MAY 20, 2025

DEBT DOWNGRADE: MOODY'S LOWERS U.S. CREDIT RATING

Executive Summary

- **Moody's Downgrade:** On May 16, 2025, Moody's downgraded the U.S. federal government's credit rating from Aaa to Aa1, citing persistent fiscal deficits, rising debt and interest burdens, and political gridlock. This aligns Moody's rating with earlier downgrades by S&P (2011) and Fitch (2023).
- **Market Response:** The downgrade triggered a modest rise in Treasury yields and a brief dip in equity markets, though volatility remained contained. The U.S. dollar weakened slightly, but Moody's reaffirmed its confidence in the dollar's reserve currency status.
- **Investor Implications:** The downgrade is unlikely to affect Treasury market functioning or regulatory treatment in the short term, but it underscores growing concerns about long-term U.S. fiscal sustainability—potentially increasing the risk premium on U.S. assets and reinforcing the case for global portfolio diversification.

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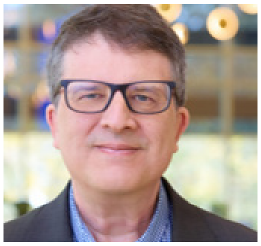

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What happened:

Late Friday afternoon, May 16, 2025, credit ratings service Moody's downgraded the debt rating of the U.S. federal government from its highest rating of Aaa to Aa1. Moody's (one of three major rating agencies, along with S&P and Fitch) had already placed the U.S. on negative watch from stable in November 2023, citing political polarization, debt affordability, and large fiscal deficits. In March of this year, Moody's said that U.S. "fiscal strength is on course for a continued multiyear decline" having already "deteriorated further" since November 2023. Alongside Moody's recent downgrade, it is worth noting that S&P and Fitch previously downgraded the credit rating on U.S. debt in 2011 and 2023, respectively.

In making the downgrade, Moody's cited "the increase over more than a decade in government debt and interest payment ratios to levels that are significantly higher than similarly rated sovereigns" and noted that "successive U.S. administrations and Congress have failed to agree on measures to reverse the trend of large annual fiscal deficits and growing interest costs. We do not believe that material multi-year reductions in mandatory spending and deficits will result from current fiscal proposals under consideration."

Near term, Moody's noted that while U.S. GDP growth is likely to slow as the economy adjusts to higher tariffs, it does not expect the U.S.'s long-term growth to be significantly affected.

The downgrade announcement came just as the U.S. Congress had been crafting a bill to extend the 2017 Tax Cut and Jobs Act (TCJA), which, all else equal, could add almost $4 trillion to the budget deficit in the next 10 years (according to the Congressional Joint Committee on Taxation). A few days earlier, Treasury Secretary Bessent indicated that the U.S. Treasury would hit its borrowing limit in August, absent action to raise the nation's debt limit.

Market reaction:

Reaction in the bond, equity and currency markets over the weekend of May 17-18, and on Monday morning, May 19 was negative, but not extraordinary.

At 4 PM ET on Friday, May 16, the yield on the 10-year Treasury note was 4.44%; in the minutes after the downgrade was announced, yields rose to 4.50% and moved another 5 basis points to 4.55% Monday morning before settling back near 4.45% by the end of the day Monday. The reaction in the 30-year bond—which, all else equal, is generally more sensitive to the ability of the U.S. government to repay its debts in the long term—was more significant. Yields rose from 4.89% before the downgrade to 5.04% on Monday morning, before settling back down into the 4.90% range by Monday afternoon.

While the macro backdrop for Treasuries is different today, it is important to note that after Fitch downgraded U.S. debt in August 2023, the yield on the 10-year Treasury note rose from 4% in late July 2023 to 5% by mid-October later that year.

U.S. equity markets opened weaker on Monday, down roughly 1% from Friday's close, but by the end of the session, were flat on the day. U.S. equities, as measured by the S&P 500, had surged 19% since early April amid the ramping up and dialing down of trade tensions. Equity volatility, as measured by Wall Street's 'fear gauge' known as the VIX index, moved higher over the weekend and on Monday, but remains below average following a record decline in volatility over the past month as trade tensions eased.

At its worst levels on Monday, May 19, the U.S. dollar was down 1% versus the currencies of its major trading partners since Friday afternoon. Although the greenback recovered in afternoon trading on Monday, it still ended the day down 0.7%. Moody's, in revising its outlook on U.S. debt to stable from negative, has cited the state of the dollar several times. The rating agency noted that "the U.S. dollar's status as the world's dominant reserve currency provides significant credit support" and that "the credit benefits of the dollar are wide-ranging and provide the extraordinary funding capacity that helps the government finance large annual fiscal deficits and refinance its large debt burden at moderate and relatively predictable costs." In addition, Moody's said that "despite reserve diversification by central banks globally over the past twenty years, we expect the U.S. dollar to remain the dominant global reserve currency for the foreseeable future".

What changes for investors:

In our view, little is likely to change in the short term. The U.S. debt already carried a "split rating" given that S&P and Fitch had already downgraded the U.S. federal rating to a notch below AAA (on August 5, 2011 and August 1, 2023, respectively). In 2011, the spike in market volatility following the S&P downgrade was mainly due to the risk of "forced selling" by institutions, investors and lenders tied to contracts and guidelines requiring "AAA-only" exposure. However, these requirements were quickly adjusted to reflect the change in the U.S. credit profile, and the "AAA-only" mandate was converted to "government securities-only" mandate.

In addition, the banking regulatory framework defines "highly rated sovereign exposure" as government bonds rated between AAA and AA- (the U.S. is rated AA+ by all three major agencies now). Therefore, capital requirements related to commercial banks' U.S. Treasury holdings are not impacted by Moody's decision.

As a result, we view the Moody's decision to align their U.S. long-term rating to S&P's and Fitch's as having little effect on the role played by Treasury securities in the global financial system.

That said, this decision puts a spotlight on long-term fiscal sustainability, a concern we have highlighted frequently over the past few months. This is timely, given the ongoing budget reconciliation process in Congress where another large fiscal package is under discussion. According to the Joint Committee on Taxation's initial assessment of the House draft, the proposed budget bill could maintain or even widen the deficit for the next decade, therefore validating one of the key reasons underpinning Moody's rating decision ("[...] we expect federal deficits to widen, reaching nearly 9% of GDP by 2035").

Escalating fiscal concerns may continue to raise the risk-premium demanded to invest in U.S. assets. This could translate to a combination of smaller equity valuation differentials between the U.S. and international markets, a higher Treasury term-premium,[1] and a weaker U.S. dollar (currently trading well above many measures of long-term equilibrium).

Portfolio Considerations:

The questions many investors will be asking in the coming days and weeks will center around the ability of the U.S. federal government to set a more sustainable course for its long-term fiscal policy, without inflicting substantial damage to the U.S. economy.

While the U.S. downgrade was not completely unexpected—and had limited immediate impact on U.S. markets, given that other major credit agencies had already taken similar actions in 2011 and 2023—it does increase the case for greater global diversification in portfolios.

1 The extra compensation required to invest in long-maturity bonds rather than rolling over short-maturity bond holdings.

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