US Rates Watch

Minimal impacts of Fitch US downgrade

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SOFR: Secured Overnight Financing Rate

OIS: Overnight Index Swap

Fitch downgrades to AA+ from AAA

Yesterday, Fitch downgraded the US long-term credit rating one notch to AA+ from AAA and changed the outlook from negative to stable. This was a similar move we saw from S&P back in 2011 which also lowered the credit rating from AAA to AA+. The justification for the downgrade according to the Fitch report "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."

Little impact on demand for USTs

Credit rating have largely been removed or minimized from financial infrastructure since the passage of Dodd-Frank in 2010 and the S&P downgrade of the US in 2011. We expect no impact in terms of major index inclusion or acceptance of USTs as collateral in exchange margin accounts or in private bilateral collateral agreements. We do not expect any changes to risk weights of Treasuries or their treatment as Level 1 high quality liquid assets in the Basel liquidity regulations. This should limit any impact on rate levels.

Debt problem is not an ability to pay

We disagree with Fitch regarding the US federal government's ability to pay interest on a growing outstanding debt with higher interest rates. Like most sovereigns, the US does not rely on revenues or borrowing but instead prints the money required to spend, and then controls the total government money supply by taxing some portion back. Treasuries are a liability of the Fed to pay reserves at a specified future date. As long as the Fed can create reserves as it does today, there is no risk to payment on Treasuries other than self-imposed constraints such as the debt ceiling law.

Growing debt is a market structure issue

The growing Treasury debt market does pose a growing threat to market functioning and liquidity. As long as dealer balance sheets remain constrained while the debt market grows, we expect it will become more and more difficult to transfer duration risk during times of acute stress, such as the March 2020 episode. As seen in 2020, however, the Fed can become the dealer-of-last-resort and buy Treasuries and/or reduce the size of the publicly traded float of Treasury securities to smooth through period of sudden decline in market liquidity and functioning. While this is not an ideal solution to the trading problem, it appears to work and limits the tail scenarios of market disruption. The growing illiquidity of Treasuries we think will manifest itself over time in a trend of cheapening vs fed funds or SOFR swaps, ie tighter swap spreads.

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Downgrade impacts minimal

For market impact consideration, the main issue with a downgrade is whether it creates forced sellers or unwinds. We think the impact will be very limited, and we would note that the Treasury market rallied post the downgrade announcement. Credit ratings from Fitch and others has largely been removed from financial infrastructure including indexes, exchange collateral, bilateral collateral, Basel capital and liquidity regs. A rating below investment grade is where more serious issues can arise with the bond indexes or with USD as a reserve currency but that is not a likely outcome at any point for the US sovereign in our view.

There are 2 main risks that investors worry about with growing Treasury debt markets: 1) the ability to pay interest and other obligations, and 2) the ability to trade Treasuries easily during times of stress. Rating agencies focus on ability or willingness to pay.

In our view, ability to pay is a non-issue. There is not a problem in paying the interest, as the US like most sovereigns prints its own currency. Treasuries are an obligation of the Fed to pay reserves at a specified date in the future. As long as the Fed can electronically create reserves, the payment of Treasuries is assured. That includes social security and health care obligations which are also Treasury obligations. The debt ceiling is the only real constraint to payment of Treasury interest, but we believe there are workarounds there though it has never been tested.

At high rates and high debt levels, Treasury debt could generate more income than policy makers desire for the private sector which could add to inflationary pressures. If tax policy and discretionary spending policies are unchanged while total interest payments rise due to higher rates and larger amounts of securities outstanding, it creates more income for households which can become substantial relative to GDP in future years. This is an inflationary risk, but not a risk to ability to pay.

As we discussed during the recent debt ceiling episode earlier this year, a single notch downgrade is unlikely to result in forced selling from any major indices. Our understanding is that the main index programs that are used as benchmarks across global portfolios have adopted rule changes to remove ratings requirements which would reduce the index-related impacts (see US Rates Viewpoint: Debt limit FAQ: late spring 2023 update 16 May 2023)

Market functioning is an issue

The other main risk for Treasuries is the ability to trade the growing size of duration risk - which we see as a developing problem. In crisis times, the Fed has become the dealer-of-last-resort and the Fed can step in at any time to buy and/or reduce market size as we saw in March 2020. But in periods when the Fed is not buying or is doing QT (equivalent to selling Treasuries to the public), the increasing supply – especially of less traded off-the-runs - could lead to lower liquidity and reduced capacity to transfer large risk amounts. Decreased liquidity with growing debt relative to dealer balance sheet should manifest itself over time in tighter swap spreads (cheaper Treasuries vs OIS swaps). We think this is the main market impact of increasing debt supply relative to dealer balance sheet capacity.

Knock-on impacts

It is difficult to assess all the knock-in impacts, but our initial thoughts are they will be minor. We expect government-sponsored entities to be moved to the same rating level as the United States. We do not think this will impact demand for GSE securities. Agency MBS for example would still count as Level 2a high quality liquid assets in the liquidity regs, and the business model of FHLB (Federal Home Loan Banks) we think would not be altered. Government money funds we believe will continue to invest in short-term GSE securities as they normally do. In general, we think the market has largely prepared for US rating downgrades since 2011.

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