from that country. If you have to pay a very high interest rate (coupon level), that in itself is a great indication that your ratings are ‘on the nose’.”

Solutions for the troubled Western economies are often paradoxical. Continuing to spend requires increased tax revenue. “But if you collect tax, it takes away the stimulus impact of your spending,” she adds.

Impact of sequestration

The U.S. decision to impose automatic spending cuts (sequestration) is considered controversial and one that may have unexpected consequences for U.S. trading partners.

In the case of Asia, the impact of both the downgrades and sequestration will be immediate, says Koh. Many U.S. companies may stop or reduce their buying: their domestic market may start to look for substitutes; and manufacturing plants located overseas may be encouraged to return to the U.S. to meet local market needs.

On the other hand, the net effect for Asia may be an opportunity.

“Asia will need to look towards other markets in Asia. We have to learn how to buy from one another and to build our own domestic markets,” she says.

It means identifying Asian global companies that can provide the same services once provided by the Western multinationals.

Singapore itself is in an excellent position in the post downgrade scenario, she adds.

“Every company looking to build a presence in Southeast Asia will naturally come to Singapore and use her as their headquarters, or their knowledge centre. Meanwhile the operational units that require large numbers of people—something Singapore doesn’t have—are located in Indonesia, Malaysia, Thailand, and the Philippines. To me, it’s complementary.”

At the same time, ASEAN Connectivity 2015 and theTrans Pacific Partnership (TPP) are set to broaden domestic consumption and our intra-Asian trade, she adds.

Further down the road, continues Koh, if investors no longer wish to buy U.S. or European bonds, and institutional investors start to liquidate to try to get their cash back, they will need to consider whether or not to park their funds in Asia’s bonds, private equity funds, gold, or high-grade corporate bonds.

“There is a demand for quality credit bonds and we are seeing a number of Asian bonds being issued, such as those from Temasek-linked companies.”

Getting the political house in order

Interestingly, says Koh in a nod to some of Asia's newer economies, there are very few occasions in which there is a correlation between political risk and credit ratings.

"People like to think that the two are related. Credit involves your ability to borrow and repay money. But that doesn't mean that if you cannot pay your interest or debt, you suddenly become more likely to expropriate other people's property and are a political risk."

In newly emerging markets, the political climate, more so than credit rating-related issues takes priority. Investors looking at Myanmar, for example, are worried about the rule of law in place in that country, she says.

"The chances of Myanmar being able to issue its own bonds is highly unlikely right now, because given the political uncertainty, nobody is going to give them a good credit rating."

Basically the country doesn't have a rating, she continues, and the only way for Myanmar to build its economy and to encourage people to invest there is through borrowing from the World Bank, or the International Bank for Reconstruction and Development (IBRD).

Credit will only be able to come to Myanmar's market place when the country moves to the next level, when the rule of law is respected, and investments ownership can be respected. In addition, markets will need to be open and only then , will the respective Myanmar ministries and regulators be able to entice more banks and capital into enter the country.

Once the private sector has been convinced, Myanmar will be in a position to get a credit rating. "Credit will come if you get your political house in order first."