

Comment on the US downgrade

For professional investors only

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Last week, US Treasury debt was downgraded by Standard & Poor's (S&P). In this document we provide a short comment on the US downgrade.

The S&P announcement

The rating on long-term sovereign debt of the US has been reduced from AAA to AA+. The A-1 short term rating has been confirmed. The CreditWatch negative has been removed, but the outlook to the rating remains negative, which implies that a further cut of the rating is possible within the next two years. Earlier in the week, after the debt ceiling was lifted, the two other main rating agencies, Moody's and Fitch have confirmed their triple-A rating of US debt.

Main reason behind the downgrade

The main argument for S&P to cut the rating was a disappointment on the recent fiscal consolidation plan. S&P stated: "The downgrade reflects our opinion that the fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what, in our view, would be necessary to stabilize the government's medium-term debt dynamics". However, there is more than just a disappointment on the size of fiscal consolidation. S&P is also disappointed in the effectiveness, stability and predictability of US policymaking and pessimistic on the capacity of US politicians to deliver a broader fiscal consolidation plan any time soon.

Market response

The initial response in Treasury markets to the downgrade was muted. There was no sell off in the future markets in US Treasuries. The main effect visible was a higher spread between 30-year and 10-year bonds. The same was visible in the weeks prior to the decision on the debt ceiling. The 5-year CDS premium for US government debt rose by 5 basis points (bps) this morning to 60 bps. To compare, the CDS premium was 50 bps in the weeks prior to the debt ceiling talks.

Why the muted market response?

First, it was a bold step for S&P to take and therefore perceived as negative, but the arguments to take this decision were already on the table. The debt ceiling decision fell short of expectations and illustrated the lack of will among US politicians to bridge their differences. The market already had some time to digest this reality. The announcement by S&P to give the US a negative CreditWatch on July 14 illustrated this process. At the same time, confidence will get a new shock from this announcement. This is bad news for risky assets and probably also for economic growth. In such a scenario the demand for safe haven assets is high. US Treasuries have lost some of their status, but they still are a safe haven asset. The combination of these effects explains the muted response.

Longer-term horizon

First, the US downgrade has increased market uncertainty. It has never happened before and it highlights the lack of trust in US politics. This means more negative news for risky assets. This negative sentiment will keep demand for safe haven assets high and US government bonds are still seen as safe haven assets. Second, it will raise the pressure on politicians to change their attitude and start working together. Still, it remains to be seen how big this effect will be, given the lack of response to earlier warnings by S&P. Third, it could further undermine confidence in the US dollar. On a longer term horizon this could be negative, but counterweight is the lack of alternatives for the dollar.

Conclusions

The main impact from the downgrade comes from the signal that it gives to markets and politicians. The dominant impact is probably the negative influence on confidence. Going forward it does signal that the attitude of US politicians will have to change in order to avoid further downgrades. This means that the markets will follow the fiscal debate very closely and this debate could be a cause for further unrest. A continuation of the political deadlock could lead to more credit risk being priced into especially the longer end of the yield curve and to higher CDS premiums.

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