America’s Credit Rating

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In early August, Fitch Ratings downgraded the U.S. debt rating from the highest AAA to AA+ citing “a steady deterioration in standards of Governance.” The downgrade came after a public showdown and eventual last-minute debt ceiling deal, which was finally reached in late May. Fitch raised concerns over our country’s growing debt and its deteriorating financial conditions. Fitch also expressed considerable doubt about the country’s ability to address the debt given the sharp political divide.

This is the second time the U.S. government’s debt has been downgraded. The first downgrade occurred in 2011, when the credit rating agency, Standard & Poor’s, cut the U.S. credit rating from AAA to AA+, following a rancorous debate in Congress over the size of the debt. At the time, Standard & Poor’s cited the growing deficit and the prolonged debate as reasons for the downgrade, themes that have been echoed in the Fitch shift a dozen years later.

What is a credit rating?

In basic terms, credit ratings indicate how safe it is to invest in a debt instrument, issued by a country or a company. It is similar to a personal credit score and helps determine the interest rate one should pay on their loans. The lower the credit rating, the higher the interest rate one would pay to entice investors.

There are three major rating agencies: Standard & Poor's Global (S&P), Moody's and Fitch Ratings. Although there are slight differences, all agencies issue ratings on a sliding scale with AAA being the best and D being the worst, indicating default.

How reliable is the credit rating?

While credit ratings are important, their reliability has been questioned in the past. During the 2008 financial crisis, many subprime mortgages that went under were highly rated by the credit agencies. It is important to remember that credit ratings are subjective and often reactive — meaning their downgrades often don't provide any new information.

Impact of the downgrade?

Markets initially slumped but quickly recovered after the U.S. debt was downgraded by S&P Global in 2011. This time, while the markets have sold off, the overall reaction has seemed more muted. This may be because the reasons mentioned by Fitch like erosion of governance, deterioration of the country's finances and the growing debt are widely known and the downgrade was not entirely unexpected.

Some investors are concerned about the impact of downgrade on their investments, the U.S. dollar and treasuries. At Westwood Wealth Management, our expectation is that the Fitch downgrade will have little impact, if any, on financial markets. It is unlikely that any treasury holders would be forced to sell based on the ratings change.

Similarly, the U.S. dollar will continue to be the world's top reserve currency. Investors all over the world, from other top central banks to pension funds, hold trillions of U.S. government debt, and that's unlikely to change simply because of Fitch's downgrade. The U.S. dollar is still seen as a safe haven.

While we do not expect a material impact of the downgrade on U.S. equities, bonds or the U.S. dollar, the downgrade does reiterate some serious concerns about the growing U.S. debt. We believe that the U.S. government will eventually need to address the debt. It will likely require a combination of measures, including reducing government spending, reforming entitlement programs and/or finding ways to increase revenue through tax reform or other means. We believe that it will need political leadership and a commitment to finding solutions by both Democrats and Republicans to ensure the long-term prosperity and financial stability of the country.

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