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U.S. rating downgrade: latest update

Key takeaways

- Fitch Ratings announced their decision to downgrade longer-term U.S. sovereign debt from AAA to AA+. This follows their previously announced decision in May to place U.S. debt 'on watch' during prolonged debt ceiling negotiations.
- Within their statement, the ratings agency cited the combination of tax cuts and spending initiatives, which have contributed to debt level increases, as well as a lack of a medium-term fiscal framework.
- The somewhat surprising announcement triggered selling pressure in both equities and credit markets as investors weighed up the possible long-term implications.

1. What happened?

Following yesterday's market close, Fitch Ratings announced it was downgrading long-term (i.e., longer than one year) U.S. government debt from AAA to AA+. The announcement to downgrade U.S Treasuries comes two months after the ratings agency had previously stated that U.S. debt was being closely watched given the protracted debt ceiling negotiations between the Biden Administration and U.S. Congress.

Within Fitch's statement, the rating agency highlighted several drivers behind its downgrade decision and its expectation that the U.S. governments fiscal health will deteriorate over the next three years. Chief amongst them was the "steady deterioration in standards of governance" as protracted negotiations around the debt ceiling and "cliff-edge" resolution talks have become more frequent in recent years.

The overall growing levels of debt were also flagged as a concern, fueled predominately by a combination of economic shocks, tax cuts and new spending initiatives. Fitch forecasts that the U.S. debt-to-GDP ratio will reach 118% by 2025.

Broader economic factors have also played a role in Fitch's downgrade decision with the Federal Reserves aggressive monetary policy, both in raising the Fed Funds Rate and reducing the size of its balance sheet. Such actions have further tightened financial conditions within the U.S. economy.

Combined with the apparent erosion in governance, there appears to have been a lack of progress made in medium-term challenges related to both Social Security and the funding of Medicare. The increased cost of debt servicing, and unfavourable demographics has placed further pressure on future costs. Fitch noted that the tax cuts that were implemented in 2017 are set to expire in 2025, but the current political landscape will most likely mean that such cuts will be made permanent, further widening out deficit projections.

2. How did markets react?

The announcement from Fitch caused markets to witness selling pressure in both equities and credit with investors, who have witnessed considerable gains so far this year, trying to assess the long-term impact. Equity markets were in negative territory with both the S&P 500 and NASDAQ down -1.3% and -2.5% respectively during this mornings trading.

Alongside the ratings downgrade, the U.S. Treasury also announced an increase in the amount of securities planning to be auctioned, up from USD 96bn to USD 103bn. Placing further upward pressure on Treasury yields. At the time of writing, 10-year Treasury yield reaching 4.12%, its's highest level since November 2022.

3. What does it mean for investors?

In recent weeks, investors have been able to enjoy their summer vacations witnessing the strong gains seen in both equity and credit markets. The surprising uplift in U.S. GDP (+2.4& Q-on-Q ann.) as well as another resilient earnings season has fueled conversations that a 'soft-landing' could possibly be achieved. Today's price action acts as a reminder that, following on from weeks of rising markets, investor complacency can be tested at any time.

There will be much discussion over the long-term effects that yesterday's announcement will have on markets and the economy at large. Market commentators will look back to 2011 when S&P Global Ratings first downgraded U.S. debt and the initial impact felt by markets as a possible signpost for market direction with both the S&P 500 and NASDAQ falling -6.7% and -6.9% respectively.

Twelve years on, we are not expecting similar price movements. Concerns around the U.S. governments fiscal health, following on from prolonged debt ceiling debates and sizeable COVID-relief packages, is something investors have had to adjust to in recent years. Furthermore, whilst the headlines will no doubt be around the rating downgrade, the outlook for U.S. debt was moved from "negative" to "stable". Elsewhere in the report, Fitch also maintained that the risk of any possible capital or exchange controls being imposed due to the fiscal health of the economy as being a "de minimis" risk.

The announcement of U.S. debt being downgraded has clearly been felt by markets today. However, we feel this will be an isolated incident given the already known debt challenges being faced. Our view is that such a rating change will have little lasting-impact on the credit worthiness of the United States nor the status of the USD as a reserve currency.

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Glossary

The Fed funds rate is the interest rate at which depository institutions lend overnight to other depository institutions.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

Fitch Ratings is a credit rating agency

Standard and Poor's (S&P) is U.S. financial services company, providing research and ratings.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

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