Q&A with Investment Strategy
The US Loses Its 'AAA' Credit Rating

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MOODY'S STRIPS THE US OF ITS TRIPLE-A CREDIT RATING

After markets closed on Friday, Moody's downgraded the US credit rating by one notch, from Aaa to Aa1. While the timing caught many off guard, the move wasn't entirely unexpected—S&P and Fitch had already removed the US from their top-tier ratings in 2011 and 2023, respectively. Moody's had also placed the US on watch for a potential downgrade in 2023. Still, the decision sends a clear warning to Congress as it prepares to pass President Trump's budget and tax bill, which is widely anticipated to increase the national debt. Below, we explore the key questions this development raises for investors.

IS MOODY'S DOWNGRADE A BIG ISSUE FOR THE MARKETS?

Moody's decision to strip the US of its Aaa rating is historic as it was the last of the top three rating agencies to maintain the top-notch status—something the US has held since 1917. Although the downgrade doesn't reflect any new specific developments, it reinforces a message we've emphasized for some time: the US is on an unsustainable fiscal trajectory. Moody's cited three primary reasons for the downgrade:

1. **Rising National Debt**—Moody's cited that "successive US administrations failed to agree on measures to reverse large annual fiscal deficits," leading to a rising debt burden. As we have noted, federal debt has more than tripled since 2008—rising from $10 trillion to over $36 trillion today. Moody's cited current fiscal proposals will lead to further deterioration in the fiscal outlook with the debt burden expected to climb from over 120% of GDP today to 134% by 2035—3x higher than the median AAA-rated sovereign.

2. **Persistent Deficits**—The US government has long operated with budget deficits, consistently spending more than it collects in tax revenue. Since 1962, the deficit has averaged around 3% of GDP, typically widening during recessions and narrowing during recoveries. However, in the aftermath of the COVID-19 recovery, the deficit averaged ~7% (projected at 6.2% in 2025)—nearly double the historical average. Moody's expressed concern that rising entitlement spending, escalating interest costs, and a fiscally expansionary budget proposal could push the deficit to as high as 9% of GDP over the next decade.

3. **Growing Interest Burden**—Net interest costs for servicing the national debt have surged over the last few years as interest rates climbed to a 15-year high. This has driven annual interest payments from $375 billion in 2019 to $881 billion at the end of 2024, with rolling 12-month outlays now ~$1 trillion. Notably, interest costs consume ~18% of total tax revenue—the highest level since the early 90s. With elevated interest rates, Moody's is concerned that the interest burden will climb to 30% of tax revenue over the next decade, significantly limiting the government's flexibility during future economic downturns.

	Moody's	*S&P*	*Fitch*	*Investment Grade Rating*
Germany	Aaa	AAA	AAA	***AAA/Aaa***
Switzerland	Aaa	AAA	AAA	Minimal Risk
Canada	Aaa	AAA	AA+	
US	Aa1	AA+	AA+	**AA/Aa**
France	Aa2	AA	AA-	Very Low Risk
UK	Aa3	AA	AA-	
Japan	A1	A+	A	**A**
China	A1	A+	A	Low Risk
Mexico	Baa2	BBB	BBB	**BBB**
Italy	Baa3	BBB	BBB	Moderate Risk

Source: FactSet

OUR VIEW: Moody's action doesn't reveal anything new—the US fiscal trajectory has been unsustainable for some time. What's more concerning is the continued lack of political will in Washington to address the deteriorating fiscal outlook. This inaction leaves financial markets vulnerable to bouts of volatility, especially given elevated equity valuations. It also raises the risk of a bond market disruption akin to the UK's 'Liz Truss moment,' when investors forcefully signal their concerns through a spike in interest rates. While no immediate changes are expected, it's increasingly clear that Washington will eventually need to confront this long-term challenge.

HOW CONCERNED SHOULD INVESTORS BE ABOUT THE DOWNGRADE?

The downgrade is a psychological blow to the US' standing in the world, particularly at a time when the US' safe-haven status is being questioned by investors. However, we do not want to exaggerate its importance. While symbolically significant, the downgrade is not likely to trigger any forced selling of US debt. Yes, investors prioritize the credit worthiness of their investments; however, the downgrade to Aa1 is not likely to prohibit investors from owning Treasuries. With S&P and Fitch already assigning the US an AA rating, Moody's decision is late in the game. To be fair, S&P's 2011 downgrade did create some investor angst as it was the first ratings agency to strip the US of its AAA rating. However, there was no forced selling at that time. While some investor mandates require investors to hold only AAA-rated securities, after the US downgrade, most guidelines were amended from an explicit credit rating to "government securities" to avoid any market disruptions. In addition, many benchmarks now use a blended approach, using the average of the top three rating agencies (i.e., S&P, Moody's, and Fitch) to calculate an average quality rating. Given these changes, Moody's downgrade is not likely to move the needle.

HOW DID THE MARKET PERFORM DURING PRIOR DOWNGRADES?

S&P 2011 Downgrade—The S&P downgrade occurred against a fragile macroeconomic backdrop, marked by the ongoing European debt crisis and a tense US debt ceiling standoff. The debt limit was raised just hours before a potential default, narrowly averting a crisis. Although S&P issued its downgrade days after the debt ceiling legislation passed, the move triggered a surge in market volatility. The CBOE Volatility Index (VIX) spiked to nearly 50, and risk assets sold off sharply. The S&P 500 plunged nearly 7%—its worst single-day drop since the 2008 Financial Crisis—while credit spreads widened significantly. Amid already strained financial conditions, the downgrade intensified market stress. From peak to trough, the S&P 500 fell 17%, investment-grade credit spreads widened by 99 basis points, and high-yield spreads ballooned by 358 basis points. Investors rushed to safety, driving the 10-year Treasury yield down by ~85 basis points over two weeks—its steepest decline since 2008. While risk assets almost fully recovered within six months, Treasury yields continued to march lower.

Fitch 2023 Downgrade—The S&P 500 was in the midst of a 10% pullback when Fitch downgraded the US credit rating on August 5, 2023. While volatility increased, the impact on risk assets was far less pronounced than during the 2011 episode, with the S&P 500 recovering fairly quickly from its modest pullback. However, the bigger moves came in the bond market in 2023. Bond yields were moving steadily higher before the Fitch downgrade, responding to elevated inflation and a Fed that was still in tightening mode. But fiscal concerns came to the fore after President Biden passed the Fiscal Responsibility Act of 2023 and suspended the debt limit until early 2025. This caused the 10-year Treasury yield to surge from 3.8% in July 2023 to nearly 5% in October 2023.

WHAT IMPACT WILL THE DOWNGRADE HAVE ON THE ECONOMY AND FINANCIAL MARKETS?

Economy—Our chief economist's 2024 whitepaper, *Debunking the US National Debt Problem: A Political Dilemma*, highlights a critical truth: the US debt challenge is not about the ability to pay, but the political unwillingness to place the debt on a sustainable path by lowering the primary deficit. Without structural reforms, the US faces the risk of further credit downgrades, rising borrowing costs, and eroding investor confidence. We do not expect Moody's decision to change the contours of President Trump's tax bill, which is expected to add between $4 and $5 trillion to the deficit over the next decade. However, it does serve as a warning shot to Congress that the trajectory of fiscal policy is untenable.

Interest Rates—Yields increased following the Moody's announcement, as the 30-year Treasury yield is now above the key 5% level for the first time since October 2023. While the Moody's decision could provide a fresh catalyst for another leg higher in rates as investors have become increasingly nervous about US policy more broadly, we think the bond market has been pricing in the deteriorating fiscal outlook for some time now. That is a key reason why longer-maturity yields have been rising despite weakening growth prospects. As we have said all year, we think Treasury yields will remain in a wide trading range as the year progresses, as the bond market balances between growth risks and fiscal concerns. Moody's decision does not change our view that the 10-year Treasury yield will end the year at ~4.25% as the growth slowdown becomes more evident in the 'hard' economic data. However, in the interim, we do not rule out the possibility that 'bond vigilantes' could send another shot across the bow to policymakers to get their fiscal house in order.

Equities—As the Moody's downgrade does not alter our outlook for the economy or interest rates, we do not anticipate it will have a material, long-term fundamental impact on the equity market. However, following the approximately 20% rally from the early-April lows (which pushed the market above our year-end target of 5,800), the downgrade serves as another reminder of the growing risks on the horizon for the equity market. With equity technicals stretched (RSI in overbought territory and the put/call ratio depressed), valuations in the 91st percentile relative to historical levels and the 10-year Treasury yield rising above the key 4.50% level (an area that was led to volatility over the last 12 months), earnings will need to drive the market higher from here. As many of the tariff-related impacts have yet to be fully reflected in economic activity and earnings, we expect S&P 500 earnings revisions to accelerate to the downside—from the current consensus of $264 to a range of $250–$255. Therefore, we maintain our cautious stance on the equity market and urge investors not to become complacent, as the risk of a pullback and periods of volatility remain elevated.

Bottom Line—As previously mentioned, the Moody's downgrade delivers a psychological and symbolic blow to the US in terms of its global standing—unanimously no longer holding a AAA rating—and reinforcing concerns about the US' unsustainable fiscal trajectory. However, the downgrade does not reveal anything fundamentally new. It's unlikely to materially impact economic activity, alter the path of interest rates (beyond a short-term knee-jerk reaction), or change the long-term outlook for equities. That said, with many risk assets already appearing stretched following the recent strong rally, the downgrade serves as a timely reminder for investors to remain vigilant. It underscores the importance of not overlooking the mounting macroeconomic risks.

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S&P 500 | The S&P 500 Total Return Index: The index is widely regarded as the best single gauge of large-cap US 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.

SECTORS | Sector investments are companies focused on a specific economic sector and are presented here for illustrative purposes only. Sectors, including Info Tech, Industrials, and Health Care, are subject to varying levels of competition, economic sensitivity, and political and regulatory risks. Investing in any individual sector involves limited diversification.

US TREASURIES | US Treasury securities are guaranteed by the US government and, if held to maturity, generally offer a fixed rate of return and guaranteed principal value.

THE CBOE VOLATILITY INDEX | The CBOE Volatility Index, or VIX, is an index created by CBOE Global Markets, which shows the market's expectation of 30-day volatility.

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Source: FactSet

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