Key Questions

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US Bonds Face a Credit Downgrade. Are My Bonds Safe?

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

A few caveats merit mention, but we believe US treasuries are safe and will remain so.

"The political brinksmanship of recent months highlights what we see as America's policymaking becoming less stable, less effective, and less predictable.... The effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of significant fiscal and economic challenges."

Does this sound like something you recently heard or read? It's understandable if it does. But in reality, it was written 12 years ago and marked a seminal moment in America's financial history that has many parallels with today.

On April 18, 2011, credit rating agency Standard and Poor's (S&P) issued a "negative" outlook on debt issued by the US. It was the first such action since S&P began rating US debt in 1860. S&P based their change on two factors: a large budget deficit and a lack of political unity (and courage) to adequately address it.

Four months later, S&P announced its decision to lower its rating of US debt by one notch from AAA (the highest possible rating) to AA+ with a negative outlook. In response, US stock prices fell over 5% the very next day. US treasury bonds (the subject of S&P's downgrade) and US dollar, however, both gained in value in a general "flight to safety." Notably, S&P's downgrade came after the debt ceiling was raised.

Fast forwarding to today, late last week, Fitch, another credit rating agency, put the US on "negative watch" citing "political partisanship that is hindering a resolution to raise or suspend the debt limit despite the fast-approaching 'X Date' (when the US Treasury Department exhausts its cash position and capacity for extraordinary measures without incurring new debt). The brinksmanship over the debt ceiling, failure of US authorities to meaningfully tackle medium-term fiscal challenges that will lead to rising budget deficits, and a growing debt burden signal downside risks to US creditworthiness."

What is a Rating Agency?

A rating agency is a company that assigns credit ratings to debt securities and issuers. Currently, the top three rating agencies are Standard & Poor's, Moody's and Fitch.

What Does a Rating Agency Do?

Credit rating agencies evaluate a company's or a government's ability to repay its debt and take into consideration the entities' financial strength and likelihood of default. Credit agencies assess the company's or government's financial condition, operating performance, and other factors and assign a rating based on these elements similar to our personal credit (or FICO) score.

Credit Rating Levels

	Credit Ratings		
	S&P	Moody's	Fitch
Investment Grade	AAA	Aaa	AAA
	AA+	Aa1	AA+
	AA	Aa2	AA
	AA-	Aa3	AA-
	A+	A1	A+
	A	A2	A
	A-	A3	A-
	BBB+	Baa1	BBB+
	BBB	Baa2	BBB
	BBB-	Baa3	BBB-
Speculative	BB+	Ba1	BB+
	BB	Ba2	BB
	BB-	Ba3	BB-
	B+	B1	B+
	B	B2	B
	B-	B3	B-
	CCC+	Caa1	CCC

What Happens if the US Is No Longer AAA Rated?

In 2011, when S&P downgraded US debt from AAA to A+, Moody's and Fitch retained their AAA ratings. With two of the three major credit rating agencies keeping their AAA ratings, the AAA held. Should Fitch lower its rating to AA+, however, the US debt would, in essence, be rated AA+, leaving 11 countries with a higher credit rating than the US (Australia, Canada, Denmark, Germany, Liechtenstein, Luxembourg, Netherlands, Norway, Singapore, Sweden and Switzerland).

As noted earlier, after the S&P downgrade in 2011, "safe-havens" such as US treasury bonds rallied, driving yields lower. The same could hold true today, but one of the forces behind the rally in treasury bonds 12 years ago was the fact that other parts of the global economy were struggling, namely Europe. Those challenges are not as prevalent today, so it might be unwise to think a similar outcome might occur.

That said, should we reach the "X Date" and no agreement regarding the debt ceiling has been reached, the President will decide what payments are made, and in that case, we believe that payments on outstanding treasury bonds will be a top priority. This approach could alleviate a scenario that may trigger a rating downgrade.

If the US Is Downgraded to AA, Are My Bonds Still Safe?

In a word, yes. All else equal, a lower-rated security results in a higher yield. After all, investors need to be compensated for taking additional risk. Moreover, credit ratings are an expression of the probability of a default. However, investors' view of an actual default may be higher or lower relative to the rating itself, and because most investors will likely conclude that the risk of a US default is still very low, we believe US treasuries are safe and will continue to play a key role in many investors' portfolios.

Two Important Caveats Merit Mention:

While treasuries are likely to retain their status as the world's preferred risk-free (or near risk-free) asset of choice, there is a risk that the plumbing that underlies global financial markets could become plugged and cause some short-term disruptions. To wit, many important agreements between various counterparties specifies the need to own AAA securities as a collateral. In the event the US debt is downgraded, these contracts would likely be rewritten, which could cause some short-term volatility. In addition, the deeper the political divisions and the longer they persist, the greater the damage on America's reputation could ensue, something we have mentioned in prior communications. That said, because the US is blessed with many structural, economic, cultural and geographical advantages, we continue to believe such concerns pose limited near-term risk.

For more information, please contact your advisor.

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