

CHIEF INVESTMENT OFFICE

Investment Insights

Fitch Downgrades U.S. Government

August 2, 2023

All data, projections and opinions are as of the date of this report and subject to change.**Fitch Ratings Downgrades U.S. Sovereign Rating by One Notch to AA+**

Yesterday afternoon, Fitch downgraded the U.S. Government's rating by one notch to AA+ from AAA, removing its Rating Watch Negative and moving its Outlook to Stable. The agency cited deteriorating credit metrics in response to large debt funded deficits, which have accelerated since the pandemic, rising entitlements, and poor governance relative to similarly rated developed market sovereign peers—leaving the U.S. less flexibility to manage through economic downturns and exogenous shocks. Fitch's concerns are certainly valid; however, we would note that these worries have more significant longer-term implications with regards to the U.S. government's fiscal challenges/outlook, and are mitigated by the strength, competitiveness, and diversity of the U.S. economy in addition to the U.S. dollar's status as the international reserve currency, in our opinion.

Expect Muted Market Reaction—Not An S&P 2011 Downgrade Redux

While the downgrade may have come as a surprise to some, these trends are well known by market participants and nothing new. Market reaction, thus far, has been muted. Treasury yields, which initially rose modestly on the news, quickly retraced this move with the 10-year yield relatively unchanged at around 4% and U.S. sovereign credit default swaps (CDS) roughly unchanged, as of the morning of August 2. Similarly, U.S. Equity futures indicated just a modest selloff and short-term funding markets continue to operate with no issue.

While it is easy to make comparisons to S&P's 2011 downgrade of the U.S. Sovereign, which caused some significant short-term volatility across Equity and Fixed Income markets, there are several important distinctions that lead us to believe that this time is indeed different. Firstly, the Fitch downgrade comes at a time when the U.S. economy is exhibiting unexpected strength and resiliency. Inflationary pressures continue to moderate, Q2 gross domestic product (GDP) growth was stronger than expected at 2.4%, and unemployment remains at structurally low levels. Conversely, in August 2011, when S&P downgraded its U.S. sovereign rating, the economy was in a very different place. The world was still grappling from the fallout from the 2008/2009 Global Financial Crisis, credit spreads were materially wider near recessionary levels, unemployment was still over 8%, and GDP growth well below trend/slowing.

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Data as of August 2, 2023

Credit-Weightings of G-7

	S&P	Moody's	Fitch
U.S.	AA+	Aaa	AA+
Germany	AAA	Aaa	AAA
Canada	AAA	Aaa	AA+
France	AA	Aa2	AA-
U.K.	AA	Aa3	AA-
Japan	A+	A1	A
Italy	BBB	Baa3	BBB

Source: Trading Economics, Nikkei Index Asia. Data as of August 2, 2023. **Please refer to index definitions at the end of this report. It is not possible to invest directly in an index.**

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Considerations On The U.S Economy and Importance Of U.S. Dollar As The Reserve Currency

The downgrade comes at a time when the U.S. economy—on a relative and absolute basis—is exhibiting unexpected strength and resiliency. Moreover, the downgrade is based on discounted risks: negotiations over debt ceiling and implicitly, continued political discord. Since the last time the U.S. credit was downgraded, in 2011, the U.S. economy has grown from roughly \$15.6 trillion then to over \$26 trillion today.

Cyclical And Structural Macro Variables In Favor Of U.S.' Longstanding Creditworthiness

- Q2 real GDP growth stronger-than-expected, at 2.4%, according to the Bureau of Economics Analysis.
- Inflationary pressures are moderating—headline inflation 9.1% a year ago versus 3% today.
- Largest and most dynamic economy on the planet. Of the three largest economic entities in the world—the U.S., the European Union and China—the U.S. is the most competitive and innovative.
- U.S. dollar still the world's reserve currency: roughly 60% of central bank holdings in U.S. dollars; next closest: Euro with roughly 20% share, according to the Federal Reserve Flow of Funds data.
- Gross public sector debt as a percentage of GDP—slightly under 100% of GDP—very manageable given growth dynamics of the U.S. economy. Comparable figures for Japan and China: 200%+, according to the World Bank.
- Near-term challenges to the economy are breaking favorably: stronger-than-expected GDP growth in Q2; moderating inflation pressures and expectations; at or near the peak in federal funds rate; resilient U.S. consumer.
- The downgrade in 2011 did temporarily weigh on Equities—the S&P 500 Index fell 5.7% in August and another 7.2% in September. However, by the end of October, the index was back up above pre-downgrade levels. In addition, S&P total returns were stronger in 2012 (+16%), 2013 (+32.4%) and 2014 (+13.7), according to Bloomberg.

Bottom Line: The downgrade by Fitch of the U.S. Government's rating by one notch to AA+ from AAA was well telegraphed back in May when it flagged the risk of a downgrade. Given the experience from the original downgrade some 12 years ago by S&P, market participants are well prepared, in our view, for the current market environment. Finally, U.S. Treasuries remain a foundational, bedrock asset that continues to be the top choice of collateral for lending facilities of the largest central bank in the world, the Federal Reserve (Fed).

With Equity markets rallying strongly, year-to-date, and bond yields remaining stuck in a narrow range, we continue with our balanced (neutral) stance between Equities and Fixed Income. We expect some softness in August after the strong gains from June and July and would use weakness as an opportunity to rebalance portfolios on a dollar cost averaging basis.

The downgrade is unlikely to affect the use of the U.S. Treasury as a bedrock asset. After all, U.S Treasuries remain the Fed's top choice of collateral for its lending facilities.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index is a stock market index tracking the stock performance of 500 of the largest companies listed on stock exchanges in the United States.

Nikkei is a stock market index for the Tokyo Stock Exchange.

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