Breaking News: The US credit rating has been downgraded!
(...and the crowd went wild)

Global Ratings Agency Fitch downgraded the US credit rating on August 1st from AAA to AA+ due to fiscal concerns, a deterioration in US governance, as well as political polarization reflected partly by the January 6th insurrection. The news took markets by surprise and caused a minor flutter, but despite the downgrade being an undeniable bad omen the financial media pretty much ignored the news. Does a downgrade to the US credit rating matter? Does it have any effect on investors here in Australia - or anywhere else for that matter?

On August 1st the Global Ratings Agency Fitch stripped US government debt of its pristine, top-tier rating (something it warned of two months ago when Republicans were refusing to raise the debt limit, potentially triggering an historic default). Despite criticism from Wall Street and Washington, the rating agency's reasons weren't a surprise: ballooning US deficits and political dysfunction.

From Fitch's announcement[1]: "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 resolutions".

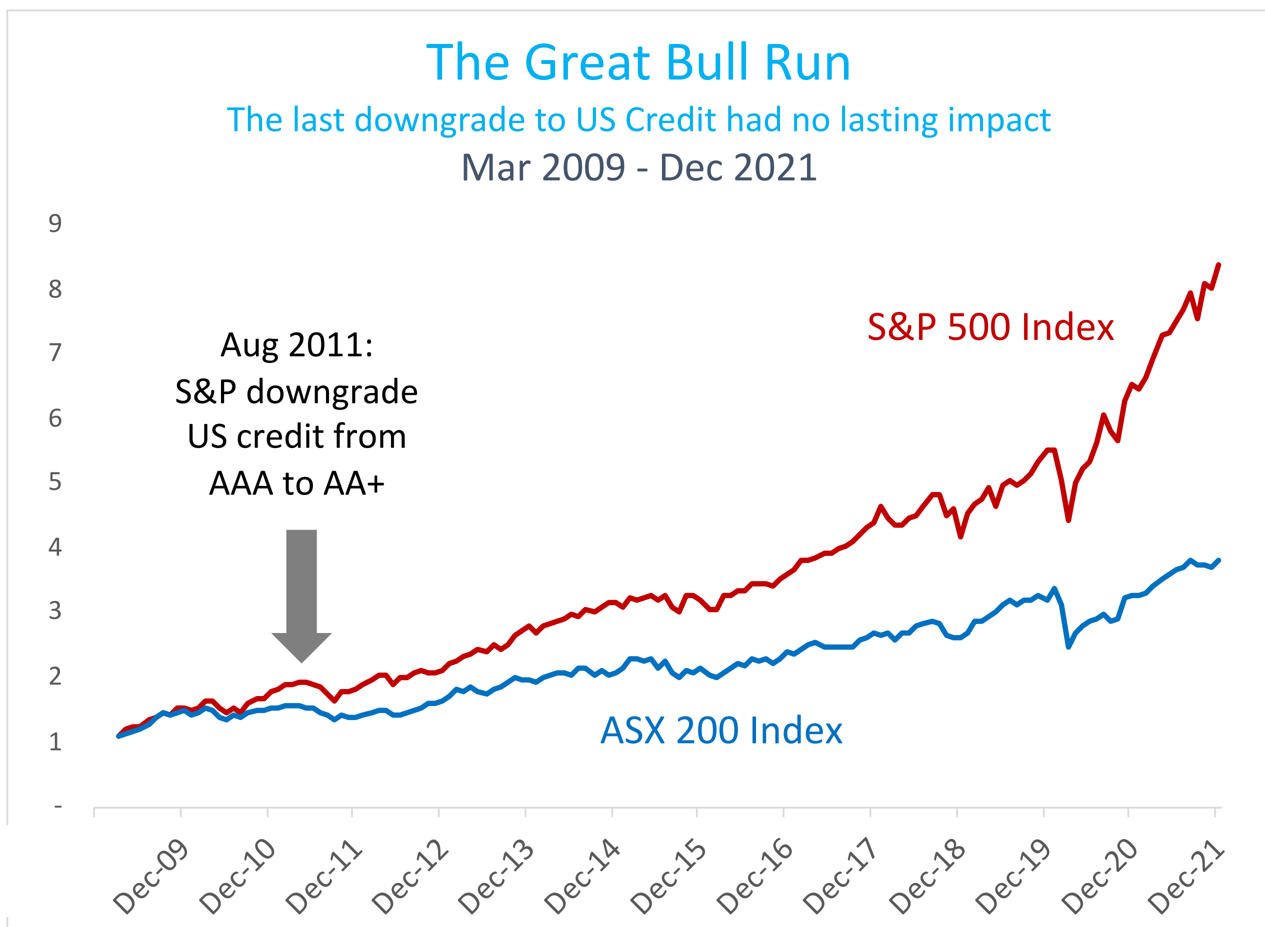
[1] https://www.fitchratings.com/topics/us-debt-ceiling

These reasons will come as no surprise to anyone who broadly follows what is going on in the US politically and economically, and yet markets did have a little flutter on the announcement. But stock and bond markets had moved on to other news and events within a few hours, the downgrade seemingly forgotten.

And this is not the first time. Back in August 2011 Ratings Agency S&P Global caused a much greater shock when they downgraded the US debt from AAA to AA+. At that time stocks had a significant correction and investors rushed to buy government bonds (which is odd as these bonds were the very thing that had been downgraded and therefore supposedly had become riskier). But the market recovered within a short period.

At the time the U.S. government was entangled in drama around raising the debt ceiling, an event that really was unprecedented, and the ensuing downgrade of U.S. credit was a true shock to the markets. Uncertainty was high, and therefore market volatility was understandably high.

But looking through the lens of history, the stock market downturn after the 2011 ratings downgrade was a mere blip in the middle of the Great Bull Run – the market rally that started in March 2009 and went all the way to the end of 2021. As the graph below shows the S&P downgrade had no lasting effect on the S&P 500 Index as it made a cumulative return of 740% in that period (by comparison the S&P/ASX 200 Index had a cumulative return of 280%).



These days, American politicians having a "stand-off" around raising the debt ceiling seems much more commonplace. The January 2023 US debt ceiling "crisis" was generally met by an air of indifference by most market commentators, in that most believed the politicians were playing games (albeit a high stakes game) and eventually a compromise would be reached before the US literally ran out of money to pay for services and wages of government employees by June 1st.

Given the subdued market reactions immediately following the Fitch announcement, traders and investors seem largely unfazed. So does this recent downgrade of US debt actually matter for the markets or the economy?

The short answer is "*almost* definitely not". After all, US Treasuries (government bonds) remain the most liquid, coveted securities globally and the risk-free asset off which just about everything else is priced. Furthermore, since the debt is in US dollars the US can always repay this debt by simply raising taxes. Granted, that requires political will, to which there is not a lot going around these days.

But a longer answer may conclude that the actions by Fitch are another warning that US governments (present and future) can only ignore at great risk to the US and global economies. There is little flexibility in the US system for higher taxes, increasing inflation, cuts to benefits or some combination of those. So while an actual default may never occur, Fitch is sending a message.

This sort of problem was described by policy analyst Michele Wucker in her book "The Gray Rhino". Unlike a "black swan" event that cannot be forecast, a gray rhino is a very probable event with plenty of warnings and inescapable evidence that is ignored until it is too late.

But to quote Paul Krugman, the bottom line is that the US is highly unlikely to face a debt crisis anytime soon, or even in the next decade or two[2]. His view is that "if you're worried about the longer run, I'd suggest that you pay less attention to the possibility of runaway debt and more to what increasingly looks like runaway climate change".

Dr Steve Garth
August 2023

[2] https://www.nytimes.com/2023/08/04/opinion/us-economy-debt-crisis.html