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MARKET SIGHT *LINES*

The Short-, Medium-, and Long-Term Implications of the U.S. Debt Downgrade

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Fitch Ratings ("Fitch") is one of three U.S. credit agencies rating the bonds of corporations and governments. Investors use these ratings to gauge the credit worthiness of a bond and its issuer, both to understand how likely it is that a bond will be repaid at maturity, and what might be a fair interest rate, the coupon rate when a bond is first issued. Fitch recently lowered the credit rating of U.S. government debt from AAA to AA+, only the second time a rating agency has downgraded U.S. government debt.

In this Sight|Lines, we summarize the Fitch U.S. government debt downgrade and the short-, medium-, and long-term implications of this action.

THE TAKEAWAY: IN SOME WAYS THE FITCH DOWNGRADE WAS NOT SURPRISING.

Rating agencies study the fiscal practices, financial strength, and ability and willingness of bond issuers to pay interest and repay debt. The Fitch downgrade is the result of higher deficits, growing debt, higher interest costs, and a polarized political environment. In summary:

- The U.S. budget deficit has increased meaningfully recently, especially in the wake of the pandemic.
- The cost of higher debt is being amplified by higher interest rates resulting from the Fed's policy shift.
- Our governance of the debt has eroded as a result of the polarized political environment.
- While we see no evidence of meaningful selling of U.S. debt, the short-term implications include increased stock and bond market volatility.
- Over the medium term, we may well expect higher rates and a steeper yield curve because of this action, but, more meaningfully, holders of U.S. debt, and voters, may look for better fiscal discipline.
- In the long term, there is a risk that the U.S. dollar loses its reserve currency status, and investors may demand higher rates to hold U.S. debt.

We maintain an optimistic outlook that over the long term U.S. Treasuries will remain the preferred risk-free asset class among investors, along with the dollar retaining its position as the global reserve currency. Nevertheless, the downgrade may well be a wake-up call to investors, politicians, and voters to improve our fiscal practices.

IN-DEPTH: THE FITCH DOWNGRADE WAS NOT SURPRISING AND HAS MEANINGFUL IMPLICATIONS OVER THE SHORT, MEDIUM, AND LONGER TERM.

To quote Fitch on the action: "The rating downgrade of the United States reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance

relative to ‘AA’ and ‘AAA’-rated peers over the last two decades that has manifested in repeated debt limit standoffs and last-minute resolution…" Going deeper:

- Fiscal practices are eroding, and the level and cost of debt are increasing in the U.S.:
    - The U.S. budget deficit averaged 8.1% of GDP over the last five years, well above prior levels.
    - The Federal debt hit 100% of GDP in 2020, the highest level since the great depression.
    - Fitch estimates that the interest-to-revenue ratio is expected to reach 10% by 2025, well above the median for AA issuers of 2.8% and the median for AAA issuers of 1%.
- The polarized political environment complicates our ability to improve our fiscal practices:
    - Increasing revenues through higher taxes and reducing spending are politically unpalatable.
    - Congress has raised the debt ceiling over 90 times since it was created in 1917, but in both 2021 and 2023, debt ceiling “standoffs” resulted in politicians threatening a debt default during debt ceiling negotiations.
    - On a related note, Stifel’s Chief Washington Policy Strategist, Brian Gardner, shares an update on the increased risk of an October government shutdown.
- While we see no evidence of meaningful selling of U.S. debt, the short-term implications include:
    - An increase in stock market volatility, as measured by the VIX Index, which has jumped ~30%.
    - An increase in bond market volatility, as measured by the MOVE Index, which has jumped ~4%.
    - The U.S. 10-year Treasury yield rose 22 basis points to 4.17% in the first couple of days following the downgrade, but has since fallen back to around the 4% range.
- Give this downgrade, over the medium term, we see:
    - The prospect of higher rates and a steeper yield curve, and
    - The holders of U.S. debt, and voters, calling for better fiscal discipline.
- Long-term risks and opportunities include:
    - The U.S. dollar could lose its reserve currency status.
    - Investors may demand higher rates to hold U.S. debt, given increased risks.
    - With better fiscal discipline and lower debt, the U.S. could solidify its status both in terms of a U.S. dollar reserve currency and as the issuer of “risk-free” debt.

CONCLUSION

Fitch downgraded U.S. government debt from AAA to AA+, only the second time such a downgrade in U.S. government debt has occurred. This move represents a “shot across the bow” for U.S. debt investors, politicians, and voters, in terms of the need to improve our fiscal practices and standing. Our leaders are fully capable of solving these problems, but the issue remains as to whether such action will be politically palatable in the current polarized environment.

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. The Merrill Lynch Option Volatility Estimate (MOVE) Index reflects the level of volatility in U.S. Treasury futures. The index is considered a proxy for term premiums of U.S. Treasury bonds (i.e., the yield spread between long-term and short-term bonds).

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