Fitch downgrades U.S.

August 3, 2023

On Aug. 1, Fitch Ratings cut the United States to a AA+ rating from AAA. This follows a similar move by S&P in 2011 and leaves Moody's as the only major rating agency to still classify the U.S. as AAA.

Standard bond market practice is to use the median level when evaluating so-called split-rated issuers, meaning the U.S. is now considered a AA-category issuer for the first time since Treasuries were initially rated in the early 1960s.

Drivers

Fitch ascribed its decision to a combination of macroeconomic factors and governance issues. It highlighted the current debt burden—which it attributed to a combination of tax cuts and spending initiatives—and projections on future increases in debt levels driven by rising interest rates, an aging population, and higher healthcare spending. On the governance front, Fitch's comments focused on debt-limit showdowns that are only resolved at the last minute.

Not much to see

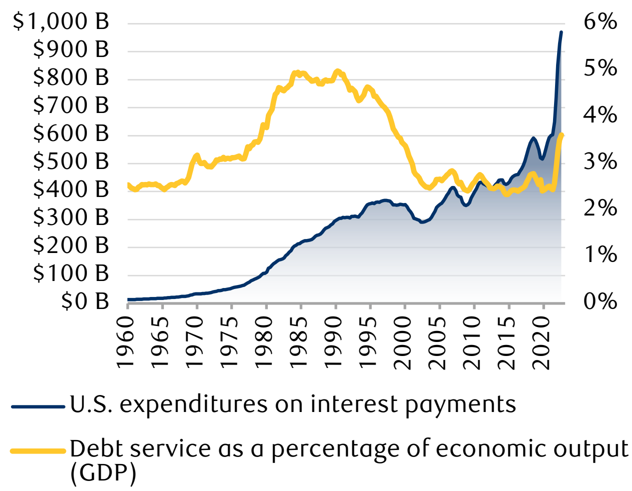
We believe that the loss of AAA-status is unlikely to have a significant, durable impact on U.S. Treasuries.

To begin with, there is nothing new in Fitch's report. Market participants will not be shocked to learn that U.S. debt metric projections are problematic. We think it was clear early in the debt ceiling negotiations that governance had deteriorated. The rating cut itself is also not entirely unexpected. We, along with other commentators, specifically highlighted the risk that even a successful negotiation of a debt ceiling raise could lead to a rating cut.

In addition to the lack of insight, we think participants will rightly discount the intermediate term debt projections, given the sensitivity of this analysis to the underlying assumptions. While it's useful to look at forward-looking projections based on current state policy, we should keep in mind that these projections almost never materialize in practice.

Most importantly, we believe there is nothing in Fitch's report that raises a credible threat to the U.S.'s ability to service its debt.

Even as interest expenses rise, affordability remains in line with historical norms



Source - RBC Wealth Management, Bloomberg, Bureau of Economic Analysis

And even less to care about

The more significant reason to think that Fitch's move will have limited market impact is that, in our view, few investors buy U.S. Treasuries based on a fundamental analysis of the underlying credit quality.

The two largest investor types—the Federal Reserve and overseas institutions—hold more than half of marketable Treasury debt outstanding. The Fed is, of course, holding Treasuries as part of monetary policy making, and we do not believe the downgrade will accelerate the central bank's ongoing quantitative tightening program.

For important disclosures, see page 2.

Overseas investors, in our view, choose Treasuries largely because of currency preferences. They choose to save in U.S. dollars, given its dominant role in international trade, and because of that currency choice they buy Treasuries as a holding vehicle. There may be modifications to currency preferences driven by de-dollarization, but we think it is highly unlikely Treasury default risk plays any role in the process.

Treasuries also offer unique and attractive characteristics for non-official buyers. They are the deepest and most liquid fixed income market in the world, allowing investors to enter and exit with relatively low costs. Treasuries also serve as the benchmark collateral for securities financing markets, meaning investors are usually able to borrow against their Treasury holdings with greater ease and at lower cost than most—if not all—other financial assets.

For most investors, switching out of Treasuries based on the credit risk difference implied by a cut to AA+ from AAA is difficult to justify. Other alternatives—such as AAA-rated corporates or foreign currency denominated bonds from other countries—are likely to be less liquid than Treasuries and more volatile, after accounting for currency moves.

Potential technical moves

We believe the most likely negative impact for Treasury markets from the Fitch downgrade is a technical one. Some investors are prohibited from holding non-AAA securities, and they may be forced to exit or reduce their Treasury holdings as a result. In our experience, most investment restrictions treat Treasuries as their own asset class, independent of rating, and we do not expect widespread forced selling because of Fitch's move.

In our view, the recent rise in Treasury yields is attributable to recent strong economic data, an increase in the size of upcoming Treasury bond auctions, and the relatively low trading liquidity typical of August. To the extent that the Fitch downgrade impacted bond prices, we believe the effect was likely minimal.

A pebble in the road

Fitch, S&P, and countless other economic commentators, rightly highlight weaknesses in the U.S. budget process and outcomes. For investors, however, the issues that Fitch raised are well-known, unlikely to be material in the near term, and fail, in our view, to make a case for switching out of Treasuries and into other assets.

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