

MAY 2025

# US rating downgrade highlights debt sustainability concerns

Moody's downgrade of the US credit rating was not unexpected, but we think it will intensify the spotlight on the country's debt sustainability and the strength of its assets.

Moody's stripped the US of its top credit rating on 16 May, citing worries about the nation's growing debt levels. The ratings agency lowered the US's "Aaa" rating, which had been in place since 1919, by one notch to "Aa1".

US long-term borrowing costs surged to their highest level since late 2023, while US equities and the US dollar slid as markets digested the news.



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## Key takeaways

- We expect the downgrade may cause ripples across financial markets, magnifying structural downward pressure on the US dollar and upward pressure on long-term US Treasury yields.
- Moody's move comes at a delicate time for the US as negotiations continue over stimulus measures that could further raise the fiscal deficit.
- For international investors seeking to diversify away from US Treasuries, German Bunds may emerge as an increasingly appealing liquid alternative.
- Investors are likely to stay focused on the sustainability of US debt, and we expect trades positioning for a steepening in US Treasury yields to remain a viable strategy in an actively managed diversified portfolio.



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We think the downgrade is not entirely unexpected: Moody's maintained a negative outlook on the US since November 2023 due to larger fiscal deficits and higher interest payments. And the downgrade follows similar moves by the other two main ratings agencies: S&P already cut the US's top-notch rating in August 2011 and Fitch did the same in August 2023.

But the timing of Moody's move is somewhat surprising given that it comes at a crucial time for the country's fiscal outlook. Negotiations are ongoing over the current reconciliation bill, which is expected to lift the statutory debt ceiling and provide fresh stimulus, while raising both the fiscal deficit and public debt. Moody's move may also incur the wrath of US President Donald Trump and open the agency up to the risk of political and business headwinds.

### Moody's: US strengths are not enough to counterbalance declining fiscal metrics

From an analytical standpoint, the downgrade was overdue and is justified by Moody's highlighting the following points:

- **Limited budget flexibility:** "Without adjustments to taxation and spending, we expect budget flexibility to remain limited, with mandatory spending, including interest expense, projected to rise to around 78% of total spending by 2035 from about 73% in 2024. If the 2017 Tax Cuts and Jobs Act is extended, which is our base case, it will add around USD 4 trillion to the federal fiscal primary (excluding interest payments) deficit over the next decade."
- **Widening fiscal deficits:** "We expect federal deficits to widen, reaching nearly 9% of GDP by 2035, up from 6.4% in 2024, driven mainly by increased interest payments on debt, rising entitlement spending, and relatively low revenue generation. We anticipate that the federal debt burden will rise to about 134% of GDP by 2035, compared to 98% in 2024."
- **Higher interest payments:** "Despite high demand for US Treasury assets, higher Treasury yields since 2021 have contributed to a decline in debt affordability. Federal interest payments are likely to absorb around 30% of revenue by 2035, up from about 18% in 2024 and 9% in 2021. The US general government interest burden, which takes into account federal, state and local debt, absorbed 12% of revenue in 2024, compared to 1.6% for Aaa-rated sovereigns."

Moody's acknowledged the US's significant economic and financial strengths. But it said these strengths were no longer able to fully counterbalance the decline in fiscal metrics.

### We anticipate a rise in US debt relative to economic growth in the years ahead

We think the somewhat belated downgrade serves as a timely reminder of rising debt sustainability risks over the medium to longer term:

- Even without new stimulus, the Congressional Budget Office (CBO) expects a long-term deterioration in the fiscal situation, with the budget deficit rising to 7.3% (from 6.4% in the fiscal year 2024) and the debt-to-GDP ratio to 156% (from 98% in the fiscal year 2024) by 2055.
- Our calculations show that in an extreme scenario the US's debt-to-GDP ratio could climb to more than 250% over the next 30 years. This scenario assumes a further deterioration in the fiscal primary deficit by an additional 1% of GDP per year (relative to the CBO base case) and a rise in average interest rates to 5%.

### Market impact: Upward pressure on Treasury yields, downward pressure on the dollar

In our view, the US downgrade and current fiscal dynamics could magnify structural downward pressure on the US dollar and upward pressure on long-term US Treasury yields. Higher spending and ongoing discussions about a "Mar-a-Lago accord", which could deliberately weaken the dollar (and, inadvertently, its status as the leading reserve currency), may undermine capital flows into the US and create headwinds for the country's assets.

The downgrade and any continued dollar weakness could encourage more investors from high-saving Asian countries to question the need to hold large US Treasury reserves when their own countries have rebuilt their fiscal positions in the decades since the 1997 Asian currency crisis. Several Asian currencies have rallied against the dollar in recent weeks.

For international investors seeking to diversify away from US Treasuries, German Bunds may also emerge as an increasingly appealing liquid alternative. Germany is set to increase its borrowing rate to finance infrastructure projects and has a debt-to-GDP ratio of only 63% (well below the US).



We expect long-term Treasury rates to continue to face upward pressure, with the yield curve maintaining a steepening bias. The outlook for US Treasuries may differ if the US economy slips into recession, as the Federal Reserve would likely significantly ease monetary policy, causing a cyclical decline in bond yields that could, at least temporarily, offset structural headwinds.

### Trump administration counter measures may be insufficient to limit market concern

The Trump administration may attempt to counter negative market dynamics. For example, the so-called “Bessent put,” (named after the Secretary of the Treasury Scott Bessent) increases focus on shorter-maturity funding

and pushes for banking deregulation, such as revisions to the SLR (supplementary leverage ratio) to enable banks to increase their holdings in US Treasuries.

The risk for the administration is that pushing for a weaker dollar to boost the US’s competitiveness while labelling countries with a trade surplus against the US as “currency manipulators” backfires and hurts the US economy, especially if imported inflation rises due to a lower exchange rate.

In this environment, we expect investors to stay focused on the sustainability of US debt. Trades positioning for a steepening in US Treasury yields should remain a viable strategy in an actively managed diversified portfolio.

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