On The Mark

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US Credit Rating Downgrade

Key Takeaways

- Ratings agency Fitch downgraded the US government credit from its highest rating of AAA to AA+
- The downgrade reflects "erosion of governance" from repeated debt ceiling standoffs and rising debt.
- The downgrade, however, does not reflect new fiscal information and is unlikely to have material impact on financial markets.

What happened?

The rating agency Fitch downgraded the US government credit rating one notch from AAA, its highest grade, to AA+ on August 1, 2023. The justification was rising debt, fiscal deterioration, and "the erosion of governance" from repeated debt limit standoffs. Fitch issued a downgrade warning back in May 2023 following the debt ceiling debate. This is the second downgrade for US credit. S&P downgraded the US credit rating to AA+ from AAA back in 2011, when the political standoff also led to a prolonged debt ceiling debacle. Interestingly, the third well-known credit rating agency, Moody's, currently still has the US credit rating at the highest level of Aaa.

Why do credit ratings matter?

Credit ratings are an assessment of the creditworthiness of an individual, business, or government entity. For individuals, generally having a higher credit score could have several benefits, such as potentially lower mortgage rates compared to those with a lower credit score.

Similarly, a lower credit rating for the US could make it more expensive for the government to borrow money, thus potentially raising costs for taxpayers. This could also push yields on US government debt higher, as investors demand a greater premium to be assured they will be paid back in full.

How can this impact investors?

So far, the Treasury market's response has been benign, while stocks slid modestly lower. The yield on the 2-year Treasury fell, while the yield on the 10-year Treasury rose slightly. Concerns of a forced selloff from institutional investors from a downgrade are unlikely as many institutional investors had already prepared for the move by changing mandates to specifically refer to Treasuries rather than AAA credit rating. This reflects the importance of US Treasuries, given the sheer size of this market. Looking ahead, US Treasuries could also benefit should the cooling economy head into a recession.

Conclusion

The US faces serious long-run fiscal challenges with a large debt, deficits, and political brinkmanship that makes the best of us question the strength of the world's largest economy. However, the decision by Fitch to downgrade the US debt appears strange, given it's months after the debt ceiling stalemate has passed and the economy is relatively resilient and surprisingly stronger than many had expected. The downgrade does not reflect any new fiscal information and is unlikely to have a material impact on financial markets. This latest ratings cut by Fitch in some ways is similar to the debt ceiling debacle earlier this year, which leads to some short-term anxiety but does not amount to much else.

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