Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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What Will be the Impact of the U.S. Credit Downgrade?

In early May, the company Fitch Ratings put out a press release warning of a potential downgrade to the U.S.'s sterling AAA credit rating. Fitch was responding to the debt ceiling drama as it unfolded, attaching its name to the largely misguided narrative that the U.S. was charging towards a debt default.[1]

Now, nearly two months after a debt ceiling deal was struck – and with worries about debt default gone – Fitch made its splash in the news cycle by lowering its rating on the U.S. to AA+, one notch down from the top AAA grade.

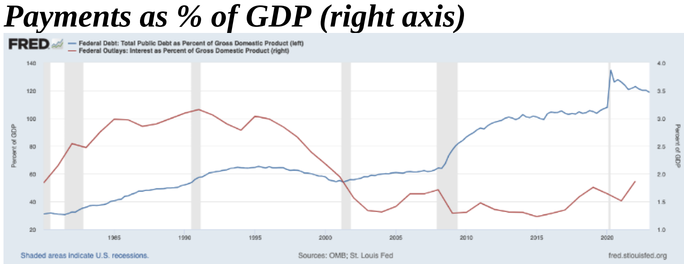
If investors were expecting the downgrade to be accompanied by new revelations about the U.S.'s fiscal standing, they were greatly disappointed. Instead, Fitch Ratings cited the debt ceiling drama, Congressional Budget Office debt and deficit forecasts, Social Security and Medicare funding, the 2017 tax cuts, and high government spending as the causes for concern.

In other words, it was a collection of information that markets and investors have long, long known and understood.

To be clear, I do not intend to minimize problems the U.S. faces with mounting debt and interest payments. As seen in the chart below, total debt as a percent of GDP (blue line, left axis) has soared since the 2008 Global Financial Crisis, and remains above 100%. That's too high.

Additionally, interest payments as a percent of GDP (red line, right axis) are still benefiting from a prolonged period of low interest rates, but yields are rising – which means borrowing is becoming more costly. This dynamic of high absolute debt and rising interest rates can restrict the U.S.'s ability to borrow more in the future, which can crimp spending and investing – and therefore impact GDP growth.

Debt as % of U.S. GDP (left axis) and Interest Payments as % of GDP (right axis)



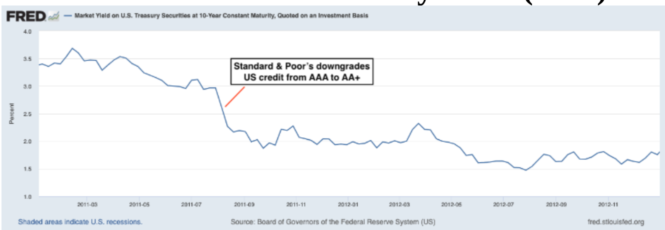
Source: Federal Reserve Bank of St. Louis[2]

While I think debt and interest cost issues are worth monitoring, I do not think the opinions of ratings agencies should factor much into an investor's decision-making process. In my view, they lack credibility. You do not need to look very far back in history to understand why. In the spring of 2008, Fitch gave Lehman Brothers' preferred stock an A+ rating, about a month after Bear Stearns failed. Five months after receiving Fitch's A+ rating, Lehman Brothers collapsed.

A few years later, 2011's 'fiscal cliff' drama gripped the headlines for months, and Standard & Poor's – another ratings agency – made waves when they downgraded the U.S.'s debt rating from AAA to AA+. At the time, this felt like a huge deal that could impact the U.S.'s ability to borrow (issue Treasurys) at attractive rates. Logic would say that a debt downgrade should put upward pressure on the cost of borrowing, which would imply rising yields on U.S. Treasurys.

But the opposite happened – yields fell after the downgrade.

Yield on 10-Year U.S. Treasury Bond (2011)



***Source: Federal Reserve Bank of St. Louis*[3]**

As a follow-on to Fitch's downgrade of the U.S., Moody's came out this week and cut the credit ratings on 10 regional banks, while placing six noteworthy financial institutions into 'review.' At first glance, many investors might have seen this news and thought that early spring's bank stress was back. But it turns out that Moody's downgrades were just a rehashing of the same issues that came to light months ago.

In their report, Moody's said that rising interest rates "continue to have a material impact on the U.S. banking system's funding and its economic capital," adding that higher rates are impacting the value of bonds and other assets on bank balance sheets, leaving lenders with "sizable unrealized losses." Moody's also cited risks that a recession could have on loan demand and called out issues in the commercial real estate markets like plummeting demand for office space.

The market has known about these problems for months.

Bottom Line for Investors

Back in May, Fitch rightly characterized the U.S. missing a debt payment as a "very low probability event." It seemed like an acknowledgment that the U.S.'s issues around debt and obligation payments were more of a political problem than an economic one, which I think is an accurate framing of the issue.

But Fitch issued its downgrade anyway, citing other pieces of dated and widely-known information about taxes, entitlement programs, and CBO budget projections. It's a delayed reaction based on old news, which I think renders its impact on markets and the economy as insignificant.

An alternate telling of the U.S.'s credit and fiscal standing is not that far away, either. Both Standard & Poor's and Moody's continue to give the U.S. the highest possible rating.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. August 1, 2023. https://www.wsj.com/articles/fitch-downgrades-u-s-credit-rating-56c73b89?mod=djem10point

[2] Fred Economic Data. June 29, 2023. https://fred.stlouisfed.org/series/GFDEGDQ188S#

[3] Fred Economic Data. August 8, 2023. https://fred.stlouisfed.org/series/DGS10#

Weekly Market Update

Important Market News We Think Worth Considering

STEADY INVESTOR WEEK

- **The fall in the unemployment rate**
- **Core inflation cools in July**
- **Possible higher gas prices soon**

The Unemployment Rate Falls, But So Does the Pace of Hiring

The Labor Department reported that nonfarm payrolls rose by 187,000 in July, up from a revised 185,000 new hires in June. The unemployment rate fell to 3.5%. By most accounts, the U.S. jobs market remains in solid shape, but these recent figures signal a cooling that may come as welcome news to the Federal Reserve. Though 187,000 new hires in July signals the labor market remains tight, it's meaningful to note that this pace is a marked step down from the 399,000 jobs/month posted in 2022 and the 287,000 jobs/month pace of the first five months of 2023. While private sector pay rose 4.4% in July – which is materially higher than the pace needed to achieve 2% inflation – the takeaway from this jobs report is that the labor market appears to be finding a balance of not being too hot nor too cold. In other words, the Fed may interpret recent data in the jobs market as being on a steady path to a soft landing.[1]

Core Inflation Cools Slightly in July

Readers may sometimes get confused by the myriad inflation measures cited in the media. CPI, the core PCE price index, trimmed-mean CPI, PPI, and so on. The Atlanta Federal Reserve tracks nine different inflation measures, with each one often sending different messages about underlying inflation trends. To simplify matters and to get at the root of what influences the Fed and interest rate policy, readers should focus on just two inflation measures: core CPI and the core PCE price index. The Fed cares more about core prices because they tend to be better predictors of future inflation trends. The Labor Department reported on Thursday that core CPI rose by 4.7% year-over-year in July, which marked a slight cooling from June's 4.8% annual rate. Month-over-month data offered a similar takeaway of improving conditions, with core CPI rising 0.2% from June to July. Another way of looking at core inflation is by tracking the 3-month annualized rate, which in July came in at 3.1% – the lowest print in two years.[2]

Why Americans Could See Higher Prices at the Pump in the Coming Weeks

Many readers have likely noticed gas prices ticking higher lately. Higher oil prices are to blame. In the past six weeks, benchmark crude oil prices have risen over 21%, following decisions by Saudi Arabia and Russia to cut production in a targeted effort to mitigate rising global supply levels. Supply and demand of course impact the price of crude, and the demand side of the equation has also had an impact – investors have grown more optimistic about a soft landing in the U.S., which implies better-than-expected demand for oil. When oil prices are rising and are expected to rise further, the price of gas tends to follow. But other factors are affecting the price at the pump – summer heat makes refining oil into gas more costly, since it slows the cooling process; and a looming hurricane season has many oil futures traders betting that refineries could take a hit to production later this summer and fall, which also puts upward pressure on prices.[3]

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[1] Wall Street Journal. August 4, 2023. https://www.wsj.com/articles/jobs-report-july-today-unemployment-economy-d9af32f3?mod=economy_more_pos5

[2] Wall Street Journal. August 10, 2023. https://www.wsj.com/articles/consumer-price-index-report-july-inflation-a4a0a670?mod=hp_lead_pos1

[3] Wall Street Journal. August 7, 2023. https://www.wsj.com/articles/gas-prices-inflation-oil-crude-diesel-eec0645f?mod=djemRTE_h

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