Money Talks
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On May 16, Moody's Ratings downgraded its rating on U.S. government long-term debt from its highest rating of Aaa to the next highest rating of Aa1. The move was particularly significant because Moody's was the last of the Big Three credit rating agencies to maintain the triple-A rating for U.S. debt. S&P Global Ratings made a similar downgrade in 2011, and Fitch Ratings did so in 2023.

The reason for the downgrade was the same for all three agencies – excessive, growing debt in relation to revenues. Moody's indicated that its recent action was driven by the long-term trend of "large annual fiscal deficits and growing interest costs" coupled with the lack of potential relief in sight. "We do not believe that material multi-year reductions in mandatory spending and deficits will result from current fiscal proposals under consideration." The agency pointed specifically to the current effort in Congress to extend provisions of the 2017 Tax Cuts and Jobs Act, which it estimated would add about $4 trillion to the federal primary deficit (excluding interest payments) over the next decade. For perspective, the Congressional Budget Office projected in January 2025 that federal debt held by the public would grow from 100% of gross domestic product (GDP) in 2025 to 118% in 2035, the largest percentage in U.S. history. The projection assumed that the 2017 tax cuts would not be continued and would thus increase revenue, which does not appear likely.

The Moody's announcement drove Treasury yields higher temporarily, because in theory bond investors demand higher interest rates in return for taking on more risk. However, despite the downgrade, there is no expectation of default, as the federal government guarantees U.S. Treasury securities as to the timely payment of principal and interest. As Moody's pointed out: "The U.S. economy is unique among the sovereigns we rate. It combines very large scale, high average incomes, strong growth potential and a track record of innovation that supports productivity and GDP growth. While GDP growth is likely to slow in the short term as the economy adjusts to higher tariffs, we do not expect that long-term growth will be significantly affected." Some experts believe that the U.S. government debt is so unique that credit ratings are irrelevant.

Even so, some investors might be more cautious about buying U.S. securities, which could keep yields slightly higher than they might have been without the downgrade. Yields were already on the high side in response to other factors, including the elevated federal funds rate and economic uncertainty due to changing tariff policies. These factors will likely continue to be the primary drivers of Treasury yields.

Higher Treasury yields, for whatever reason, are good for investors who want stable income. But they can be bad for consumers because rates on some consumer loans, notably 30-year fixed mortgages, are tied to Treasury yields. The U.S. government may be hardest hit, because it must use a larger percentage of revenues to pay interest. Due to higher rates as the Fed has battled inflation, federal interest payments have risen from about 9% of revenues in 2021 to 18% in 2024 and are projected to require as much as 30% of revenues by 2035.

For now, the credit downgrade should have little or no effect on the U.S. economy and is unlikely to require changes to your investment strategy. Other factors will continue to drive the economy. As always, a wise investment strategy would be designed to weather economic changes and focus on personal goals, time frame, and risk tolerance.