

MARKET SIGHT LINES



U.S. Debt May Be “Money Good” For Now, But the Downgrade is Another Negative Signal

By Michael O’Keeffe, *Chief Investment Officer*



Will our government repay its debt? Experienced fixed income investors describe a bond as “money good” if they believe the bond issuer will honor its coupon interest payments and repay principal at maturity. U.S. Treasury bills are perceived as “risk free,” with other types of bonds, like corporate issues, paying a “spread” above these rates to compensate the investor for the extra credit risk. Last year, we added the theme [Financial Instability](#) to our geopolitical risk dashboard — highlighting how higher debt levels and higher rates can lead to a painful [Fiscal Transition](#). In this Sight|Lines, we summarize the recent Moody’s U.S. government debt downgrade and how it relates to the troubling U.S. fiscal trajectory.

THE TAKEAWAY: MOODY’S DOWNGRADE WAS UNSURPRISING BUT YET ANOTHER WARNING SIGN

Rating agencies study the financial strength and ability of bond issuers to pay interest and repay debt. Moody’s was the third such organization to downgrade U.S. debt, which was unsurprising, but troubling. In summary:

- Moody’s downgrade follows previous, [similar actions](#) from Standard & Poor’s and Fitch Ratings.
- These new rating levels are still considered very high quality and subject to very low credit risk.
- Moody’s cited concerns over rising national debt, persistent fiscal deficits, and the increasing cost of debt — the interest payments — as reasons for its downgrade.
- Reduced spending and higher taxes are politically unappealing to members of Congress, and the current reconciliation bill is projected to result in little change to the deficit.
- In the very near term, poor fiscal management and an eroding quality of U.S. debt may cause increased stock and bond market volatility.
- Over the short-to-medium term, investors may demand a higher “term premium,” a higher yield to be compensation to hold longer-dated U.S. debt.
- Over the longer term, fiscal mismanagement puts the U.S. dollar reserve currency status at risk, and investors may demand even higher yields to hold U.S. debt.

We remain optimistic that, over the long term, U.S. Treasuries will remain a preferred low risk asset class among investors, and the dollar will retain its reserve currency status. That said, the Moody’s downgrade is yet another wake-up call to politicians and voters that we must improve our fiscal practices.

IN-DEPTH: THE UNSURPRISING MOODY'S DOWNGRADE SERVES AS ANOTHER WAKE-UP CALL TO POLITICIANS AND VOTERS THAT WE MUST IMPROVE OUR FISCAL PRACTICES

Rating agencies study the financial strength and ability of bond issuers to pay interest and repay debt. Moody's was the third such organization to downgrade U.S. debt, which was unsurprising, but troubling. Going deeper:

- Moody's was the third to downgrade U.S. Debt:
 - The rating was lowered to AA+ by Standard & Poor's in 2011 and Fitch Ratings in 2023.
 - Moody's lowered its rating to Aa1 on May 16, 2025.
- These new rating levels are still considered very high quality and subject to very low credit risk:
 - Moody's defines debt obligations rated Aa as "judged to be of high quality and subject to very low credit risk," and the suffix of "1" designates the upper end of that category.
- Moody's cited concerns over rising national debt, persistent fiscal deficits, and the increasing cost of debt — the interest payments — as reasons for its downgrade.
 - The U.S. deficit has averaged \$2.2 trillion from 2020 to 2024, bringing our debt to \$36 trillion.
 - Our debt interest payments represented 33% of our discretionary budget in 2024.
- Reduced spending and higher taxes are politically unappealing to members of Congress:
 - While the current reconciliation bill could change, the latest projection from the CBO estimates this year's deficit to remain largely unchanged from last year, at approximately \$1.8 trillion.
- In the very near term, poor fiscal management and an eroding quality of U.S. debt may cause increased stock and bond market volatility:
 - The VIX Index, a measure of stock market volatility, jumped 5.2% in the wake of the downgrade, while the MOVE Index, a measure of bond market volatility, jumped 7.4%.
- Over the short-to-medium term, investors may demand a higher "term premium," a higher yield to be compensated to hold longer-dated U.S. debt:
 - The 30-Year Treasury yield, a reflection of long-term views, has risen to over 5% recently.
- Over the longer term, fiscal mismanagement can create [Financial Instability](#) and greater systemic risks:
 - The U.S. dollar may lose its reserve currency status.
 - Investors may demand even higher yields to hold U.S. debt, driving interest rates higher.
 - These moves could shake one of our foundations for investing, creating the risk of severe bear markets for both stock and bond investors.

CONCLUSION

Moody's recent U.S. debt downgrade once again brings U.S. fiscal mismanagement into focus. While we remain optimistic that U.S. government will eventually get its fiscal house in order, Moody's action is yet another wake-up call to politicians and voters that we must improve our fiscal practices.

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