

Liquid Insight

US downgrade & US fiscal FAQ

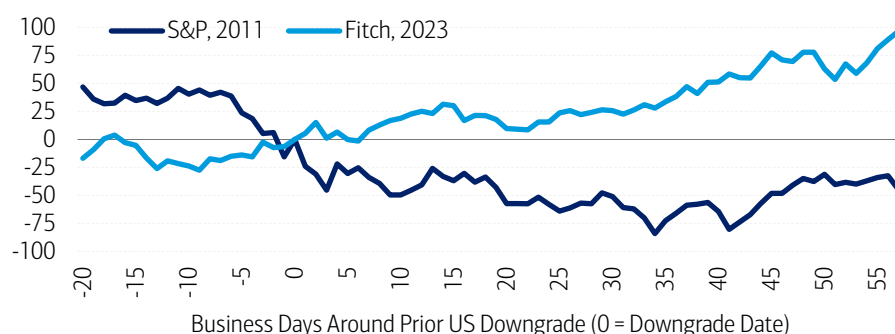
Key takeaways

- Friday's US sovereign downgrade by Moody's is unlikely to result in forced selling but may worsen UST sentiment
- US tax law discussion likely to result in annual US deficit / GDP to 7-8% over next 10Y, esp after Senate changes
- USTs to cheapen at long end, we like 10s30s steeper & short 30Y asset swaps; UST issuance likely to angle lower over time

By M. Cabana, M. Swiber, S. Juneau, R. Axel & B. Braizinha

Exhibit 1: 10Y UST move around prior US downgrades (bps)

US rate moves have been very different around prior downgrades; US macroeconomics > ratings action



Source: Bloomberg

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US debt FAQ: downgrades, tax cuts, & issuance

On Friday the US was downgraded by Moody's by one notch from Aaa to Aa1. The US is now rated one notch below AAA by all big 3 ratings agencies. The downgrade is expected to negatively impact UST sentiment but is unlikely to result in any forced selling. There has been no consistent UST market response to prior US downgrades (Exhibit 1); macro shifts are much more important than downgrades for US rate market direction.

Moody's action was due to deteriorating US fiscal dynamics, which are likely to become worse with upcoming US tax cuts. Our US economists have long expected the US annual fiscal deficit to deteriorate to 7% / GDP in FY '26 & '27. This is far from Treasury Secretary Bessent's stated annual deficit objective of 3% / GDP.

We address FAQs on the US downgrade, US fiscal outlook, and UST debt implications. Our bottom line: (1) US downgrade has no mechanical forced selling impact but will worsen UST sentiment; (2) the fiscal trajectory to worsen with the Senate version of tax law and likely results in annual deficits of 7-8%/GDP over the next 10Y; (3) USTs to cheapen and the curve will steepen; be short 30Y asset swaps & in 10s30s steepeners.

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What is the US sovereign rating now?

Below AAA. The US sovereign rating is now one notch below AAA by all big 3 ratings agencies (Exhibit 2). All big 3 agencies have the US sovereign outlook as stable.

Exhibit 2: Current US ratings

US rating is now 1 notch below AAA by all big 3 ratings agencies

	Ratings	Outlook	As of Date
S&P	AA+	Stable	Mar-24
Fitch	AA+	Stable	Aug-24
Moody's	Aa1	Stable	May-25

Source: Fitch, Moody's, S&P

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Moody's downgrade was driven by "the increase over more than a decade in government debt and interest payment ratios to levels that are significantly higher than similarly rated sovereigns." There was no specific catalyst for the downgrade but Moody's noted their base case is an extension of the 2017 Tax Cut & Jobs Act (TCJA) which will support a widening of federal deficits & annual deficits / GDP of nearly 9% by 2035. Our US economists generally agree with Moody's baseline for TCJA & the deficit outlook.

Will there be forced selling due to the downgrade?

Very unlikely. Our understanding from major fixed income indices (BofA ICE & Bloomberg / Barclays) is that they either require ratings of above investment grade or have no explicit sovereign ratings requirements. As a result, no forced selling from these indices is likely in our view. Other indices may have different requirements but likely have substantially lower associated AUM.

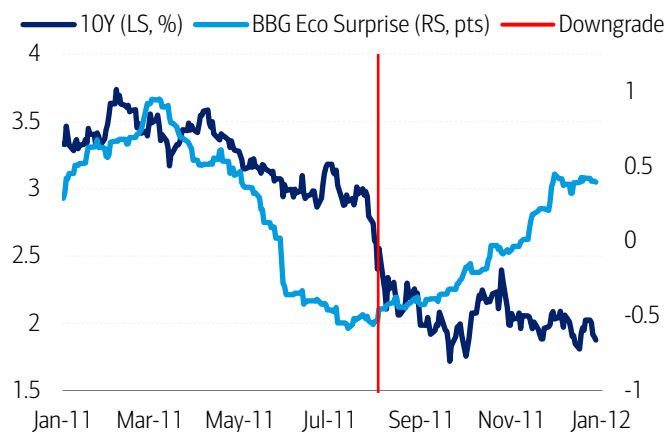
Index requirements are more specific when they pertain to technical default. These are more relevant considerations around "selective default" or "restricted default". Such ratings are relevant when considering very low probability outcomes related to the US debt limit; for detail see: [Debt limit FAQ: spring 2025 update](#).

What is the rate impact of a US sovereign downgrade?

Very limited direct impact. The direct impact of prior 1-notch US sovereign ratings downgrades has been relatively small in relation to broader macro & financial conditions. The 2011 S&P downgrade was a catalyst for a sharp decline in US 10Y yields but occurred in the context of softening US economic data (Exhibit 3). In contrast, the 2023 Fitch downgrade was a catalyst for a large increase in US 10Y yields but occurred in the context of strengthening economic data (Exhibit 4). Macro > downgrades.

Exhibit 3: US 10Y & BBG eco surprise index around S&P downgrade

S&P downgrade was a catalyst for lower rates but macro mattered more

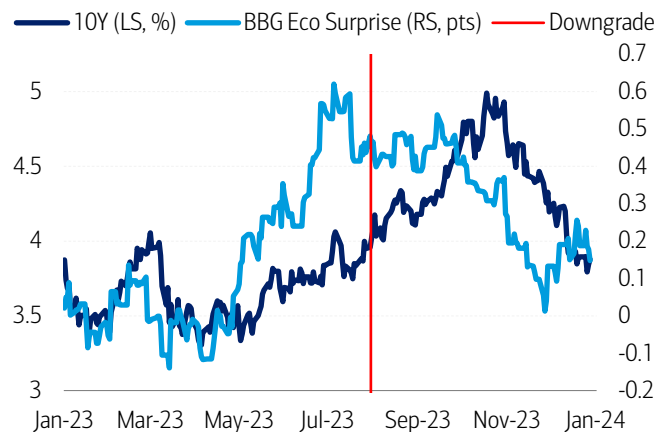


Source: Bloomberg

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Exhibit 4: US 10Y & BBG eco surprise index around Fitch downgrade

Fitch downgrade was a catalyst for higher rates but macro mattered more



Source: Bloomberg

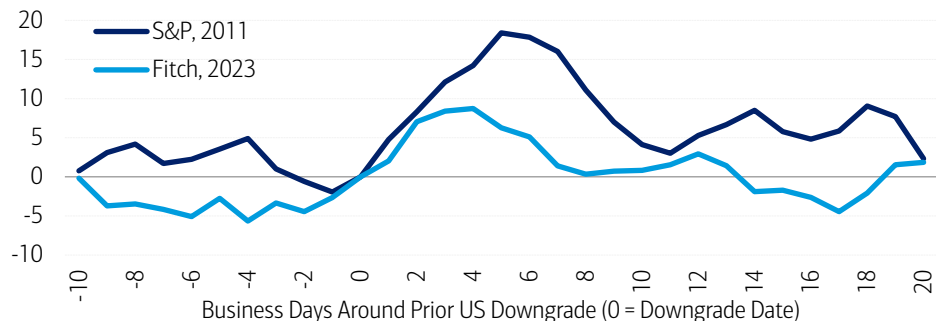
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A clearer short-term market impact can be seen when looking at the UST curve. Specifically, US 10s30s tends to temporarily pop steeper after a US downgrade (Exhibit 5). This impact tends to be short lived & eventually overwhelmed by other curve drivers. The initial curve move supports our 10s30s steepening bias.

Exhibit 5: UST 10s30s curve around prior US sovereign downgrades (bps)

The UST 10s30s curve typically pops steeper after downgrades but subsequently reverses



Source: Bloomberg

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Notably, the long end asset swap spread move has been more mixed. The '23 Fitch downgrade saw long end SOFR asset swap spreads widen (widen = richer USTs) which may have been driven by increased long end receiving demand after the initial pop higher in 30Y rates. The '11 S&P downgrade saw long end LIBOR spreads also widen but this was likely a reflection of acute risk off & heightened recession risks. The SOFR to LIBOR transition in asset swaps also complicates the historic swap spread comparison. On the Moody's announcement, 30y spreads tightened only about 0.5bp. We think this underscores that credit agencies are lagging movers versus markets which already price very cheap Treasuries vs swaps resulting from a steadily worsening supply/demand landscape over the years.

In implied volatility space, we note an increase in gamma and intermediate expiries in 10y tails over the last two downgrades (c.+5bp for 1m10y and c.+19bp for 1y10y), but lower left side vol (c.-10bp for 1y1y vol). In delivered volatility (3m windows) we saw a material increase in 10yT and 30yT rates (c.+27bp and c.+54bp, respectively), but a decrease at the frontend of the curve (c.-19bp and c.-10bp lower for 2yT and 5yT, respectively). The fact that we only have two downgrade events is limiting in terms of generalizations for the vol dynamic, but these results do reflect some support for right side vol (outperformance of vol on the right side of the grid and delivered vol at the backend of the curve) and make intuitive sense.

What is the status of US fiscal bill?

The reconciliation bill is making its way through the House of Representatives. Committees have finished their work on proposals consistent with the reconciliation instructions. Last Friday, the bill's aggressive timeline took a blow as it failed to advance out of the Budget Committee. Conservative Republicans voted against the bill to extract more significant and earlier spending reductions.

This is not a nail in the coffin, but it does make passing the bill before Memorial Day less likely. The Budget Committee is set to vote again. If it passes, it will go to the Rules Committee before finally a floor vote. Changes are likely to be made to get party-line support, Watch SALT (State and Local Tax) cap, work requirements, and IRA (Inflation Reduction Act). While moderate and conservative Republicans do not have consensus on these issues, we expect the House to eventually advance the bill to the Senate.

The Senate is likely to make its own amendments to the bill. In general, we expect them to water down the spending cuts proposed by the House. That could be another speed bump for the timeline. It also would result in a bill that adds even more to the deficit than what the House is considering.

What is the deficit impact? What is potential range?

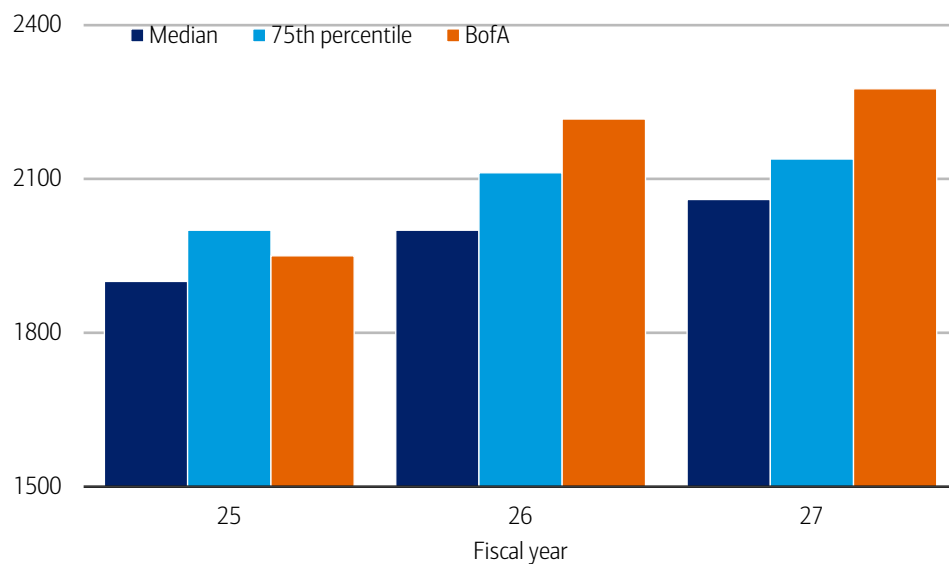
The deficit is going to increase in any outcome, we believe. According to the Committee for a Responsible Budget, the House Republican bill as its written would add \$2.7tn to the primary deficit over the next 10-years. While this is less than the \$3.8tn estimated cost to extend the expiring TCJA provisions, its misleading since many of the tax provisions expire early. As we've seen time and again, Congress extends temporary tax cuts. Assuming all provisions are made permanent, CRFB estimates the House Bill will add \$4.5tn to the primary deficit over the next 10-years. We also expect the Senate changes to add-to rather than reduce the deficit. Depending on these changes, the final bill might add closer to \$5-\$6tn to the deficit.

The range of outcomes for near-term deficits is narrower than over the long-run due the expect front-loading. Indeed, CRFB, estimates the House bill would add \$600bn (1.8% of GDP) to the FY '27 deficit. Tariff revenue would only be a partial offset to this increase.

While the current spending proposals by the House do not change our base case deficit forecasts, the market may be moving closer to our expectations for around 7% deficit in FY '26 & '27 (Exhibit 6). The market is likely realizing lower effective tariff revenues, limited scope of DOGE spending reductions and potential incremental tax cuts on top of TCJA extension support a higher deficit trajectory in both the medium and longer term.

Exhibit 6: BofA deficit forecasts vs primary dealer forecasts (\$bn)

As of May refunding meeting, BofA was at top end of dealer deficit forecasts for FY '26 & '27 deficits



Source: BofA Global Research, US Treasury

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How will UST fund the package?

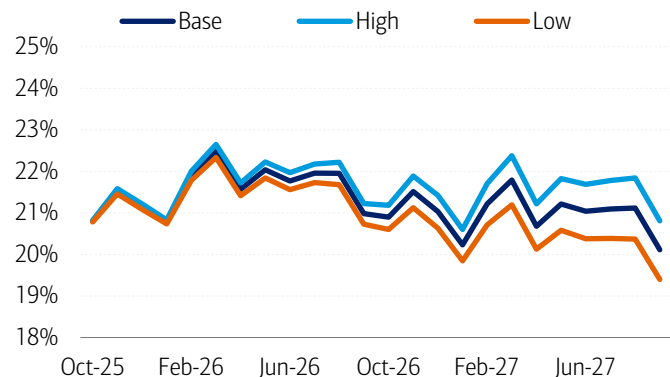
Initially bills. Coupon sizes will rise, eventually. In our base case, we assume UST grows coupons starting at the February refunding. A proactive UST has room to grow coupons sooner than Feb but deficit uncertainty will likely push coupon increases out to '26.

In Exhibit 7, we show bills as % of marketable debt assuming \$280bn growth over four quarters starting in Feb '26 (similar to \$300bn in four quarters observed in '23-'24). Even under the lower deficit scenario, the auction growth we forecast is required for bills to not persistently exceed 22% of marketable debt in FY '26. It is possible UST allows higher bill supply growth vs Treasury Borrowing Advisory Committee (TBAC) guidance; we interpret TBAC guidance as recommending a soft cap of bills as % of total UST debt around 22%.



Exhibit 7: Bills % marketable debt assuming baseline coupon growth across curve starting in February

Assuming coupon growth we expect, bills stay below 23% through FY '27 under base & alternate deficit scenarios



Source: BofA Global Research

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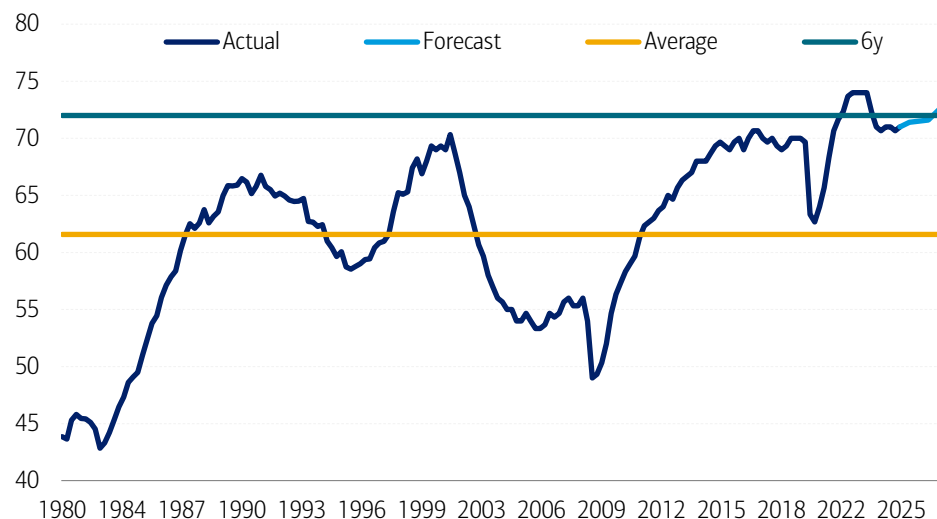
Our base case for coupon growth is shown in Exhibit 8. We reflect coupon increases across the curve consistent with observed growth observed in '23 – '24. We anticipate that UST will view bill supply above 22% as too high and then look to grow coupons. UST may argue for persistently higher bill supply if stablecoin is more broadly adopted which could structurally increase demand for bills (see: [Stablecoins & USTs](#)). Treasury Secretary Bessent may also prefer to fund the deficit via bills to limit upward pressure on longer-term USTs (despite his prior criticism of Yellen for a similar approach).

Will UST shorten WAM?

Likely, but they have not admitted it yet. UST has capacity to shorten UST WAM but has yet to show willingness. In [May refunding preview](#), we discussed the options that UST has for shifting WAM of issuance to the front end and belly of the curve. Because UST WAM is at historically elevated levels (Exhibit 9), UST can consider alternate coupon supply growth that only modestly shift WAM lower and keep WAM above longer term average. We perceive the likelihood of a lower UST WAM as rising.

Exhibit 9: Actual and expected WAM through FY '27 (months)

WAM expected to rise unless Treasury adjusts issuance allocation

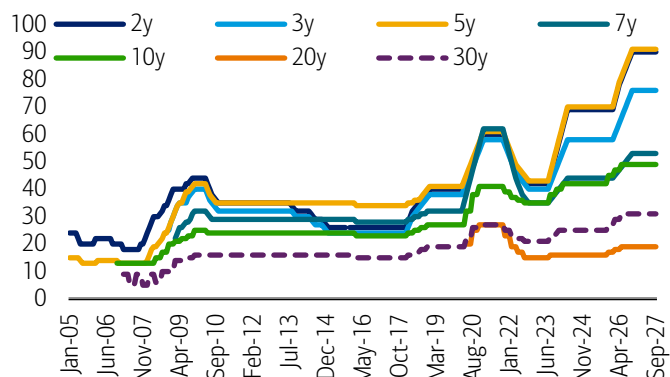


Source: BofA Global Research, US Treasury
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Assuming coupons grow across the curve consistent with recent adjustments, WAM will continue to shift higher (Exhibit 9). If back-end cheapness remains into the end of the

Exhibit 8: Treasury auction sizes by tenor with projections through FYE '27 (\$bn)

We forecast that Treasury note auction sizes will grow starting in Feb '26 through Oct '26



Source: BofA Global Research, US Treasury

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year, UST may be motivated to consider keeping bill share elevated or managing gross issuance across shorter-dated coupons.

What is market impact of fiscal developments?

Both the Moody's US downgrade & expected fiscal deterioration spell trouble of the UST back end. As discussed in [Global Rates Weekly](#) we hold a 10s30s steepener and 30y spread short to position for continued cheapening pressure at the back end as the market grapples with more supply and the limited scope for back end demand (see: [Flows report](#)). The UST back end will absorb much of the supply risk as Treasury has yet to show responsiveness to this supply/ demand imbalance and market signals from term premium, spread curve shape, and 20y cheapness (see: [Signal miss](#)). While we are hopeful WAM UST/ TBAC discussion will be had in coming refunding meetings, we have limited conviction on what levels will garner enough concern for action.

Bottom line: (1) US downgrade has no mechanical forced selling impact but will worsen UST sentiment (2) the fiscal trajectory to worsen with the Senate version of tax law & likely results in annual deficits of 7-8%/GDP over the next 10Y (3) USTs to cheapen & the curve will steepen; be short 30Y asset swaps & in 10s30s steepeners.



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