Mizuho Brief: US Risks

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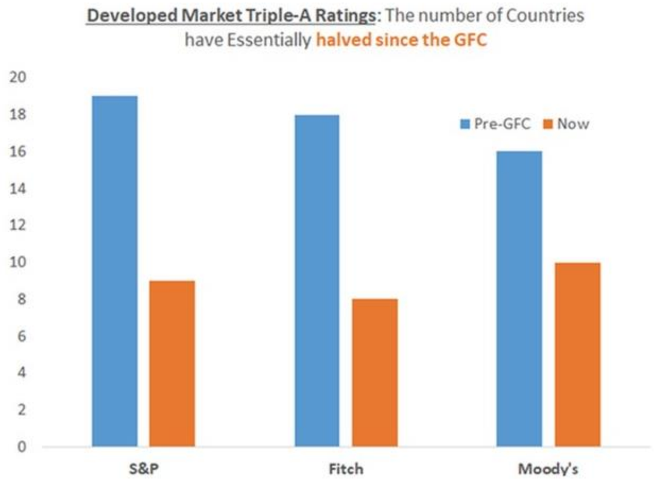
Moody's US Downgrade to Clip, Not Crush

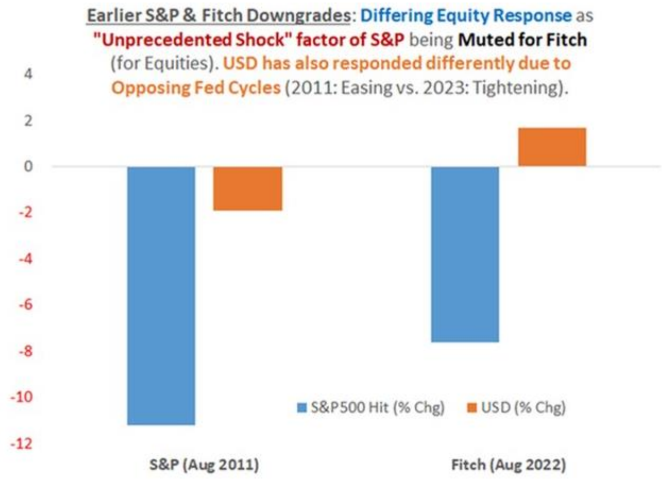
"It has not yet become obvious to me that there is no real problem." **– Richard P. Feynman**

In a Nutshell:

- The **one-notch downgrade of US credit ratings from Aaa to Aa1** by Moody's is **admittedly significantly dire** (as US loses its last top-notch ratings). ***But*** arguably, is ***ultimately inconsequential*** **for markets**.
- Hence, while the resultant **jolt may clip already tentative market optimism/buoyancy**, it **is unlikely to crush the broader recovery**. **Not on account of Moody's downgrade trigger** in any case.
- Point being, this is an **unsurprising** (move even if timing isn't) **catch down** by Moody's **with S&P and Fitch**, that *does not reveal anything new about mounting US credit/fiscal woes.*
- Crucially, the **downgrade does not adversely impact the liquidity and collateral value of USTs**, therefore not presenting an inadvertent and imminent shock from forced liquidation.
- What' more, the **post-GFC relaxation in global fund mandates** and regulations also **significantly mitigate forced liquidation** of USTs **simply and solely because of top-notch** ('AAA/Aaa') **ratings lost**.
- Above all, there are no triple-A alternatives for markets that are sufficiently deep and liquid to threaten the reserve asset status of USTs that is tagged to the US Dollar's global reserve currency status.
- So, this is will **neither** be **a crisis for USTs and the USD's reserve currency status** nor an **inadvertent shock to global liquidity plumbing**.
- UST Slippage to Benefit AAA Universe: That said, amid **long-end UST volatility on knee-jerk selling** may **at the margin benefit** (lower yield spreads of) **bonds** with **undisputed* triple-A ratings** (Australia, Germany, Netherlands, Switzerland, Sweden, Denmark, Norway and Singapore).
- Attendant FX Gains vs. USD: The **attendant pullback in the USD** is also likely to be accentuated by **corresponding gains in** CHF, AUD, SGD, EUR, SEK, NOK and DKK.
- Gold: Gold, which has already been on a **stellar ascendancy** for a couple of years now could **admittedly be further underpinned**. ***But*** **further and sustained buoyancy** is **checked as a limited hedge rather than a substitute**.
- Credit Spreads: Counter-intuitively, **ring-fenced risks from Moody's ratings downgrade could tactically/temporarily dampen credit spreads** elsewhere. *but wider geo-economic risks warn of wider credit premium as the sustained direction of travel.*

*Defined as triple-A ratings from all three agencies, hence Canada is excluded after Fitch's downgrade in 2020.





- Moody's Downgrade a Significant Status Hit: The **after-hours one-notch downgrade of US credit by Moody's from Aaa to Aa1** (equivalent of 'AAA to AA+) is admittedly a **blow to US ratings status** as it **loses the last of its top-notch ratings from the 'big three'** (S&P, Fitch, Moody's).

- Feed into Pre-existing Fiscal Woes: Moreover, Moody's warning that "*significant economic and financial strengths .. no longer fully counterbalance the decline in fiscal metrics*" is a **dire warning that may feed into pre-existing US fiscal worries**. And **given already stretched and tentative buoyancy of US markets**, this blow to the standings of the US (as a creditor) may **prompt a convenient sell-off** in all things US (bonds, equities, and the Greenback).

- But Inconsequential for USTs, USD & Markets: Nonetheless, **once the initial volatility gets out of the way and the dust settles**, the Moody's downgrade trigger is likely to be a (relatively) **measured capitulation reflex** *based on caution,* and **not a sustained meltdown** on catastrophic financial shocks that persist. The wider point being that **Moody's downgrade, while contextually painful,** will ultimately prove ultimately inconsequential on its own merits. Especially given vital relief of liquidity buffer, resilience of the financial architecture, and retained reserve currency/asset status (of USD and USTs).

- Merely a Catch-Down: For a start, **Moody's move is *not revelatory*** in any way. Instead, it is **a belated catch-down** with **earlier downgrades** of the US **by S&P** (in 2011) and **Fitch** (in 2023). Whereas the fiscal deterioration has been well-flagged and hence, increasingly priced in, therefore mitigating the threats of sudden, unexpected shocks. In other words, this is **not a 'Black swan"**, **not even a 'Grey Rhino'**, it is the **proverbial (stampeding) elephant** in the room.

- Shock Factor Dampened: Admittedly, **S&P's equivalent downgrade of the US** (from AAA to AA+), the first by any ratings agency, back in 2009/2011, **resulted in significant sell-off in markets**. This was however the *shock of the unprecedented, unthinkable and hence unexpected*, which *has passed.* Tellingly, **by the time Fitch followed in (2023) the reaction was considerably muted**. Admittedly, ***Moody's could have more significance than Fitch, as the "last refuge" of triple-A ratings***. *But* it is ***unlikely to replicate the shock of S&P*** in either magnitude or duration.

- Credit Woes Arguably Already Baked-in: Sure, it's **not a "nothing to see here"** move. ***But equally***, it is **far from tectonic**. Fact is, **markets have already been fretting**, and **have** accordingly **baked in**, **much of US' fiscal deterioration** - alarming as it is. This has showed up as **long-end USTs have been baking in far more term premium** that also *indirectly accounts for credit risk premium* for USTs by virtue of being the "risk free" benchmark.

- Potential for Liquidity Shocks Dampened: As a result of which, **market liquidity is likely to prove resilient *after initial "risk off" knee-jerk***; if any. Specifically, as the threat "forced liquidation" of USTs spilling over more widely into asset/financial markets have been meaningfully mitigated by **stress-tested bond markets** further enhanced by a **Fed leaving more UST liquidity buffer** (by virtue of QT pace for USTs curtailed).

- Crucially as Collateral Risks are Mitigated: What's more, **USTs are still well-placed to function as the global collateral anchor**, **without major upset to the global plumbing**. Neither regulation nor market conventions are set to trigger collateral write-down or covenant breach from a one-notch downgrade, *which could inadvertently set off a "risk off" cascade/contagion.* In fact, the **risk capital penalties leave further downgrade buffer** intact, thereby **mitigating even the propensity for precautionary, large-scale culling of UST positions**.

- Buy-Side Exodus Not Imminently Triggered: What's more, a **mass exodus by the buy-side and longer-term investors** from USTs is also **not an imminent threat** as **global mandates** have, **since the 2008 GFC, by and large eased up to accommodate a global deterioration in DM** (developed market) **credit ratings**.

- As 'New Norms' in Ratings Have Slipped: Consider that pre-GFC (in 2008) around 16-19 countries had triple-ratings. This has now **dwindled to just 8-9**. Simply put, the **global credit curve has shifted down materially** over the years, ***dragging down the "norms" of developed market credit standards*** considerably.

- Backstopping Relative Ratings Standings: As such, **on a relative basis**, **US ratings at 'Aa1' is not a catastrophe for the US or the holders of USTs**. Some may even argue that 'AA+/Aa1' is the new triple-A. Whereas the *handful of triple-A rated economies* may **command some relative premium at the margin**, these are deemed additional hedges that *supplement, not supplant, USTs* as the core reserve assets. What this means is that at the margin this may **modestly deepen the discount of these bonds** *vis-à-vis corresponding UST yields.*

- USTs Not Challenged: The **upshot** being **Moody's downgrade does not change the view** that **there is simply no risk-adjusted alternative to USTs** that are ***sufficiently deep or liquid*** to meaningfully impair the status of the USTs as the "risk free" reserve asset of choice. Not AGBs, not Bunds, not Swiss paper, nor a smattering of other European (Dutch, Swedish, Danish of Norwegian) bonds. And certainly not the SGS (for all its relative allure showing up as deep yield discount vs. USTs).

- Not Even by Gold that will Shine, but Not Supplant: Not even by **Gold**, which *despite the propensity to enhance its shine,* will **almost certainly not supplant**. While Gold's allure is undisputed, it is *compelling only as a limited hedge,* *not a viable substitute.* The **Gold market is simply not deep, liquid, or efficient enough for the resplendent metal to function as the global reserve currency**. Not without a huge deflationary shock to the global system.

- UST Yields Bumped Up, Not Blown Out: So, all said, **Moody's pulling the trigger** on what is an arguably overdue downgrade (spray-painted all over the wall), **will probably only bump-up, not blow out, long-end UST yields**. Not only because a lot of US fiscal risks have already been priced in prior to the Moody's downgrade. But also because investors will be inclined to lock in higher UST yields. Especially **in an uncertain economic environment amid global trade hostilities *that entail demand shocks*.** Crucially, (comfortably) retained reserve currency/asset status with the benefits of network effects means that credit downgrades will not/cannot be fully reflected in USTs.

- USD's Reserve Currency Status Grudged, Not Challenged: The FX corollary is that the **Greenback's status as the global currency** *may be begrudged* even more with Moody's validation, but **not meaningfully challenged** in any way. But the **unavailability of viable alternatives** does not mean that USD cannot soften further. In fact, our **base case is for a softer USD** *along a bumpy path subject to heightened headline volatility.* But that is a **structural shift subject to US policy risks**, and **not an imminent response driven by Moody's downgrade**.

- US Assets/Risk Clipped, Not Crushed: All said, the wider point is that **Moody's downgrade** may be a trigger (perhaps an excuse) to **clip positive momentum** in US assets, and even the perhaps only momentarily. Whereas it **does not meaningfully and durably crush** the current run of relief recovery that has lent to buoyancy. **Even as USTs and the Greenback take a knock** from the grim reminder of fiscal deterioration.

- Triple-A Bonds to Gain at the Margin: Nonetheless, at the margin, this may **underpin reserve asset diversification** already underway. And the **most obvious beneficiaries** are likely to be the **remaining, handful of triple-A assets**. But *even then,* it may be tempered by already lower, risk-adjusted yields/returns in these assets.

- With Attendant FX Gain at the Margin: Accompanying currency buoyancy from these incremental shifts **suggest some boost for EUR** (*albeit dampened by a wider dispersion of EZ ratings and increasing German fiscal relaxation*), and **more prominently for CHF**, **AUD**, and **SGD** (especially with the AXJ space). A **handful of other European currencies** such as the **SEK**, **NOK** and **DKK** could also be propped up. But these are ***subject to liquidity premium*** and/or other ***inherent volatility*** (e.g. oil and NOK).

- (Credit) Spreads Could Ironically Tighten: One initially counter-intuitive outcome may be **narrower credit spreads**, all else equal. Specifically, *if* Moody's trigger results in a *ring-fenced recalibration of US asset risks* that spare markets of widespread "risk off" contagion. This as relative credit risks vis-a-vi US are gauged. *But* the warning is that this may be ***more tactical than strategic or structural***. Especially as the **on-going US shake-up of the global order, led by the trade assault**, but **with widening targets on financial and security objectives** that **render the risk climate** remains *fluid, volatile,* and **inclined to widening credit spreads**.

Rating agency
Moody's
S&P
Fitch
AAA
AA+
AA
AA-
A+
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BBB+
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FINANCIAL TIMES
Source: S&P, Moody's, Fitch

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