FISCHER STRALEM

300 Madison Avenue, New York, NY 10017

July 31, 2023

Dear Client:

A significant event unfolded in the financial landscape as the calendar rolled over into August that warrants comment. Fitch Ratings, a prominent credit rating agency, downgraded the U.S. credit rating, citing its concerns surrounding the government's soaring budget deficits and fiscal trajectory. Fitch's decision reflects their assessment of the country's fiscal outlook and financial obligations -- adding further stress to the nation's financial health and economic dynamics -- but it also serves as a dressing down of our political dysfunction and lack of fiscal policy.

Coming more than two months after a deal to lift the U.S. borrowing limit was reached, the timing is a little strange, but in downgrading the government's credit rating to AA+ from AAA, Fitch cited "expected fiscal deterioration" over the next three years, and a high and growing borrowing costs (Bloomberg). Fitch also noted a lack of a medium-term fiscal framework, and that the Federal government has made "only limited progress" in tackling rising Social Security, Medicaid, and Medicare costs. The repeated borrowing-limit standoffs and last-minute resolutions of the past two decades "have eroded confidence in fiscal management", it went on to say. Essentially, Fitch has had enough of political games of chicken over the debt ceiling -- but who hasn't?

The downgrade specifically highlights the debt pile that Congress has allowed to build up in recent years, largely due to massive tax cuts in 2018 followed by vast pandemic stimulus. More recently, the government has also launched investment programs for infrastructure, technology, and clean energy. Meanwhile the cost of borrowing has soared as the Fed pushed interest rates to a multi-decade high. According to U.S. Treasury data, the U.S. has spent $131 billion more on interest payments this fiscal year/year through June, a 25% increase while tax revenues dropped by 11% year/year. Ultimately, if the deficit isn't contained, taxes will be raised to the point that the engine of the U.S. economy -- the all-important consumer -- will have considerably less discretionary income.

There's no need to panic. Standard & Poor's downgraded its U.S. credit rating in 2011 as a result of the first meaningful, post-GFC debt ceiling posturing. Things didn't change. This current downgrade is rooted in debt ceiling politics as well, but with the addition of leveraged Congressional opposition threats to servicing these deficits. At 8.4% of GDP, the last reading is an alarming first-world figure. The markets' muted reaction thus far -- and global investors' seemingly bottomless appetite for U.S. government debt -- allows fiscal dysfunction to persist. It has been many years since bond vigilantes stalked the Treasurys market demanding lower deficits. With the 10YR U.S. Treasury yield sitting at 4.2% and the potential to move higher, a return of bond vigilantism would not come as a surprise.

The downgrade is a reputational blow to the U.S. but it's unlikely to stop investors buying U.S. Treasuries in times of crisis. While there is validity to the rating agency's downgrade, it would be taken more seriously if its rating of some euro area almost bankrupt nations would have been downgraded accordingly!

Regards,

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U.S. Large Cap Equity Strategy

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