The latest debt ceiling passed in June, but U.S. debt is back under the microscope after being downgraded by Fitch.

Let’s address some of the key questions:

**What happened?**
Rating agency Fitch Ratings cut the U.S. long-term foreign currency issuer default rating to AA+ from AAA. This was the second time in history a rating agency did this, as S&P Global Ratings did it previously in August 2011.

**Why did Fitch downgrade U.S. debt?**
Fitch put the U.S. on watch for a potential downgrade three months ago—during the debt ceiling saga—so the possibility of a downgrade has been looming.

Fitch cited, “the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to 'AA' and 'AAA' rated peers” as reasons for the downgrade.

**The market impact?**
After a period of calm, markets appear to be reacting to this announcement. The Volatility Index (VIX) spiked nearly 20%, the S&P 500 was down more than 1%, and the Nasdaq was down more than 2%—it’s worst single day since February.

However, context is important. The S&P 500 has been positive five months in a row, the Dow had a 13-day streak of positive returns in July (one of its longest stretches ever), and the VIX has been hovering near the bottom of its historical range.

In short, we were probably overdue for some turbulence.

**Could this push the U.S. toward a recession?**
Impossible to say with certainty, but it seems unlikely.

The last time U.S. debt was downgraded—in 2011—we saw the economy grow in the quarter that followed and then eight straight years after until the pandemic hit in 2020.
This event should not be completely ignored, but the economic trends we’ve seen this year — strong consumers, slowing inflation, a healthy jobs market, improving earnings — are likely more powerful than Fitch’s announcement.

**What happened in 2011?**

Today, we have the benefit of having gone through this experience before.

The S&P 500 experienced significant volatility in the wake of the debt downgrade. There were big up days and big down days as the market filtered through the news.

**Exhibit 1**

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<td>Monday Aug. 8</td>
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<td>-4.7%</td>
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Source: Morningstar.

But one year after the downgrade, the S&P 500 was up nearly 20%.

**Exhibit 2**

| S&P 500 Return: 1-Year After the S&P Debt Downgrade |

In fixed income, bonds actually rallied during that period because interest rates fell.

**Exhibit 3**

*Bond Returns: August 2011 - August 2012*

![Chart showing bond returns from August 2011 to August 2012.]

**Will investors be forced to sell?**

From a technical perspective, there’s a question of whether a credit downgrade will force some investors to sell U.S. Treasuries. It’s not unusual for funds to state they’ll only hold securities with a specific credit rating.

Using 2011 as precedent, there was no fire sale of U.S. Treasuries—investors actually bought Treasuries. That does not mean the same outcome will unfold, but U.S. Treasuries will likely retain their status as one of the safest assets investors can hold.

Additionally, we wouldn’t anticipate large owners of U.S. debt being forced to sell because of the downgrade either. Because Treasury securities are such an important asset class, most investment mandates refer to them specifically, rather than AAA-rated government debt.

**Bottom Line**

It seems more likely the long tail of history will view this downgrade as another event that markets and the economy were able to overcome.

In fact, not all credit rating agencies agree with the Fitch assessment. DBRS Morningstar (a wholly-owned subsidiary of Morningstar, Inc.) maintained their AAA rating on U.S. debt in a recent note.

In the note DBRS Morningstar mentions:
“The AAA ratings reflect the United States’ considerable credit strengths, including the scale, diversification, and resilience of the U.S. economy, the strength of the country’s governing institutions, and the reserve currency status of the U.S. dollar. Nevertheless, we continue to monitor how political polarization could adversely impact U.S. credit fundamentals over time.”

That last sentence is very prescient. The Fitch downgrade may speak more to the political situation in the U.S. than the economic one.

In the words of Mohamed El-Erian, chief economic advisor of Allianz:

“Overall, this announcement is much more likely to be dismissed than have a lasting disruptive impact on the U.S. economy and markets.”

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