Ropes Wealth Describes Why the U.S. is Down(Graded) but Not Out

Twelve years ago, I was pregnant with twin boys who had to be delivered prematurely at 34 weeks and weighed in at a combined 9 pounds. Fast forward and they are rising sixth-graders, smart, funny, and handsome, and who are the joy of my life (along with their sixteen-year-old brother on most days). Why mention this? Because the first time the U.S. credit rating was cut from AAA to AA+ by Standard & Poor's was when they were born. I will never forget that personal and professional moment converging all at once.

Therefore, this week's big news that Fitch Ratings opted to downgrade the U.S. long-term rating from AAA to AA+ brought back memories. In 2011, we were coping with 9% unemployment (as we recovered from the Great Recession), low interest rates and inflation, a European sovereign debt crisis, and political gridlock in Washington over debt ceiling increases and budget negotiations. A bear market ensued. Will we face the same experience in 2023 as we did in 2011?

According to Fitch, *"the repeated debt-limit political standoffs and last-minute resolutions have eroded confidence in fiscal management. In addition, the government lacks a medium-term fiscal framework, unlike most peers, and has a complex budgeting process [and] the GG (General Government) debt-to-GDP ratio is projected to rise over the forecast period, reaching 118.4% by 2025. These factors, along with several economic shocks as well as tax cuts and new spending initiatives, have contributed to successive debt increases over the last decade."*

All true statements, and as Congress broke for August this week with no clear path to government funding and an October 1 deadline for a budget, we can't help but worry. Treasury Secretary Janet Yellen called Fitch's decision "arbitrary" and "unwarranted" given the American economy's fundamental strength. That strength was on display with this morning's jobs report, which showed continued solid job gains of 187,000 in the month of July, driven by adds in the healthcare sector, and the unemployment rate falling to 3.5%. Notably, wage gains were also strong, rising 4.4% year-over-year, higher than expectations, which will keep the Fed in play for further rate hikes as they weigh and measure their efforts to restrain inflation.

However, Fitch isn't wrong to call out our country's ballooning fiscal deficits, criticizing an "erosion of governance" that's led to repeated debt limit clashes over the past two decades. But Yellen isn't wrong either that against a lot of odds, the U.S. consumer and many publicly traded companies are slogging through, beaten up but not broken. The stock market remained resilient too, down modestly but not out, focusing on a stellar earnings report from Amazon but a mixed bag on Apple as iPhone sales missed expectations. Of course, after last year's major price declines, we would hope there is some cushion in the trading prices of companies.

Bond yields did rise on the news of the credit rating downgrade, with the 10-year Treasury breaking well over 4% and now trading at 4.18% at press time. We suspect the biggest driver of short-term market moves will remain investor sentiment around recession risk above all else. A less covered data point released this week was the Fed's Senior Loan Officer Survey which showed U.S. banks tightened lending standards across loan categories during Q2 and potentially plan to tighten standards further later in the year. At the start of the year, 45% of large and medium banks reported tighter standards and 44% of small banks. In the latest Q3 report, 51% of large and medium banks reported tighter standards and 49% of small banks reported tighter standards. Demand slowed widely, for C&I loans, commercial real estate loans, residential real estate, home equity lines of credit, auto and other consumer loans. Demand was reportedly unchanged for loans linked to credit cards.

As the Fed continues to embark on a campaign of higher rates to tackle inflation, and fiscal governance remains missing in action, it would seem we have only ourselves to rely upon to sustain activity. Can we do it? I suspect we can, like my little preemie babies born twelve years ago, who did the work to get stronger and grow up, though not without some bumps along the way. I note that former New York Fed President William Dudley was quoted this week saying, *“Although the recent economic news has been reassuring, the economy isn’t out of the woods. A hard landing might simply have been deferred, not avoided.” I*n case it is not avoided, let’s continue to work together to plan for your short-term cash needs, balance your allocations, reaffirm your holdings, and use these bouts of volatility and uncertainty to add to the enduring businesses that will prevail over the long-term.

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Ropes Wealth Advisors LLC
800 Boylston Street Boston, MA 02199-3600