US Debt Rating Downgrade

Below is our assessment of the US debt rating downgrade by Fitch as of the date of publication, August 4, 2023. We will continue to monitor the situation as it evolves.

The general consensus thus far is that the market impact will likely be minimal. Fitch's downgrade decision was not in reaction to any new developments related to the fiscal health of the US government. Based on initial reactions gathered from the core and core plus fixed income managers RVK follows closely, this development is not expected to materially affect their outlook or how client portfolios are managed.

Background

Several months ago, Fitch issued a warning of a potential downgrade for the US debt rating as the debt ceiling X-date approached and the risk of a missed payment grew. The risk of a missed payment never materialized because a debt ceiling deal was reached and signed into law on June 3, 2023.[1] After the market closed on Tuesday, August 1st, Fitch announced it would be downgrading the US long-term credit rating from AAA to AA+. The downgrade was attributed to concerns over rising fiscal deficits in the near-term, unsustainable debt and deficit trajectories, increased political dysfunction, and polarization among policymakers in addressing fiscal challenges.[2]

With this downgrade, Fitch's rating of AA+ is now the same as S&P's at AA+ Stable (S&P downgraded the US in April 2011 and has not revised the rating since). Moody's, the other member of the three largest global credit rating agencies, retains its AAA rating with a Stable Outlook for the US.

Fitch has not yet provided guidance on Government Agencies and quasi-government entities with explicit or implicit backing from the US Treasury. However, we anticipate that these entities (e.g., FNMA, FHLMC, TVA, FFCB, FHLB, etc.) will likely be downgraded in line with the US Treasury, similar to what happened with the S&P downgrade 12 years ago. Despite the sovereign downgrade, Fitch maintained the country ceiling rating at AAA, indicating low ratings risk to the private sector based on the sovereign's downgrade.

Market Reactions

Though the S&P downgrade in 2011 came as a shock to investors, Fitch's rating action appears less impactful. A summary of reactions from key market sectors is below, as of August 2, 2023:

- **Treasuries:** Yields are higher, particularly in the long end with the 30-year rate up almost 8 bps, causing a steepening of the Treasury yield curve. However, the rate move is more likely being driven by the US Treasury's recent announcement during the August 2nd Quarterly Refund Meeting that higher funding needs will lead to increased supply,[3] coupled with economic data, rather than investor

Figure 1: 10-Year US Treasury Yield

Source: Federal Reserve Bank of St. Louis

[1]https://apnews.com/article/joe-biden-debt-ceiling-budget-signing-f78a000d83cf85ffbaa2d08637844053
[2]https://www.fitchratings.com/research/sovereigns/fitch-downgrades-united-states-long-term-ratings-to-aa-from-aaa-outlook-stable-01-08-2023
[3]https://home.treasury.gov/news/press-releases/jy1671

selling due to the rating downgrade. **Figure 1** shows recent fluctuations of the 10-year maturity yield-to-date in 2023, including the regional bank failures in March and the debt ceiling debacle in late April.

- **Money Market Funds:** No immediate impact, functioning properly.
- **Investment-Grade/High-Yield Corporates:** Subdued, the downgrade has not been enough to keep issuers on the sidelines.
- **Securitized:** Muted reaction. Agency mortgage pools do not possess individual ratings; instead, they inherit the credit rating of the US government.
- **US Dollar:** Mixed reaction, but generally slightly stronger versus major currencies.

Potential Implications

RVK does not expect the rating downgrade will cause a significant surge in yields. However, considering the recently announced additional funding needs and increased interest costs due to higher outstanding debt and interest rates, US Treasury yields may experience upward pressure in the short-term. These factors could lead to a steeper yield curve, as longer-maturity yields rise while the front end remains anchored by the Federal Reserve.

In response to the downgrade of the US credit rating, certain investors mandated to hold only AAA-rated securities may be required to adjust their holdings of US-issued or US-guaranteed securities or modify their investment management agreements (IMAs). However, considering the prominent role of the US government in global bond markets and the US dollar’s continued status as the world’s reserve currency, we anticipate that most investors will likely adapt their IMAs to accommodate the lower credit rating.

We will also keep a close eye on how major fixed income indices (e.g. Bloomberg) handle this situation and assess the impact on index average quality ratings.

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