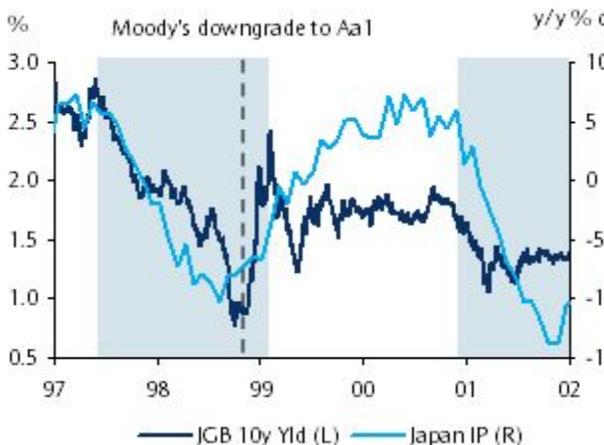


Similar to the Japanese sovereign downgrade in 1998, we believe macro fundamentals will drive asset prices rather than the ratings revision. If Congress falls short of \$4trn and S&P sticks to its words, we expect that after a brief muted market reaction, the direction of the markets will be highly leveraged to the data with expectations of a 2H11 rebound in economic activity hanging in the balance.

"We expect the debt trajectory to continue increasing in the medium term if a medium-term fiscal consolidation plan of \$4 trillion is not agreed upon. If Congress and the Administration reach an agreement of about \$4 trillion, and if we conclude that such an agreement would be enacted and maintained throughout the decade, we could, other things unchanged, affirm the 'AAA' long-term rating and A-1+ short-term rating of the U.S." *Standard & Poor's, Research Update: United States of America 'AAA/A-1+' Ratings Placed On CreditWatch Negative On Rising Risk Of Policy Stalemate, July 14, 2011.*

Our current expectation in these highly fluid negotiations is that a \$4trn agreement will not be "enacted and maintained throughout the decade". Instead, a more likely outcome is that the House Majority Leader Boehner Plan is amended by the Senate and, in essence, becomes a merged bill with the Senate Majority Leader Reid Plan, which in total does not meet S&P's standards, leading to a downgrade. With this in mind, we decided to look back on November 1998 when Moody's downgraded Japan's sovereign rating to Aa1 from Aaa. Many readers will immediately recognize the period as the autumn of the Long Term Capital Management (LTCM) collapse. The resultant disorderly swings in capital markets make using the Japanese downgrade as a guide to potential market reactions to a possible downgrade of the U.S. sovereign debt rating rather precarious. Still, our read of the events and the movements in Japanese government bonds (JGBs), the Japanese equity market, and the yen is that the macroeconomic fundamentals were the major drivers of asset prices rather than the ratings downgrade.

Figure 1: The move higher in JGB 10y yields in the aftermath of the downgrade was coincident with a rebound in Japanese industrial production



Source: Ministry of Finance, Haver, Barclays Capital

Figure 2: Counter-intuitively, the Nikkei and the yen rallied as well following the downgrade



Source: Reuters, Haver, Barclays Capital

At first blush, we were struck by the pronounced underperformance of JGBs relative to German Bunds and sharp steepening of the 2s10s JGB yield curve, which implied that the downgrade did have a significant impact on longer-term yields. However, while JGB 10y yields rose sharply following the downgrade, counter-intuitively, the Nikkei

and the yen rallied as well. As it turns out, Japanese industrial production had just bottomed and was rebounding sharply, leading Japan out of a recession by early 1999. The sharp move in JGB yields was undoubtedly further exacerbated by the recovery in global capitals markets following the LTCM crisis. Moody's not only chose to downgrade Japan at the end of a recession, but also on the precise date of the third LTCM-related 25bp cut in the fed funds rate by the FOMC. Between the November 17 FOMC rate cut and the following February, the Nasdaq index rallied 40%, underscoring the recovery in risky asset classes. The flight-to-quality rally associated with the LTCM crisis had pushed JGB 10y yields to 73bp at the height of the crisis in early October; the sharp move higher in yields had already begun prior to the downgrade and continued as the economy emerged from recession.

The initial reaction for Japanese equities in the two weeks following the downgrade was positive, underscoring how other factors were driving the markets. However, within a couple of weeks, equities were struggling, again, likely because it was becoming clear that the first round of bank recapitalizations (early 1998) were insufficient, setting the stage for a second round (in early 1999). Bank stocks dragged the Nikkei lower until it became clear that the recovery was indeed sustainable in early 1999. The yen initially sold off (for two weeks) before rallying for two months. Once the recession ended and the second round of bank recapitalizations occurred, the yen was right back to where it started before the downgrade.

We have been asked frequently how the S&P 500 can be near the higher end of the 1250-1350 range in light of all the risks concerning the debt ceiling and a potential downgrade. Our answer is that earnings season is off to a good start. We do not think this will last, but not because of the political risks. Instead, we expect the macroeconomic fundamentals to again become the primary driver of stocks, bonds, and the dollar, perhaps as soon as Friday's GDP report, followed by Friday's July employment report (also likely to affect the market strongly). Our expectation on the debt negotiations is a compromise solution that avoids default but not a downgrade. So, if Congress falls short of \$4trn and S&P sticks to its words, we expect that after a brief muted market reaction, the direction of the markets will be highly leveraged to the data with expectations of a 2H11 rebound in economic activity hanging in the balance.

Analyst Certification:

I, Barry C. Knapp, hereby certify (1) that the views expressed in this research report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

Important Disclosures:

Barclays Capital does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.

Investors should consider this report as only a single factor in making their investment decision.

The analysts responsible for preparing this research report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by investment banking activities. For current important disclosures, including, where relevant, price target charts, regarding companies that are the subject of this research report, please send a written request to: Barclays Capital Research Compliance, 745 Seventh Avenue, 17th Floor, New York, NY 10019 or refer to <http://publicresearch.barcap.com> or call 1-212-526-1072.

Barclays Capital produces a variety of research products including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations contained in one type of research product may differ from recommendations contained in other types of research products, whether as a result of differing time horizons, methodologies, or otherwise.

Barclays Capital offices involved in the production of equity research:

London

Barclays Capital, the investment banking division of Barclays Bank PLC (Barclays Capital, London)

New York

Barclays Capital Inc. (BCI, New York)

Tokyo

Barclays Capital Japan Limited (BCJL, Tokyo)

São Paulo

Banco Barclays S.A. (BBSA, São Paulo)

Hong Kong

Barclays Bank PLC, Hong Kong branch (Barclays Bank, Hong Kong)

Toronto

Barclays Capital Canada Inc. (BCC, Toronto)

Johannesburg

Absa Capital, a division of Absa Bank Limited (Absa Capital, Johannesburg)

Mexico City

Barclays Bank Mexico, S.A. (BBMX, Mexico City)

This publication has been prepared by Barclays Capital, the investment banking division of Barclays Bank PLC, and/or one or more of its affiliates as provided below. It is provided to our clients for information purposes only, and Barclays Capital makes no express or implied warranties, and expressly disclaims all warranties of merchantability or fitness for a particular purpose or use with respect to any data included in this publication. Barclays Capital will not treat unauthorized recipients of this report as its clients. Prices shown are indicative and Barclays Capital is not offering to buy or sell or soliciting offers to buy or sell any financial instrument.

Without limiting any of the foregoing and to the extent permitted by law, in no event shall Barclays Capital, nor any affiliate, nor any of their respective officers, directors, partners, or employees have any liability for (a) any special, punitive, indirect, or consequential damages; or (b) any lost profits, lost revenue, loss of anticipated savings or loss of opportunity or other financial loss, even if notified of the possibility of such damages, arising from any use of this publication or its contents.

Other than disclosures relating to Barclays Capital, the information contained in this publication has been obtained from sources that Barclays Capital believes to be reliable, but Barclays Capital does not represent or warrant that it is accurate or complete. The views in this publication are those of Barclays Capital and are subject to change, and Barclays Capital has no obligation to update its opinions or the information in this publication.

The analyst recommendations in this publication reflect solely and exclusively those of the author(s), and such opinions were prepared independently of any other interests, including those of Barclays Capital and/or its affiliates. This publication does not constitute personal investment advice or take into account the individual financial circumstances or objectives of the clients who receive it. The securities discussed herein may not be suitable for all investors. Barclays Capital recommends that investors independently evaluate each issuer, security or instrument discussed herein and consult any independent advisors they believe necessary. The value of and income from any investment may fluctuate from day to day as a result of changes in relevant economic markets (including changes in market liquidity). The information herein is not intended to predict actual results, which may differ substantially from those reflected. Past performance is not necessarily indicative of future results.

This communication is being made available in the UK and Europe primarily to persons who are investment professionals as that term is defined in Article 19 of the Financial Services and Markets Act 2000 (Financial Promotion Order) 2005. It is directed at, and therefore should only be relied upon by, persons who have professional experience in matters relating to investments. The investments to which it relates are available only to such persons and will be entered into only with such persons. Barclays Capital is authorized and regulated by the Financial Services Authority ('FSA') and member of the London Stock Exchange.

Barclays Capital Inc., U.S. registered broker/dealer and member of FINRA (www.finra.org), is distributing this material in the United States and, in connection therewith accepts responsibility for its contents. Any U.S. person wishing to effect a transaction in any security discussed herein should do so only by contacting a representative of Barclays Capital Inc. in the U.S. at 745 Seventh Avenue, New York, New York 10019. Non-U.S. persons should contact and execute transactions through a Barclays Bank PLC branch or affiliate in their home jurisdiction unless local regulations permit otherwise.

This material is distributed in Canada by Barclays Capital Canada Inc., a registered investment dealer and member of IIROC (www.iiroc.ca).

Subject to the conditions of this publication as set out above, Absa Capital, the Investment Banking Division of Absa Bank Limited, an authorised financial services provider (Registration No.: 1986/004794/06), is distributing this material in South Africa. Absa Bank Limited is regulated by the South African Reserve Bank. This publication is not, nor is it intended to be, advice as defined and/or contemplated in the (South African) Financial Advisory and Intermediary Services Act, 37 of 2002, or any other financial, investment, trading, tax, legal, accounting, retirement, actuarial or other professional advice or service whatsoever. Any South African person or entity wishing to effect a transaction in any security discussed herein should do so only by contacting a representative of Absa Capital in South Africa, 15 Alice Lane, Sandton, Johannesburg, Gauteng 2196. Absa Capital is an affiliate of Barclays Capital.

In Japan, foreign exchange research reports are prepared and distributed by Barclays Bank PLC Tokyo Branch. Other research reports are distributed to institutional investors in Japan by Barclays Capital Japan Limited. Barclays Capital Japan Limited is a joint-stock company incorporated in Japan with registered office of 6-10-1 Roppongi, Minato-ku, Tokyo 106-6131, Japan. It is a subsidiary of Barclays Bank PLC and a registered financial instruments firm regulated by the Financial Services Agency of Japan. Registered Number: Kanto Zaimukyokuchō (kinsho) No. 143.

Barclays Bank PLC, Hong Kong Branch is distributing this material in Hong Kong as an authorised institution regulated by the Hong Kong Monetary Authority. Registered Office: 41/F, Cheung Kong Center, 2 Queen's Road Central, Hong Kong.

Barclays Bank PLC Frankfurt Branch distributes this material in Germany under the supervision of Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

This material is distributed in Malaysia by Barclays Capital Markets Malaysia Sdn Bhd.

This material is distributed in Brazil by Banco Barclays S.A.

This material is distributed in Mexico by Barclays Bank Mexico, S.A.

Barclays Bank PLC in the Dubai International Financial Centre (Registered No. 0060) is regulated by the Dubai Financial Services Authority (DFSA). Barclays Bank PLC-DIFC Branch, may only undertake the financial services activities that fall within the scope of its existing DFSA licence.

Barclays Bank PLC in the UAE is regulated by the Central Bank of the UAE and is licensed to conduct business

activities as a branch of a commercial bank incorporated outside the UAE in Dubai (Licence No.: 13/1844/2008, Registered Office: Building No. 6, Burj Dubai Business Hub, Sheikh Zayed Road, Dubai City) and Abu Dhabi (Licence No.: 13/952/2008, Registered Office: Al Jazira Towers, Hamdan Street, PO Box 2734, Abu Dhabi).

Barclays Bank PLC in the Qatar Financial Centre (Registered No. 00018) is authorised by the Qatar Financial Centre Regulatory Authority (QFCRA). Barclays Bank PLC-QFC Branch may only undertake the regulated activities that fall within the scope of its existing QFCRA licence. Principal place of business in Qatar: Qatar Financial Centre, Office 1002, 10th Floor, QFC Tower, Diplomatic Area, West Bay, PO Box 15891, Doha, Qatar.

This material is distributed in Dubai, the UAE and Qatar by Barclays Bank PLC. Related financial products or services are only available to Professional Clients as defined by the DFSA, and Business Customers as defined by the QFCRA.

This material is distributed in Saudi Arabia by Barclays Saudi Arabia ('BSA'). It is not the intention of the Publication to be used or deemed as recommendation, opinion or advice for any action (s) that may take place in future. Barclays Saudi Arabia is a Closed Joint Stock Company, (CMA License No. 09141-37). Registered office Al Faisaliah Tower | Level 18 | Riyadh 11311 | Kingdom of Saudi Arabia. Authorised and regulated by the Capital Market Authority, Commercial Registration Number: 1010283024.

This material is distributed in Russia by OOO Barclays Capital, affiliated company of Barclays Bank PLC, registered and regulated in Russia by the FSFM. Broker License #177-11850-100000; Dealer License #177-11855-010000. Registered address in Russia: 125047 Moscow, 1st Tverskaya-Yamskaya str. 21.

This material is distributed in India by Barclays Bank PLC, India Branch.

This material is distributed in Singapore by the Singapore branch of Barclays Bank PLC, a bank licensed in Singapore by the Monetary Authority of Singapore. For matters in connection with this report, recipients in Singapore may contact the Singapore branch of Barclays Bank PLC, whose registered address is One Raffles Quay Level 28, South Tower, Singapore 048583.

Barclays Bank PLC, Australia Branch (ARBN 062 449 585, AFSL 246617) is distributing this material in Australia. It is directed at 'wholesale clients' as defined by Australian Corporations Act 2001.

IRS Circular 230 Prepared Materials Disclaimer: Barclays Capital and its affiliates do not provide tax advice and nothing contained herein should be construed to be tax advice. Please be advised that any discussion of U.S. tax matters contained herein (including any attachments) (i) is not intended or written to be used, and cannot be used, by you for the purpose of avoiding U.S. tax-related penalties; and (ii) was written to support the promotion or marketing of the transactions or other matters addressed herein. Accordingly, you should seek advice based on your particular circumstances from an independent tax advisor.

Barclays Capital is not responsible for, and makes no warranties whatsoever as to, the content of any third-party web site accessed via a hyperlink in this publication and such information is not incorporated by reference.

© Copyright Barclays Bank PLC (2011). All rights reserved. No part of this publication may be reproduced in any manner without the prior written permission of Barclays Capital or any of its affiliates. Barclays Bank PLC is registered in England No. 1026167. Registered office 1 Churchill Place, London, E14 5HP. Additional information regarding this publication will be furnished upon request.

[Edit my subscriptions profile](#) | [Unsubscribe me from this email](#)

Barclays Capital uses your contact information to deliver research to you. Barclays Capital reserves the right, as permitted by applicable law, to monitor electronic communications. We use cookies and other tracking technologies to collect information about recipients of electronic communications (such as internet protocol addresses). We use the information collected to monitor the effectiveness, and extent and frequency of usage of our products, and to further improve our products and our relationships with our clients. This e-mail is intended only for the person to whom it was originally sent, and may contain information that is confidential, proprietary, privileged or otherwise protected from disclosure. If you are not the intended recipient of this e-mail, please advise the sender by reply e-mail. Do not duplicate or redistribute it by any means. Please delete it and any attachments without retaining any copies. Unless specifically indicated, this e-mail is not an offer to buy or sell, or a solicitation to buy or sell any securities, investment products, or other financial product or service, an official confirmation of any transaction, or an official statement of Barclays Capital. Any views or opinions presented are solely those of the author and do not necessarily represent those of Barclays Capital. This e-mail is subject to terms available at the following link: www.barcap.com/emaildisclaimer By messaging with Barclays Capital you consent to the foregoing. Barclays Capital is the investment banking division of Barclays Bank PLC, a company registered in England (number 1026167) with its registered office at 1 Churchill Place, London, E14 5HP. This email may relate to or be sent from other members of the Barclays Group.