Debt Downgrade: A Warning To Policymakers

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Last night, Fitch Ratings downgraded the US sovereign credit rating by one notch from AAA to AA+. The move was not a complete surprise as Fitch placed the US on watch for a possible downgrade during the debt ceiling negotiations, following Standard & Poor's playbook when they downgraded the country's AAA-credit to AA following the 2011 debt ceiling standoff. Here are the three most salient questions that we have received from clients:

Is The US Debt Downgrade A Significant Event?

While media reports are suggesting the rating action is a nonevent, Fitch's action is a serious reminder that US fiscal dynamics are on an unsustainable trajectory—a trend we have been highlighting for some time now. While this action does not change our short-term views on the markets, the fiscal well-being of our nation remains on our long-term radar.

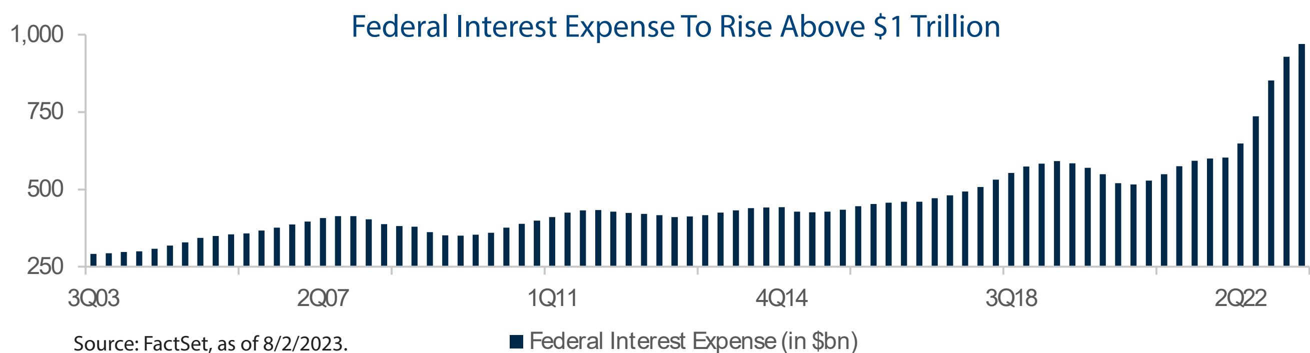
Fitch's downgrade was based on four reasons:

- **Erosion Of Governance |** Fitch noted the government's "steady deterioration in standards over the last 20 years" regarding fiscal and debt matters while specifically highlighting "the repeated debt-limit political standoffs and last-minute resolutions (that) have eroded confidence in fiscal management. "They agree with our concern that "there has been only limited progress in tackling medium-term challenges related to rising social security and Medicare costs due to an aging population." Social security is still forecast to be insolvent by 2033.

- **Rising General Government Deficits |** Fitch forecasts a government deficit of 6.6% of GDP in 2024 and a further widening to 6.9% of GDP in 2025. Of special note was the impact from the combination of higher debt levels and higher interest rates. "The interest-to-revenue ratio (the percentage of government revenues to pay just interest payments) is expected to reach 10% by 2025 (compared to 2.8% for the 'AA' median and 1% for the 'AAA' median) due to the higher debt level as well as sustained higher interest rates compared with pre-pandemic levels."

- **General Government Debt to Rise |** Fitch projects the government debt-to-GDP ratio to rise over the forecast period, reaching 118.4% by 2025. They are concerned that "the debt ratio is over two-and-a-half times higher than the 'AAA' median of 39.3% of GDP and 'AA' median of 44.7% of GDP. Fitch's longer-term projections forecast additional debt/GDP rises, increasing the vulnerability of the U.S. fiscal position to future economic shocks."

- **Medium-term Fiscal Challenges Unaddressed |** Fitch acknowledges the combination of higher costs (interest payments, healthcare, and other government spending) with the potential of lower tax revenues (political pressure is likely to build to extend the 2017 tax cuts set to expire in 2024) will lead to higher long-run deficits. Additionally, the annualized quarterly interest expense is expected to rise above $1 trillion this quarter for the first time on record.



Source: FactSet, as of 8/2/2023.

The point: Versus comparable rated countries, the debt dynamics in the US are worse (and expected to worsen over time). And given the lack of commitment by DC policymakers, the appetite to improve these conditions seems limited. The raising of the debt ceiling did not solve our issues, it just kicked the proverbial can down the road. Thus, Fitch felt the need to downgrade and send another message to Washington that this is an important long-term problem that needs to be addressed sooner rather than later.

What Would Make Us More Concerned?

While we do not expect this to have a lasting impact on the financial markets and do not feel the need to adjust our views, there are some factors that we are watching very closely which could cause us to become more concerned.

- **Moody's Downgrade |** This downgrade by Fitch is the second time in US history that a major rating agency downgraded US debt (after S&P downgraded it in 2011). As of now, Moody's is the only major rating agency with an AAA rating on US debt. If they were to downgrade the debt, the US would not consistently be viewed as an AAA rated country. This could have repercussions on what various investors and funds can hold and could modestly reduce the attractiveness of owning US Treasurys.

- **Successive Downgrades |** If the US were to receive more downgrades by Fitch or other agencies and fall even lower on the rating scale, that would pose more concerns. Admittedly, the downgrades have been few and far between, so this remains a low probability but something worth monitoring.

- **Economic Crisis |** If the economy were to experience a deeper and longer-lasting recession than we are forecasting, that would hamper tax revenues, increase spending and lead to even more debt that would have to be serviced. That could cause the forecast increases in debt to be too conservative.

- **Less Demand |** Currently, the US holds a special place in world as the most prominent reserve currency. As a result, demand for US Treasurys remains strong and healthy and we have not seen any reduction in overall demand. However, any signs of instability could lead to less demand which could cause interest rates to increase. As of now, this remains a low probability.

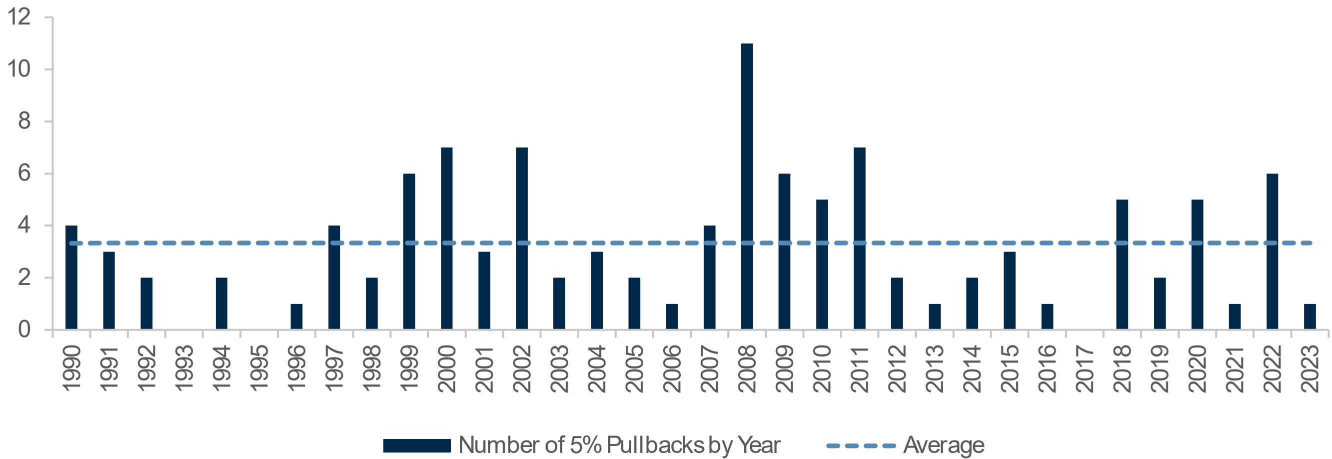
The point: Assuming the US does not experience a significant recession that causes the fiscal profile of the US to deteriorate rapidly, we do not expect this to be a long-lasting issue.

What Is The Impact To Financial Markets?

- **Equity Market |** Given the current market environment, we had already been cautious on risk assets in the near term with the S&P 500 having already priced in a lot of good news (e.g., recession forecasts being pushed out, Federal Reserve nearing the end of its tightening cycle, inflation moderating) and rising above our year-end target of 4,400. With the forward-looking P/E at 19x (and trailing at 21x), the equity market was vulnerable to a pullback. The downgrade from Fitch is another reminder for investors to not get complacent, as bullish sentiment has increased substantially from the beginning the year and is currently at the highest level in the last two years.

  While we remain constructive on the equity market longer term as we forecast earnings to move higher, we remain cautious in the near term looking for a modest pullback. Keep in mind that the S&P 500 tends to have three to four pullbacks in the magnitude of 5% or more and we have only had one year-to-date (in March with the regional bank turmoil). We also note that economic activity is likely to slow moving forward (we forecast a recession beginning in the fourth quarter) as we enter the seasonally weakest two-month period of the year in August and September.

The S&P 500 Tends To Have Three To Four Pullbacks In The Magnitude Of 5% Or More Each Year



Source: FactSet, as of 8/2/2023.

- **Fixed Income |** While the knee-jerk reaction saw Treasury yields rise over 10 bps since the announcement, particularly longer-term maturities, we do not think there will be a lasting impact on the Treasury market. Why? First, we do not expect the ratings action will result in any forced selling from fund managers due to guideline constraints as the rating downgrade of one notch is still within the parameters of most mandates. Second, it is unlikely that market participants will demand an additional premium to hold US Treasurys as investors do not have material concerns about the creditworthiness of the US government. Finally, the US still enjoys the safest, largest and most liquid bond market in the world. Furthermore, the moves in credit default spreads and the US dollar overnight have also been negligible. We maintain our view that high-quality bonds are attractive at current interest rate levels with the 10-year Treasury yield above 4% as we expect yields to reverse and end the year lower. The economy remains the biggest driver of yields and with our expectation of a mild recession unfolding as we go into 2024, 10-year Treasury yields are likely to fall toward our year-end target of 3.25%.

- **2011 Redux? |** Using the last time the US debt was downgraded in 2011 as a guide, this downgrade should not have a meaningful longer-term impact. In fact, most of worst-case investor fears did not come to fruition back then. After falling 8% in the aftermath of the downgrade, the S&P 500 was up 16% in the 12 months following, and demand for Treasurys was not dampened as the 10-year Treasury yield declined ~90 bps over the same time period.

The point: The debt downgrade does not alter our investment outlook for equities or fixed income. The headlines overnight and today may have been a catalyst for the sell-off in the equity market today that was already vulnerable given the strong rally to begin the year. As a result, we are not changing our equity targets as we maintain our long term optimistic view on equities. For bonds, our expectation of lower yields by year end make them attractive at current levels.

The S&P 500 Performance Following The Last Credit Downgrade In 2011

Source: FactSet, as of 8/2/2023.

Source: FactSet, as of 8/2/2023.

Bottom Line

The Fitch rating action does not change our longer-term asset class views but serves as a reminder that the fiscal trajectory is on an unsustainable path that our politicians must address sooner rather than later, particularly with yields now sitting at multi-decade highs.

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AGGREGATE BOND | Bloomberg US Agg Bond Total Return Index: The index is a measure of the investment grade, fixed-rate, taxable bond market of roughly 6,000 SEC-registered securities with intermediate maturities averaging approximately 10 years. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

HIGH YIELD | Bloomberg US Corporate High Yield Total Return Index: The index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

S&P 500 | The S&P Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

KBW REGIONAL BANKING INDEX | The KBW Regional Banking Index is a benchmark stock index for the regional banking sector representing small to medium U.S. national regional banks.

RUSSELL 2000 INDEX | The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

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Source: FactSet, as of 8/2/2023

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