MARKET UPDATE

August 9, 2023

FITCH DOWNGRADES UNITED STATES' CREDIT RATING FROM AAA TO AA+

In a significant move that caught global attention, Fitch Ratings, one of the major credit rating agencies, downgraded the credit rating of the United States from AAA to AA+. The downgrade signals concerns over the nation's fiscal stability and a high and growing debt burden, as well as a deterioration in governance. The move caused some equity market volatility and could ultimately push treasury yields higher but impacts on financial markets to this point have been muted.

The United States has long held a sterling AAA rating, which signifies its ability to meet its financial obligations with the highest level of confidence. The downgrade to AA+ is the first reduction in the nation's credit rating since the downgrade from S&P in 2011. Fitch cited several key factors behind their decision. First and foremost was the continued rise in the national debt, which has been exacerbated by significant spending measures and economic challenges in recent years. The general government debt to GDP ratio is expected to reach 118% by 2025. For context, the median ratio is 39% for AAA nations and 45% for AA nations. Additionally, government deficits are expected to continue widening, reflecting cyclically weaker federal revenues, more spending initiatives, and a higher interest burden. Fitch forecasts a deficit of 6.6% in 2024 and 6.9% in 2025. Such illustrates the new norm of deficit spending even when economic growth remains non-recessionary. Medium-term fiscal challenges remain unaddressed as an aging population and rising healthcare costs will raise spending needs, all in the context of increasing debt levels and interest payments. Finally, the steady deterioration in governance regarding fiscal and debt matters contributed to the decision. Notwithstanding repeated debt limit standoffs, the inability of the U.S. government to implement long-term, sustainable fiscal policies could undermine economic stability and hinder the ability to address future economic challenges effectively. The structural strengths of the U.S. like the size and diversity of the economy and the dollar’s global reserve currency status support the AA+ rating and keeps the ratings ceiling at AAA.

It's worth noting that a credit rating downgrade can lead to several consequences. Investors may demand higher yields on U.S. government bonds to compensate for the perceived increase in risk, resulting in higher borrowing costs for the government. Additionally, a downgrade could trigger a loss of confidence in the U.S. dollar as a safe-haven currency, potentially impacting foreign investment and international trade. However, nothing in this report is new information about the fiscal situation of the U.S. and so direct financial market impacts have been negligible. Some concerns about institutional investors being forced sellers because of the downgrade are overblown. In fact, 10-year treasury yields fell roughly 50 basis points in the aftermath of the downgrade, illustrating investors’ continued perception of Treasuries as the preeminent safe and liquid asset. Ultimately, this is unlikely to be a short-term issue for markets but the downgrade highlights the situation can’t go unaddressed forever.

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