

# Spotlight on U.S. fiscal challenges

BlackRock

The move by Fitch Ratings to strip the U.S. government of its top-notch AAA credit rating again underscores the long-term challenges we see for the U.S. fiscal outlook. We don't see this action as a market driver and see no impact on U.S. Treasury market functioning.

The credit rating downgrade is unlikely to cause the Federal Reserve to meaningfully change its macro assessment, we think, nor does it change our expectations for the path of policy rates: high for longer. The debt outlook does reinforce our view that central banks will be constrained on how far they can raise interest rates. This is why we believe they will end up living with some inflation.

Fitch's downgrade follows the debt ceiling standoff two months ago that brought the U.S. close to a technical default. Fitch is the second ratings agency to remove the U.S.' top AAA rating, after Standard & Poor's did so in 2011 following a similar standoff then. This is a very different market and macro backdrop compared with 2011, when policy interest rates were near zero, deflation risks were emerging and the euro area was suffering a sovereign debt crisis.

The downgrade highlights that debt levels and interest rates are much higher after the policy response to the Covid pandemic by the U.S. and other developed markets (DMs). The U.S. Congressional Budget Office (CBO) projects that the sizeable U.S. primary budget deficit, excluding interest costs, is set to persist over the next decade. On top of this, interest costs are rising after the Fed's rapid rate hikes. We estimate that U.S. debt servicing costs will nearly double over the next five years to around \$1 trillion, or 12-15% of projected tax revenue. That looks to keep the debt-to-GDP ratio on a steady upward trajectory.

The result is large-scale government bill and bond issuance, now and in the future. This adds to the supply of Treasuries at a time when the Federal Reserve is letting bonds run off its balance sheet as part of quantitative tightening. This will be a key driver of near-term bond prices, in our view, along with the Fed policy outlook.

**Our bottom line:** The rating downgrade reinforces our view that rising inflation and debt burdens will prompt investors, over time, to demand more term premia, or compensation for the risk of holding long-term government debt. We see that causing DM bond yield curves to steepen over time as long-term yields rise, underpinning our long-held strategic underweight. We stay tactically underweight broad DM equities but are overweight on a long horizon – alongside inflation-linked bonds, credit and beneficiaries of structural mega forces.

## Key views

**The U.S. credit rating downgrade underscores the long-term U.S. fiscal challenges.**

**Rising inflation and debt burdens underpin our strategic underweight to long-term government bonds.**

**We stay tactically underweight broad DM equities but are overweight on a long horizon – alongside inflation-linked bonds, credit and beneficiaries of structural mega forces.**

**Bulletin**

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**BlackRock  
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