Fitch Downgrade
More Barbie than Oppenheimer

The ratings cut on U.S. Treasuries presents an uncomfortable reality about the United States' long-term fiscal stability, but it's not a doomsday scenario.

Highlights

- Unlike S&P's 2011 downgrade, which landed in the midst of Europe's sovereign debt crisis, this action comes in a period of relative calm and **affects only long-term U.S. Treasuries, limiting the collateral damage**.
- We believe **bonds remain viable and buyable**, as higher nominal and real yields offer the potential for an attractive source of relatively stable returns, while providing more of a cushion against swings in bond prices.
- A low-probability tail outcome is that some market participants use the downgrade to increase the haircut on Treasuries that some investors put up as collateral, which could prompt forced liquidations. **Recently added waiver language regarding collateral restrictions in some portfolios may reduce this risk.**

Fitch cuts rating on U.S. government credit

Two months after President Biden and Congressional Republicans signed a last-second deal to avert a government default, Fitch Ratings downgraded long-term U.S. Treasuries from AAA to AA+, citing concerns about fiscal deterioration, a high and growing debt burden and an erosion of governance. We believe these are fair and important points that must be addressed. But for markets and investors, the news doesn't change the narrative.

Echoes of 2011

The last (and only other) time this happened was in 2011, when Standard & Poor's downgraded the U.S. credit rating days after the government resolved its most serious-to-date standoff on the debt ceiling. That event took place in the midst of a blow-out in Greek sovereign spreads, raising worries that Europe's debt crisis could be spilling over into the U.S. The news sparked intense short-term volatility, but markets eventually stabilized and U.S. equity indexes hit record highs by 2013, fueled in part by new quantitative easing measures.

A small ripple in a period of calm

A key difference this time is that the downgrade comes at a quiet moment for markets, months after the frenzy of the debt-ceiling debate, allowing investors to absorb the news in isolation. The news cycle, for the moment, remains dominated by the 2024 presidential election landscape and geopolitical concerns. It also helps that the downgrade was limited to long-term U.S. Treasuries, sparing other asset classes from collateral damage.

The market's immediate reaction has been modest. Stocks opened lower the next morning, although the move could just as well be explained by the stronger-than-expected jobs report, which raises the chances of further Fed tightening. Treasuries, gold and money markets appear relatively unperturbed. (In fact, new regulations requiring prime funds to be more conservative have created more natural demand for U.S. Treasuries.)

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Investment implications

Our case for bonds remains intact: The move higher in yields (in both nominal and inflation-adjusted terms) has made bonds more attractive, providing a source of relatively stable returns and, if interest rates were to move higher, cushioning the impact of falling bond prices.

Watch for a haircut on Treasury collateral: Many investors put up collateral for various trading strategies. That collateral comes with a haircut on its value depending on the quality of the asset, with AAA rated paper subject to the lowest haircut. If some market participants were to see the ratings downgrade to AA+ as reason to demand a larger discount, investors would need to post additional collateral, potentially driving forced selling as investors seek to raise cash.

We believe such an outcome remains highly unlikely, but the risk is not zero, and we are monitoring the situation. An additional factor that could mitigate this risk is the observation that many investors, in response to the debt-ceiling standoff, added waiver language to collateral restrictions to prevent a spiraling forced-selling situation.

Ed. note: The original version of this report stated that GNMAs retained their AAA rating. Subsequent news reports clarified that GNMA credit ratings would match the rating of U.S. Treasuries. We believe this action will have no effect on the credit quality of GNMA bonds.

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