New Frontier

David Esch, Ph.D.

Managing Director of Research
New Frontier

Dr. David Esch is the Managing Director of Research at New Frontier. Dr. Esch completed his Ph.D. in Statistics at Harvard University in 2004 and joined the firm in 2008. His specialties include mathematical statistics, numerical analysis, computation, Bayesian statistics, and econometrics.

US Credit Rating Downgraded: New Frontier's Take on the Fitch Announcement

August 3, 2022

Do Downgraded Treasurys Still Belong in Your Portfolio? What Does the Treasury Downgrade Mean for Your Portfolio?

The creditworthiness of the US Treasury is hugely important – the function of the global economy is built on it. So at first the decision of Fitch, one of three major ratings agencies, to downgrade US debt would seem to matter. But this is old news. Fitch merely downgraded the US debt to the same level that S&P already did in 2011. The stock market's negative, but small, reaction to the downgrade is an indication that this will not affect the economy or the investor.

On Tuesday August 1, the Fitch Credit rating agency downgraded the US Credit score from the top AAA grade to AA+. The agency cited increasing political dysfunction and growing total debt. This is the first change in rating among the big three credit rating agencies in the US since Standard & Poor's made a similar change in August 2011. Moody's still is maintaining the top score.
However, the stability, dominance, and sheer size of the US treasury market should not be underestimated. It underpins the entire global economy as well as the functioning of equity markets and other asset classes. US Treasurys have been and will continue to be the global risk-free asset of choice. Two companies – Microsoft and Johnson & Johnson, as well as several countries are now rated as more credit worthy than the US Treasury. We list the countries below, along with their GDP and the yield of a 10-year sovereign bond. This gives further evidence that US Treasurys will remain highly valued. While it is clear that the US Debt to GDP ratio is edging to relatively high values, the combination of size, growth rate, and competitive yield make the US the most attractive choice, considering just the numbers.

Country	Moody's	S&P	Fitch	GDP Estimate (IMF, as of 2023)	Debt (% GDP)	10- year Bond Yield (%) as of 8/1/23	GDP Growth (YoY %)	Short Term Interest Rate (%)
Australia	Aaa	AAA	AAA	1,707,548	62.17	4.02	2.3	2.30
Denmark	Aaa	AAA	AAA	405,626	31.54	2.81	1.9	3.76
Germany	Aaa	AAA	AAA	4,308,854	59.62	2.53	-0.2	-0.20
Netherlands	Aaa	AAA	AAA	1,080,880	46.26	2.87	1.9	3.84
Singapore	Aaa	AAA	AAA	515,548	136.83	3.00	0.7	4.09
Sweden	Aaa	AAA	AAA	599,052	29.96	2.54	0.8	3.94
Switzerland	Aaa	AAA	AAA	869,601	31.70	0.97	0.6	-0.75
United States	Aaa	AA+	AA+	26,854,599	136.22	4.07	2.6	5.63
New Zealand	Aaa	AA+	AA+	251,969	34.87	4.74	2.2	5.66

Table: Representative list of countries with best agency credit ratings, and some statistics related to treasury/sovereign debt bonds. Sources: Bloomberg, IMF, Report for Selected Countries and Subjects (imf.org). As of August 2, 2023.

New Frontier

Normally, significant events in the US treasury markets cause seismic waves through global equity markets. Although the credit changes caused some reactions in markets, most of these fluctuations were within normal daily volatility. The CBOE VIX was up two points but ended at a relatively ordinary 16.09, still far below levels seen rather recently. Of all the major stock exchanges, NASDAQ fell the most, but like the other exchanges, a good portion of the day's decline can be attributed to incoming earnings reports not meeting expectations, as well as other ongoing issues in the silicon industry. The S&P rating changes of twelve years ago caused far greater reaction in markets.

Nevertheless, as interest rates rise, the US must pay more to borrow, and the debt will grow with less available control in the hands of the Fed. The ability to change government spending without politically unpopular measures such as entitlement cuts will become even more limited. This is a developing issue that we will all be watching, but today's change alone should not be reason to panic or change the course of investments.

To sum up, Treasurys of various maturities will continue to be the primary asset for storing value, meeting long-term liabilities, managing risk, and hedging volatility. They are an important component of a portfolio optimized for investors' goals.

NEW FRONTIER