While the downgrade may lean against some recent "good news" momentum, CIO does not expect it to have a major direct impact on financial markets. (UBS)

Moody's downgrades the US sovereign credit rating by one notch on Friday to Aa1

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Credit ratings agency Moody's downgraded the US sovereign credit rating by one notch on Friday to Aa1, citing continued growth in the national debt and rising debt servicing costs amid still-high interest rates. With this latest action, the US government has now lost its last remaining AAA rating from a major agency; S&P downgraded the US in 2011, and Fitch followed in 2023.

The downgrade came shortly after the House Budget Committee failed to advance President Trump's "One, Big, Beautiful Bill" to extend the 2017 tax cuts, reflecting ongoing divisions within the Republican majority over spending and deficit reduction. Late Sunday, changes to appease fiscal concerns saw the tax bill advance through the committee along party lines, setting up potential passage in the House later this week.

What do we think?

The move should not come as a surprise. The federal government is running a budget deficit in excess of USD 2 trillion per year, even after a period of strong economic growth and low unemployment, and net interest costs now absorb 18% of tax revenues. But while the US debt trajectory has been worsening and is the reason for the Moody's downgrade, this is already well known by investors.

Significant selling of US Treasuries is unlikely, in our view. While yields may move 10-15bps higher in the short term, as seen after the 2023 Fitch downgrade, the Moody's move is unlikely to trigger significant selling or changes in collateral haircuts, in our view. Most investment mandates do not require AAA ratings for US Treasuries, and central banks continue to value the Treasury market for its exceptionally deep liquidity.

The US has very high credit quality, in our view, and aside from cash, US Treasuries remain the lowest-risk and lowest-yielding USD asset. The strength of US capital markets, the dollar's reserve currency status, and the significant wealth held by US households mean that the US's ability to repay debt is not in question, in our view. Academic research also shows that for countries with monetary sovereignty, rating changes have little lasting impact on short-term bond yields.

Credit downgrades are less politically costly in the US than you might think. The first US downgrade in 2011 was unexpected and triggered significant bipartisan consternation. But it ultimately resulted in few lasting financial or political repercussions. The 2023 Fitch downgrade was largely shrugged off by policymakers. The 2025 Moody's downgrade may be used as a political tool in near-term budget negotiations, particularly among lawmakers who believe that the current "One, Big, Beautiful Bill" does not do enough to shrink the deficit, but we think it is unlikely to alter the overall trajectory of US fiscal policy.

Equity investors are focused elsewhere. With Moody's the third credit ratings agency to downgrade the US, we believe that the shock factor for investors has likely faded, and we would expect a more muted equity market response to Friday's downgrade. In recent weeks, global investors have been more focused on effective US tariff rates, which we see settling in the 15% region—a headwind to growth but not enough to cause a recession, in our view. While budget negotiations and deficit implications may begin to have an increasing impact on markets in the weeks ahead, we do not think that the credit rating downgrade in itself will be a major focus for equity markets.

How to invest?

Overall, we view this latest credit action as a headline risk rather than a fundamental shift for markets. We would also expect the Federal Reserve to step in if there were a disorderly or unsustainable increase in bond yields. So while the downgrade may lean against some recent "good news" momentum, we do not expect it to have a major direct impact on financial markets.

Original report - **US downgraded: End of AAA era, 19 May 2025.**

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