Daiwa Securities

Daiwa's View

Wake-up call sounded by downgrading of US Treasuries

➢ Will this trigger move towards tighter fiscal policy?

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Wake-up call sounded by downgrading of US Treasuries

Will this trigger move towards tighter fiscal policy?

The rating agency Fitch[1] (*) has announced that it has lowered the rating of US Treasuries by one notch, from the highest AAA to AA+, with a stable outlook. The agency attributed the downgrade to "the expected fiscal deterioration over the next three years" and a decline in confidence in fiscal management as shown by "the repeated debt-limit political standoffs and last-minute resolutions" over the last twenty years. In 2011, S&P (*) also downgraded the US rating for similar reasons.

Fitch (*) expects the US fiscal deficit to rise to 6.3% of GDP in 2023, to 6.6% in 2024, and to 6.9% in 2025, from 3.7% in 2022. As a result, the agency forecasts that the general government (GG) debt-to-GDP ratio will reach 118.4% in 2025, from 100.1% in 2019. This figure is much higher than the AAA median of 39.3% of GDP and AA median of 44.7% of GDP. In Fitch's longer-term projections, it forecasts "additional debt/GDP rises, increasing the vulnerability of the US fiscal position to future economic shocks."

The agency pointed out "several economic shocks as well as tax cuts and new spending initiatives" as factors behind US fiscal deterioration. Over the medium term, the agency is concerned about the "only limited progress in tackling medium-term challenges related to rising social security and Medicare costs due to an aging population." According to the Congressional Budget Office, cuts to non-defense discretionary spending as agreed in the Fiscal Responsibility Act amount to $1.5tn in cumulative savings by 2033, but Fitch (*) views that this will "offer only a modest improvement to the medium-term fiscal outlook." The agency does not project any further substantive fiscal consolidation measures ahead of the Presidential Election in November 2024.

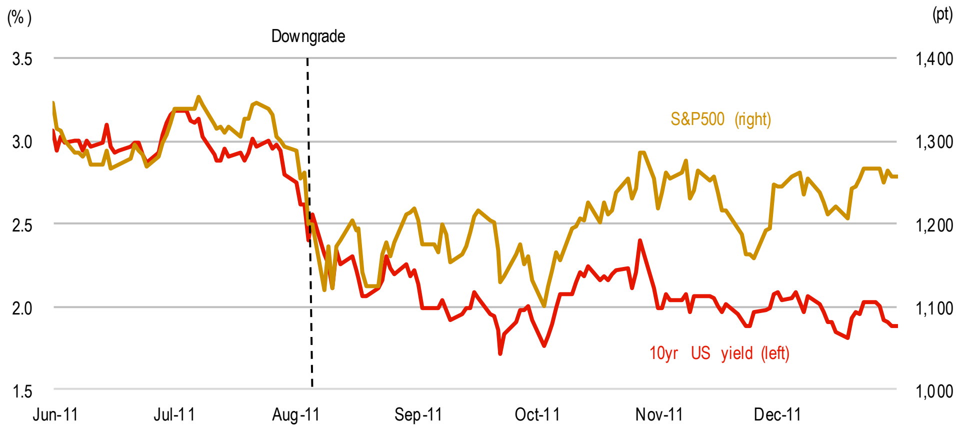
Of course, even with cuts in spending in accordance with the Fiscal Responsibility Act, there may be impacts on the US economy that cannot be ignored, such as, for example, the inclusion of the resumption of repayments of student loans. Nevertheless, as announced by the Treasury Department in its estimate for marketable borrowing on 31 July, the required borrowing amount in the Jul-Sep quarter was revised upwards, from $438.0bn as of May to $521.0bn. A high level of borrowing is also expected to continue in the Oct-Dec quarter ($487.0bn). Fitch (*) appears to have implemented the downgrade upon confirming an outlook for fiscal deterioration of this sort.

In addition to the fiscal deficit, progress has also not been made regarding the debt ceiling issue. US President Joe Biden has instructed close advisers to consider all possible legal and political options in order to avoid a recurrence of crises related to the debt ceiling, and new working groups have started to consider such measures. However, evident progress has not been seen.

[1] (*) Indicates unregistered rating agency; please see the disclaimer at the end.

In response to the announcement by Fitch (*), the market initially reacted with a decline in stock prices and a drop in yields. When S&P (*) downgraded US Treasuries in 2011, stock prices fell together with a rise in the VIX Index, which led to a decline in US yields. Therefore, the latest reaction appears to have been partially influenced by associations with the downgrading in 2011 (Chart 1). In the forex market, the dollar weakened, while the Swiss franc and the yen were bought. However, during US trading hours, US yields posted an uptrend, rather than a downtrend, followed by lower stock prices and a stronger dollar, partly due to the impact of higher-than-expected economic indicators.

Chart 1: Market Reaction to UST Rating Downgrade by S&P (*) in 2011



Source: Bloomberg; compiled by Daiwa Securities.

If a trend towards lower stock prices were to form due to the downgrading of US Treasuries, its impact could spread to other assets, such as US yields, as (1) lower stock prices push down consumption via the reverse wealth effect and (2) a change in inflation expectations would have an impact on the Fed's monetary policy. That said, once stability was gradually restored in the market, the focus of attention would be expected to once again return to the strength of the recent US economy and inflation trends. Accordingly, the short-term impact on the market would be limited.

Treasury Secretary Janet Yellen objected to the downgrade by Fitch (*), saying that the change was arbitrary and based on outdated data, and that the agency ignored improvements in governance metrics during the Biden administration. She alleged that US Treasury securities remained safe and liquid assets. However, the Committee for a Responsible Federal Budget, a nonpartisan and non-profit organization, stated that the US was clearly on an unsustainable fiscal path, and that policymakers therefore needed to build efforts with further deficit reduction, viewing the latest downgrade as "a wake-up call." The Fiscal Responsibility Act, which was enacted to respond to the debt ceiling issue, has the effect of lessening the expansionary path of US fiscal policy. Meanwhile, the latest downgrade may trigger a move towards tighter fiscal policy. Contractionary US fiscal policy, together with monetary tightening, is likely to slow down the US economy. The short-term impact of the downgrade may not be strong. However, looking back on this in the future, we may find that the rating action held the potential to become a turning point for the market.

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