HSBC

Asset Management

Fitch downgrades US

Investment event | 3 August 2023

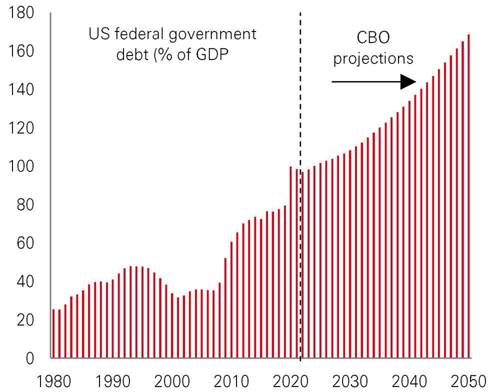
Concern over debt outlook and governance

On August 2, the rating agency Fitch has downgraded the credit rating of US federal government debt to AA+ from AAA. According to Fitch, "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".

Fitch did not downgrade its "country ceiling", which remained at AAA, so the action should not have implications for debt issued by government-sponsored entities.

The medium-term challenges facing the US public finances are well known; the Congressional Budget Offices' (CBO) projections show that on current policies, the US budget deficit would remain on a widening trend over the coming decades, resulting in the federal government debt ratio reaching around 170% of GDP in 2050, up from around 100% currently (Figure 1).

Figure 1: US federal government debt



Source: Macrobond, Congressional Budget Office, HSBC AM (3 August 2023)

The CBO's projections for a widening budget deficit reflects an expected structural rise in spending on healthcare and, to a lesser extent, social security in the context of an aging population. A significant expected increase in interest payments is a further important factor in the CBO's assessment.

Why now?

The challenges to the US public finances in the coming decades is not "new" news, so cannot really explain why Fitch chose to downgrade the US at this point. The timing of the decision may reflect:

- The rapid widening of the federal deficit to 6.3% of GDP in Q1 2023, from 3.5% of GDP in Q2 2022
- The significant increase in debt servicing costs driven by the rapid increase in interest rates over the past year
- Fitch's forecast of a mild recession in Q4 2023/Q1 2024, which would probably put further pressure on the public finances
- Fitch's expectation that there will not be any substantive fiscal consolidation measures before the 2024 Presidential election

Investment implications

Since the announcement, the US Treasury curve has steepened with 10y US Treasury yields having risen by around 15bp while the 2y yield is broadly unchanged. 10y yields are now approaching the highs seen in October and November 2022.

The S&P 500 fell 1.5% on the day while the tech-heavy NASDAQ, which is more sensitive to long-term interest rates, fell by 2.2%. Global markets also came under pressure; the Eurostoxx 50 fell by around 1.5% on Wednesday and declined further in early trading on Thursday, although a weaker-than-expected services PMI is also likely to be weighing on European investor sentiment.

Overall, the decision by Fitch does not alter our investment views. We continue to argue for a defensive positioning in portfolios, especially in developed markets. Specifically:

- Our central scenario for US and European recessions emerging from late 2023 is consistent with a difficult environment for risk assets over the next 12 months, and room for downside in market prices for credits and stocks
- Our house view is consistent with a preference for short-duration fixed income assets, especially US Treasuries, which we see performing well as recession bites. We also want to take advantage of the carry that high quality credits offer and believe solid corporate balance sheets offer protection against default risk
- Finally, we remain positive on most EM asset classes given tailwinds from relatively low valuations, cautious investor positioning, more resilient growth, the prospect of Fed cuts from late 2023 and further dollar weakness later in the year

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The rating agency Fitch has downgraded the credit rating of US federal government debt to AA+ from AAA

The move reflected a range of factors including concern over the longer-term debt trajectory, an expected recession and limited prospects for near-term fiscal consolidation

Our view:

We continue to argue for a defensive positioning in portfolios given restrictive monetary policy and analysts' expectations for GDP and corporate profits which, in our view, look too optimistic

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