AUGUST 07, 2023

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Fitch downgrade hurts markets

Last Tuesday, Fitch Ratings (Fitch) downgraded the long-term foreign currency issuer default rating of the US from ‘AAA’ to ‘AA+’. According to Fitch, the downgrade was caused by fiscal deterioration as seen in repeated debt ceiling debacles and increasing government debt. This is the first major downgrade suffered by the US since S&P cut its issuer credit rating in 2011. Following the Fitch announcement, equities tumbled and the S&P 500 fell 2.4% in four days. Bond yields jumped anew, the US dollar (DXY) rebounded, and most currencies dropped.

Reasons behind the downgrade

In a commentary, Fitch enumerated the key drivers behind the rating action. Below, we summarize the important points from Fitch’s explanation.

- **Erosion of governance:** “There has been a steady deterioration in standards of governance over the last 20 years, including on fiscal and debt matters. The repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management.”

- **Rising general government deficits:** “We expect the general government deficit to rise to 6.3% of GDP in 2023, from 3.7% in 2022, reflecting cyclically weaker federal revenues, new spending initiatives and a higher interest burden.”

- **General government debt to rise:** “At 112.9% this year, debt-to-GDP ratio is still well above the pre-pandemic 2019 level of 100.1%. The debt-to-GDP ratio is projected to rise over the forecast period, reaching 118.4% by 2025. The debt ratio is over two-and-a-half times higher than the 'AAA' median of 39.3% of GDP and 'AA' median of 44.7% of GDP.”

- **Medium-term fiscal challenges unaddressed:** “Over the next decade, higher interest rates and the rising debt stock will increase the interest service burden, while an aging population and rising healthcare costs will raise spending on the elderly absent fiscal policy reforms.”

- **Economy to slip into recession:** “Tighter credit conditions, weakening business investment, and a slowdown in consumption will push the U.S. economy into a mild recession in 4Q23 and 1Q24.”

- **Fed tightening:** “While headline inflation fell to 3% in June, core PCE inflation, the Fed's key price index, remained stubbornly high at 4.1% year-on-year. This will likely preclude cuts in the Federal Funds Rate until March 2024.”

Strong rebukes

After the announcement, there were a number of prominent figures in finance that criticized the rationale and timing of the Fitch downgrade. We list down their comments below.

- **US Treasury secretary Janet Yellen:** "I strongly disagree with Fitch's decision. Its flawed assessment is based on outdated data and fails to reflect improvements across a range of indicators. At the end of the day, Fitch's decision does not change what all of us already know: that Treasury securities remain the world's preeminent safe and liquid asset, and that the American economy is fundamentally strong."

- **JPMorgan chairman and CEO Jamie Dimon: "**It doesn't really matter that much. The markets decide; it's not the rating agencies that make big decisions." Dimon added that the US is "still the most prosperous nation on the planet, it's the most secure nation on the planet."

- **Renowned investor Warren Buffett:** "There are some things people shouldn't worry about. This is one. Berkshire bought $10 billion in US Treasurys last Monday." Buffett added, "the dollar is the reserve currency of the world, and everybody knows it."

- **Mohamad El-Erian, chief economic adviser at Allianz:** "The vast majority of economists and market analysts looking at this are likely to be equally perplexed by the reasons cited and the timing. This announcement is much more likely to be dismissed than have a lasting disruptive impact on the US economy and markets."

- **Former US treasury secretary Larry Summers:** "The idea that this is creating the risk of a default on US Treasury securities is absurd, and I don't think that Fitch has any new and useful insights into the situation. If anything, the data in the last couple of months has been that the economy is stronger than what people thought, which is good for the creditworthiness of US debt."

Déjà vu?

In 2011, we wrote about the market carnage that was caused by S&P's historic credit rating downgrade of the US (see *Panic in the streets*, August 8, 2011). It was during this time that the S&P 500 plunged by 11.1% in three days, resulting in a 21.6% decline over six months. Despite these sharp drops, the stock market ultimately recovered and was able to recoup these losses within six months.

Most powerful country in the world

With its lower assessment of US debt and the American economy, Fitch dashed investor optimism coming from easing concerns over a deep global recession. Fitch was correct to point out the fiscal problems of the US and the need to resolve these decisively. However, we agree with the views of finance luminaries that the Fitch downgrade would not have a material impact on the financial and economic standing of the US. As it is, the US is still the world's primary superpower. It possesses the strongest military, it is the world's biggest economy, it has the most liquid financial markets, and the US dollar is the primary global reserve currency. In addition, the US is the global leader in technology and AI.

Looking back, we saw how the S&P downgrade triggered a sharp drop in equities and heightened volatility across asset classes. With the benefit of hindsight, we can see that despite the short-term pain, the stock market continued to move higher in the medium and long term. By taking the lessons that we learned from a similar past event, we can plan accordingly as we can better decipher how the Fitch downgrade would affect financial markets in the present economic backdrop.

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