

What US credit rating downgrade could mean for investors



Kristina Hooper
Chief Global Market Strategist



US debt downgraded

Fitch downgraded the US credit rating from AAA to AA+ noting repeated debt limit standoffs and last-minute resolutions.

May not matter much

Despite the initial shock, it seems unlikely the downgrade will have meaningful impact beyond the very short term.

Risk that yields could move higher

A confluence of developments, including this downgrade, has the potential to move US yields higher.

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What happened

Credit rating agency Fitch Ratings downgraded US debt from AAA to AA+ on August 1. Its rationale was “expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to ‘AA’ and ‘AAA’ rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolutions.”¹

How markets reacted

Markets were somewhat surprised and rattled by the decision. The timing was odd, given that it occurred well after the debt ceiling issue was resolved. The downgrade was based on information that has been widely known for some time, so there were no real surprises.

Our take on what happened

The reality is that recent US administrations (Presidents Trump and Biden) learned from the mistakes past administrations made in providing inadequate fiscal stimulus during the Global Financial Crisis. Fiscal stimulus was far greater in response to the pandemic, which resulted in higher debt. Therefore, higher debt levels can be seen as contributing to growth. In addition, while debt-to-GDP (gross domestic product) is very elevated, debt-to-US government assets isn't a concern.

It's also important to note that, in my opinion, a downgrade doesn't typically have a material impact on markets until you get close to a junk rating. So, I believe this is largely irrelevant despite some initial shock. It seems unlikely to me that it'll have any meaningful impact beyond the very short term.

This downgrade makes the rating of the US more consistent with those of other countries: France and the United Kingdom are AA; Japan is A; and Germany, Switzerland, and Singapore are AAA.

Our outlook on the situation

We believe this downgrade will have no meaningful impact beyond the very near term. US debt was already downgraded by Standard & Poor's in 2011, with no material impact beyond a very short-term reaction. There have been concerns for many years about US government debt levels. Despite these concerns, over the last three decades, US Treasury yields remained relatively low and the stock market has made significant gains.²

Our resulting investment strategy

We maintain our existing investment views. We anticipate volatility in the near term (the Federal Reserve is still data dependent). We expect some digestion of stock market gains and the potential for a minor pullback in the near term as markets reprice when the Federal Reserve begins to cut rates. We'd expect global risk appetite, however, to start rising later this year as markets ultimately look forward to and discount an economic recovery next year.

What we're watching out for and the risks to our view

US yields may potentially move higher because of a confluence of developments, including this downgrade. Other developments include the issuance of more US debt (now that the debt ceiling is resolved), and the Bank of Japan's alterations to its yield curve control policy, which makes Japanese government bonds more attractive for Japanese investors to own than they had previously been (relative to US Treasuries).

With contributions from Brian Levitt, Paul Jackson, Arnab Das, and Tomo Kinoshita

Notes

¹Source: Fitch Ratings

²Source: Bloomberg, as of August 2, 2023

Important information

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Credit ratings are assigned by Nationally Recognized Statistical Rating Organizations based on assessment of the credit worthiness of the underlying bond issuers. The ratings range from AAA (highest) to D (lowest) and are subject to change. Not rated indicates the debtor was not rated, and should not be interpreted as indicating low quality. Futures and other derivatives are not eligible for assigned credit ratings by any NRSRO and are excluded from quality allocations. For more information on rating methodologies, please visit the following NRSRO websites: [standardandpoors.com](https://www.standardandpoors.com) and select "Understanding Ratings" under Rating Resources and [moodys.com](https://www.moodys.com) and select "Rating Methodologies" under Research and Ratings.

A basis point is one hundredth of a percentage point.

Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

The Bank of Japan's yield curve control policy seeks to fix yields on 10-year Japanese government bonds around zero, tolerating moves of up to 50 basis points above or below that level.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

The opinions referenced above are those of the author as of August 2, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.