



No panic as US default deadline looms

The Swiss franc has become the new safe haven for investors

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THREE words that investors never thought would appear in the same sentence — except in the same context as “when hell freezes over” — are “United States default.” But in just over a week, Uncle Sam faces the ignominy of not meeting its obligations as and when they fall due.

It would be the first time since 1979 that this had occurred, although that was put down to computer-system failure.

If congress does not vote by August 2 to extend the US’s debt ceiling, President Barack Obama and Treasury Secretary Timothy Geithner have warned certain social security payments will not be able to be made.

Would that constitute default? That semantic exercise is bouncing around global investment markets and the ratings agencies like a rogue pinball.

But on August 4, \$US30 billion (\$27.6bn) worth of short-term US Treasury bonds are set to mature. A further US\$29bn in interest payments on Treasury securities is due to investors on August 15. If the US government fails to honour these obligations, that is default.

Ordinarily, the US defaulting would be considered the financial equivalent of an asteroid slamming into the markets. It is unthinkable: it would make the market dislocations of the GFC look like a picnic.

But the present scenario is more a case of technical, or selective, default, where the US is reorganising its fiscal settings. However, the fact remains that in little over a week, the US could lose its AAA credit rating, to AA+, or even AA (de-

pending on whether you talk to Standard & Poor’s, Moody’s or Fitch Ratings.) So why aren’t investors panicking?

“The assumption seems to be, ‘if the Treasury market isn’t freaking out, I won’t,’” says Sean Callow, currency strategist at Westpac. “There is a wide presumption of a last-minute deal, to do just enough on the debt ceiling in terms of spending cuts — something like \$US1 trillion-\$US1.5 trillion over 10 years. US Treasuries are actually strengthening, behaving as the safest asset across the risk spectrum, which is bizarre under the circumstances.”

Michael McCarthy, equity strategist at contracts for difference (CFD) provider CMC Markets, agrees. “It looks like the bond market pros don’t think a default scenario is going to happen. The US 10-year bond is at 3 per cent: the two-year notes are only yielding 0.4 per cent. If there were any real risk of default, the market would take those yields much higher. Those implications are telling you that the market impact would be small.”

McCarthy points out that the biggest holders of US Treasuries are China and Japan, who would see any downgrade as technical. “I don’t think the Chinese or Japanese would think that the US Treasury is saying to its security holders, ‘you can’t have your interest or principal’. If they defaulted on the Treasuries’ interest later in the month, well yes, all bets are off.

“But I think the biggest holders of the Treasuries would understand that even a technical downgrade to AA+ would still

represent an assessment that it is highly likely that debts will be paid.”

Callow says the markets “definitely believe” that the interest payments due on August 15 will be paid. “If they were not, the sharemarkets would certainly be sold-off, but perversely, money would flow into Treasuries. If the Treasury market is right, there would be a knee-jerk ‘flight to safety’ into Treasuries and into the US dollar. That would result in a weaker Australian dollar.”

The combination of US and European debt uncertainty could push the Australian dollar back to parity, says Callow. “The Australian dollar is certainly at risk. If the US hit a real sovereign debt crisis when Europe was still struggling — and in fact there is scope for Europe to get a lot worse — you could see the Aussie below \$US1. How does that sound? It’s now a bearish call to see the Aussie at parity.”

Local investors are far from complacent about the US and European debt crises. In fact, says McCarthy, hedging activity is on the rise. “Over the past three months, we’ve seen a definite pick-up in the outright selling of the Australian index,” he says.

“Also, the holding period of those short (selling) positions is increasing: our average period would have moved from one week to two weeks. Like any average, that can be misleading: some people hold for more than two months, while a lot are in and out in a day. But I would say that there has been a definite increase in people holding short CFD positions on the Australian market for more than a



month.”

CFDs suit the hedging of individual shareholdings because investors can take a ‘short’ CFD position over the exact number of shares they hold, but Chris Weston, head of institutional dealing at CFD provider IG Markets, says he is “not seeing a lot of single-stock hedging activity”. But he is seeing “a huge pick-up” in short activity in the Australian index.

“We’ve been seeing a lot of traders looking to short the MIB Index (Italy), the CAC (France), the IBEX (Spain) and the US indices, but it is obvious lately that a lot of people want to sell the Australian index to protect a portfolio. Or they will express their bearishness by going long (buying) gold — gold is making higher highs and lower lows, it’s at record levels in many currencies — or in the currencies.”

With Europe holding centre-stage until recently in the sovereign-debt horror movie, Weston says it was common to see Australian CFD clients “playing” the dislocation by selling the euro to buy the US dollar. “That’s turned around now. We see a lot of people

selling the US dollar to buy the Swiss franc. The Swiss franc is the new safe haven,” he says.

Another area where Australian investors like to hedge their shareholdings or take a directional bet on the indices is the listed warrant market, but the level of protection activity apparent there is “nothing more than we’ve seen in the last couple of years”, says Rebecca Fesq, vice-president, warrants and structured product sales at Citigroup Global Markets.

“You might have thought that protection activity would have suddenly jumped as people became alarmed about the looming US debt ceiling deadline, but it hasn’t actually happened,” says Fesq. “In fact, at the moment there are just as many long warrant positions on the Australian index as short.”

Moreover, she says, traders aren’t holding short positions for long enough to indicate that they’re protecting portfolios.

On the bond market, Jim Stening, managing director of fixed-interest broker FIIG Securities, is seeing a “flight to safety” into the

commonwealth government and state government bonds. “You’re getting low 4 per cent for one to three years in the CGBs, but around 4.5 per cent for the bigger, more liquid state issues of the equivalent term — Queensland, NSW, Victoria.”

Stening says retail fixed-interest investors have learned a lesson from the GFC, when they headed into the listed interest-bearing space — for example, the listed hybrid securities (so named because they carry some of the characteristics of debt and equity) because of the higher yields.

If a retail investor is “really worried”, says Stening, term deposits are a good option to ride out the storm (see table). “Australian retail investors have a high degree of confidence in the Australian banking system, which makes term deposits a comfortable place for them to place their funds.

“These deposits are guaranteed by the commonwealth — although this is under review — and pay higher returns than government bonds so it makes sense to consider them.”



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Retail rates

Per cent per annum
RBA cash 4.75

	Days		
	90	180	365
CBA	5.50	5.90	6.00
NAB	5.55	5.90	6.00
ANZ	5.60	6.00	6.00
St George	5.50	5.85	5.90
Suncorp	5.95	6.11	6.11
BOQ	5.90	6.05	6.10
ME Bank	5.85	6.05	6.15
Bendigo	5.60	5.90	6.10

Source: FIIG Securities