CIO View
CIO Flash

August 2, 2023
Marketing material

DWS

An oddly timed U.S. rating downgrade

From both a market and a political perspective, the “news” that Fitch now rates United States' long-term ratings as 'AA+' contained no new information and is likely to have very little direct market impact.

IN A NUTSHELL

– The “news” from Fitch contained no new information.
– It is likely to have very little direct market impact.
– In the long-term, there might be minor shifts towards AAA-rated bonds issued by other countries.

In a way, at least, Fitch’s timing is quite fortuitous

From both a short-term market and a political angle, the decision to downgrade the United States' long-term ratings to 'AA+' from 'AAA' looks like a bit of non-event. In one sense, at least, the timing was quite fortuitous. Today of all days, it was reassuring to read about the country’s “exceptional strengths,” continuing to support the Fitch ratings: ”Several structural strengths underpin the United States' ratings. These include its large, advanced, well-diversified and high-income economy, supported by a dynamic business environment. Critically, the U.S. dollar is the world's preeminent reserve currency, which gives the government extraordinary financing flexibility.”[1]

To be sure, little of this would have come as news for many owners of U.S. Treasuries from overseas. Fitch’s views about the more negative aspects of the long-term fiscal prospects were just about as newsworthy. Still, just in case anyone was starting to worry – Asian trading initially looked a little wobbly – it was good to be reminded, on a day full of other, potentially worrying news coming out of Washington.

Market and policy implications

Other than that, it is hard to see why Fitch Ratings acted now, rather than at any point before, during or immediately after the latest debt-ceiling fight. Or, indeed, at plenty of other points during the past 12 years since the downgrade by S&P in 2011. For what it’s worth, we would argue that at least in terms of the “erosion of governance” and the “repeated debt-limit political standoffs and last-minute resolutions [that] have eroded confidence in fiscal management,” as Fitch mentions, the worst may actually be behind us.

None of which changes the fact that policies currently in place put the U.S. on an unsustainable path. According to the Congressional Budget Office, debt held by the public is expected to rise from 97% of gross domestic product (GDP) in 2022

[1] Fitch Downgrades the United States' Long-Term Ratings to 'AA+' from 'AAA'; Outlook Stable (fitchratings.com)

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to 181% in 2053 under current law.[2] Scarier still, the current budget balance came in at minus 8.5% of GDP in June.[3] That partly reflects delayed tax receipts. However, even the recent usual run-rate of -5% would certainly have raised alarm bells in another country or era, not least given an aging population requiring higher spending on health, in particular. Once again, neither the Congressional roadblocks towards legislative changes on entitlement spending or taxation, nor the downsides of potential "alternatives," such as letting inflation run higher for longer, should come as news to any market participant.

Asset-class implications

Given all the above, we expect to see little direct impact on markets. The rules on high-quality debt holdings put in place since S&P's downgrade in 2011 make any significant forced selling very unlikely.[4] With regards to Money Market Funds specifically, the SEC has designated government securities as "eligible securities" without reference to ratings[5]. It is also worth noting that the downgrade does not affect other AAA-rated securities issued by U.S. entities, i.e. it will not directly affect bonds issued by U.S. federal agencies, other than the Treasury, government-sponsored enterprises, or U.S. municipalities. We therefore expect any spill-over in terms of risk sentiment in foreign-currency and equities markets to prove similarly short-lived, too. In the long term, however, there might be minor shifts towards AAA-rated bonds issued by other countries.

[2] https://www.crfb.org/papers/analysis-cbos-june-2023-long-term-budget-outlook
[3] Source: Bloomberg Finance L.P.; data from Treasury
[4] The Fitch fallout | Financial Times (ft.com)
[5] In addition, the SEC has removed nationally recognized statistical rating organizations (NRSRO) ratings from rule 2a-7. Source: https://www.sec.gov/files/rules/proposed/2021/ic-34441-fact-sheet.pdf

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Glossary

The current account includes trade in goods and services, a net-factor-income balance (e.g. earnings on foreign investments and cash transfers from individuals working abroad) and transfers (e.g. foreign aid). It is a part of the balance of payments.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Municipal bonds (Munis) are debt securities issued by a state, municipality or country.

A rating is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst) , S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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as of 8/2/23; 097073_1 (08/2023)

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as of 8/2/23; 097074_1 (08/2023)