Investment News

Monthly Bulletin from the Insurance & Investment Team

June 2018

Last Month in Brief

The Office for National Statistics (ONS) announced a 0.5% decline in UK productivity (per hour) in the first quarter, the first drop since 2015. This brings hourly productivity back to the level observed pre-financial crisis and economists continue to warn that UK productivity lags behind that of major trading partners. Despite this decline, overall output has continued to rise, which economists have attributed to longer working hours and reduced unemployment levels.

In May the pound fell against the US Dollar to $1.3261 as UK inflation fell to 2.4% in April. This represents the third consecutive monthly drop in the consumer price index (CPI) and is the lowest level for CPI in 13 months. The ONS has attributed this to cheaper air fares, food and men's clothing, whilst being slightly offset by a rise in fuel prices. Traders have speculated that this will reduce the likelihood of an interest rate rise in August as the Bank of England aims to keep CPI close to its 2% target.

On May 31st Trump extended, with immediate effect, the trade tariffs on steel and aluminium to Canada, Mexico and the European Union. This announcement resulted in a rise in American steel and aluminium stocks and a fall in the Dow Jones index due to trade war fears. All three competitors have retaliated by threatening the imposition of similar tariffs on American imports. See our Trade Wars: March 2018 bulletin for more information on this.

Chart 1: Equity Indices
FTSE and European markets peaked mid May but then dropped back. North American markets rose over May.

Chart 2: Sterling Credit Spreads
Credit spreads on all bond ratings rose over the month.

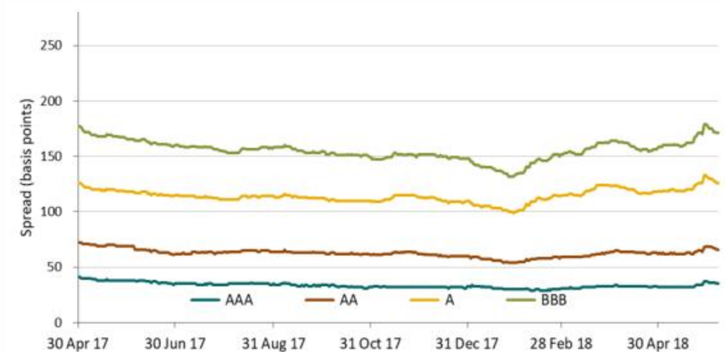


Chart 3: Gilt Yields
All yields fell over the month.

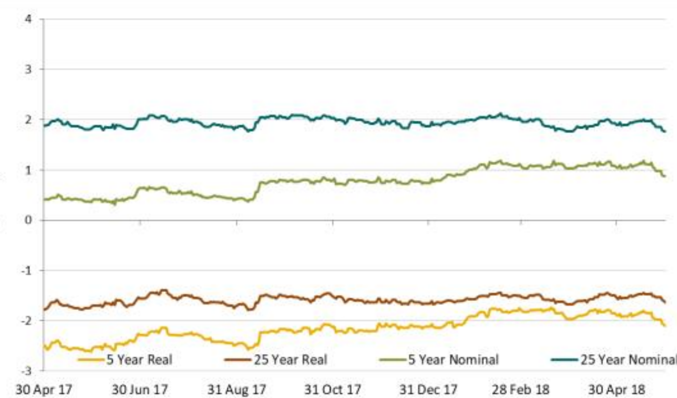
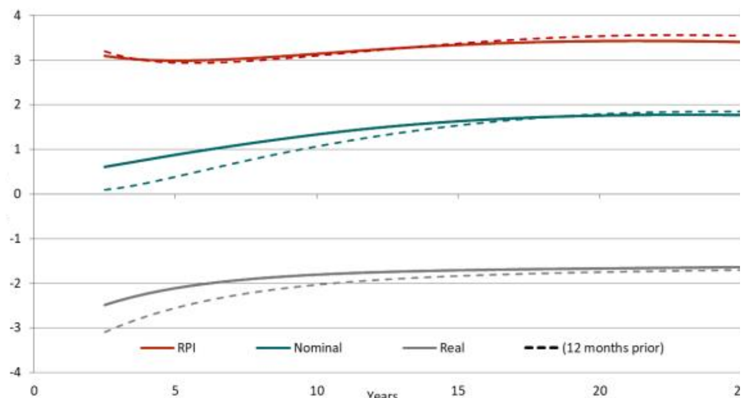


Chart 4: Gilt Spot Curves
The yield curves were stable over the month



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	+2.4%	+2.5%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	95.1%	93.1%	**$/£ exchange rate**	1.33	1.38
Halifax house prices (monthly change)*	+1.5%	-3.1%	**VIX (volatility) index**	15.43	15.93

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

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Credit Rating Agencies (CRAs)

Earlier this month, the credit rating agency Standard & Poors (S&P) downgraded Deutsche Bank's rating. In this article we take a closer look at credit rating agencies and how they influence the capital markets.

What is a Credit Rating Agency?

A credit rating agency (CRA) is a company that assigns credit ratings to governments and large companies on their ability to pay back debt by making timely interest payments, and their likelihood of default. The ratings can also affect the amount that companies or governments are charged to borrow money.

An agency usually rates the creditworthiness of issues of debt obligations including government bonds, corporate bonds, certificate of deposits, municipal bonds, preferred stock, and collateralized securities, such as mortgage-backed securities and collateralized debt obligations (CDOs).

What are the benefits of CRAs?

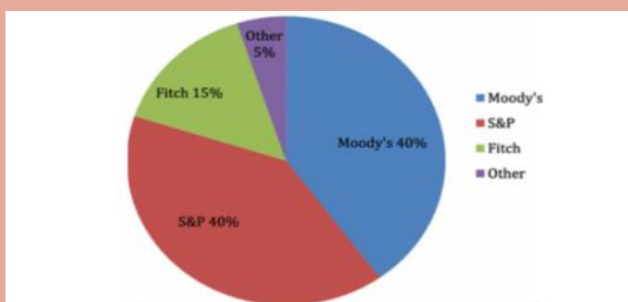
By serving as information intermediaries, CRAs theoretically reduce information costs, increase the pool of potential borrowers, and promote liquid markets. These functions may increase the supply of available risk capital in the market and promote economic growth.

Hiring credit rating agencies suggests that the management of a company is ready for independent scrutiny. Institutions and government entities can access credit facilities without having to go through lengthy evaluations by each lender. The ratings provided by rating agencies also serve as a benchmark for financial market regulations. Some laws now require certain public institutions to hold investment grade bonds, which have a rating of BBB (or equivalent) or higher.

Who are the CRAs?

Credit rating is a highly concentrated industry, with the "Big Three" controlling approximately 95% of the ratings business. Moody's Investors Service and S&P together each control 40% of the global market, and Fitch Ratings controls a further 15% (source: cfr.org).

Figure 1: Market Share by CRA
Source: Seeking Alpha



All three are private companies. Moody's and Standard & Poor's both have their headquarters in New York, while Fitch has two official HQs, one in New York and the other in London.

There are hosts of other ratings agencies, however the "Big Three" were the first to be officially endorsed by the US financial watchdog, the Securities and Exchange Commission (SEC). So a high-quality rating from any of the three is generally considered to be the gold standard.

What is the role of CRAs in Capital Markets?

In the bond market, a rating agency provides an independent evaluation of the creditworthiness of debt securities issued to produce a forecast of the bond's chance of default, expected loss, or a similar metric. In the United States, the agencies have previously been held responsible for losses resulting from inaccurate ratings, for example with Moody's receiving a penalty of $864m for ratings in the run-up to the US sub-prime crisis of 2008.

The ratings are also used in structured financial transactions such as asset-backed securities, mortgage-backed securities, and collateralized debt obligations. Ratings allow the capital structuring of the underlying assets into tranches, which feature similar risk and return profiles. Tranches with the lowest rating are first to absorb any losses in the underlying asset, and consequently offer higher return as compensation for this higher risk of loss.

Following the 2008 financial crisis, CRAs have been criticized for giving high quality credit ratings to debts that later turned out to be high-risk investments. They failed to identify risks that would have warned investors against investing in certain types of debts such as CDOs.

Rating agencies also give ratings to sovereign borrowers, who are the largest debt borrowers in most financial markets. Sovereign borrowers may include national governments, state governments, municipalities, and other sovereign-supported institutions. The ratings help governments from emerging and developing countries raise finance through issuing bonds to domestic and international investors.

A historical study found that the average AAA-rated and BBB-rated corporate bond spread (i.e. increase in yield) over riskless US treasury bonds of similar maturity was 0.43% and 1.66% respectively.

Figure 2: Ratings used by the "Big Three"
Source: Moody's, S&P, and Fitch

Credit Risk	Moody's	Standard & Poor's	Fitch
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (strong)	A	A	A
Medium grade	Baa	BBB	BBB
Below Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	C	C
In default	C	D	D

A large number of investments must carry a credit rating. This has resulted in CRAs becoming very influential. However, their role in the sub-prime crisis has damaged their reputation. Rating agencies have also been criticized for possible conflict of interest between them and issuers of securities—as issuers of securities pay the rating agencies for providing rating services, and therefore the agencies may be conflicted when giving very low ratings to securities issued by the people who ultimately pay their salaries.

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