Perspective on the U.S. Downgrade

PGIM FIXED INCOME

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The news that Fitch Ratings downgraded the United States from AAA to AA+ has little effect on the primary market dynamics of the Treasury market. The asset class remains the gold standard within the developed market bond complex in terms of its liquidity, size, and security—characteristics that will likely remain the case for years, if not decades, to come.

However, the downgrade reiterates some important questions about the country's trajectory, e.g., in terms of its deteriorating debt dynamics. As Fitch highlights, governance standards in the U.S. have eroded: the fiscal framework of the 1990s is gone (as is the budget surplus), replaced by alarmingly large deficits along with more frequent threats of government closures and default.

The governance question also pertains to the country's increasingly divisive politics, which we see as one of the key global macroeconomic anchors that is giving way over time. The implications of the expanding divide include the erosion of the political center, less orthodox policy punctuated with bouts of radicalism, and institutional decay marked by a reduction in policy credibility.

In addition, the fundamental problem of fiscal spending that exceeds revenues remains entirely unaddressed, allowing the United States' debt-to-GDP ratio to soar from 40% to more than 100% since 2000 (a level that just a decade ago during the Eurozone crisis would have been considered dangerously high) in what some otherwise regard as the "danger zone" for sovereign credits.

From a relative perspective, one saving grace is that many DM countries have experienced a similar mushrooming of government debt in recent years. Furthermore, carrying out quantitative easing during times of fiscal stimulus—effectively monetary financing—is now commonplace whereas it was once considered taboo.

In terms of Treasury yields, the additional supply of Treasuries hitting the market as the deficit rises has put, and will continue to put, inexorable upward pressure on Treasury yields relative to other fixed income instruments, such as SOFR swaps. While a major near-term swing is not anticipated, over time this relative supply / demand dynamic has taken long-term Treasury yields from 30+ bps less than swap yields in the 1990s to now typically 50+ bps above swap rates. So, there is a visible impact of the country's rising debt burden, but, at least to date, the rate of change has been incredibly slow.

As for the here and now, U.S. economic fundamentals of growth and inflation as well as central bank policy remain the primary drivers of yield levels, which are broadly in the realm of fair value. In other words, we are in the end game of a rate-hike cycle and, therefore, near peak yields. Downgrade or not, U.S. fixed income is poised for healthy returns in the years ahead.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of August 2, 2023.

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