Should Investors Worry About Another Rating Agency Downgrade?

The lower outlook by Moody's, just months after Fitch's downgrade, reflects the rating agency's concerns over the United States' long-term fiscal stability, but the impact on bonds should be near zero.

Key takeaways

- **Moody's reaffirmed its AAA rating but reduced the U.S. outlook from stable to negative**, just a few months after Fitch joined S&P and lowered its U.S. credit rating to AA+.
- Should Moody's decide to lower its rating from AAA in the future, **we'd expect a muted investor response, as two other agencies already rate U.S. Treasuries as AA.**
- **We believe bonds remain not only viable but attractive,** as investors can lock in high yields during the Fed pause and benefit from subsequent price appreciation should rates fall.

Moody's lowers its outlook on the U.S.

Three months after Fitch downgraded long-term U.S. Treasuries from AAA to AA+, Moody's Ratings voiced its concerns about fiscal deficits and debt affordability. But unlike Fitch, Moody's didn't lower its rating. We believe the agencies' similar worries are fair and that their concerns must be addressed. But for markets and investors, this latest news doesn't change the narrative.

Past market reaction was modest

Before Fitch's downgrade, the last (and only other) time this happened was in 2011, when Standard & Poor's downgraded the U.S. credit rating. This took place amid a European debt crisis and just days after the government resolved its most serious (to date) standoff on the debt ceiling. The news sparked intense short-term volatility, but markets eventually stabilized, and U.S. equity indexes hit record highs by 2013, fueled in part by new quantitative easing measures.

The reaction after Fitch's cut was more muted. Stocks opened lower—perhaps because strong jobs data raised fears of another rate hike, more than due to the downgrade—while Treasuries, gold and money markets were relatively unperturbed.

Reaffirmation should calm investors

While the Fitch hit came at a quiet moment for markets, this negative outlook arrives on the heels of October's near shutdown of the government (which is headed for a worse fate if a resolution isn't reached by November 18). The type of political infighting that led to the shutdown near miss and June's debt ceiling debate is at the heart of the "weakness of U.S. institutional and governance strength" Moody's cited in a September letter. However, investors should be heartened by the reaffirmation of the agency's highest triple-A rating.

But what if the agency has a "mood" swing and decides a cut to AA is warranted?

Despite the potential initial headline reaction, we believe a response to an additional downgrade—from AAA to AA—would be muted. Index providers, such as Bloomberg, apply a "middle rating" methodology, so U.S. Treasuries are already rated as AA.

Investment implications

Our case for bonds remains intact: The Fed's interest rate pause offers a prime opportunity in intermediate bonds. History has shown that the best opportunities to generate returns are before the first rate cut, toward the end of the rate-hike cycle, since bond yields tend to decline prior to cuts.[1] The current pause may allow investors to lock in attractive high yields and benefit from a subsequent rise in bond prices when yields move lower.

[1] Bloomberg Index Services LTD., Federal Reserve, Voya IM calculations. As of 09/30/23.

A note about risk

The principal risks are generally those attributable to bond investing. All investments in bonds are subject to market risks as well as issuer, credit, prepayment, extension, and other risks. The value of an investment is not guaranteed and will fluctuate. Market risk is the risk that securities may decline in value due to factors affecting the securities markets or particular industries. Bonds have fixed principal and return if held to maturity but may fluctuate in the interim. Generally, when interest rates rise, bond prices fall. Bonds with longer maturities tend to be more sensitive to changes in interest rates. Issuer risk is the risk that the value of a security may decline for reasons specific to the issuer, such as changes in its financial condition.

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