IR+M
INCOME RESEARCH + MANAGEMENT

IR+M SPECIAL MARKET UPDATE
August 2, 2023

WHAT HAPPENED

On August 1st, 2023, rating agency Fitch downgraded the United States' long-term rating from AAA to AA+.

- In May, Fitch placed the credit rating on negative watch amid the ongoing debt ceiling negotiations.
- Fitch cited the expected fiscal deterioration over the next three years, and a high and growing debt burden.
    - Fitch also believes governance standards have steadily deteriorated over the last 20 years, including on fiscal and debt matters, eroding confidence in fiscal management.
- The short-term rating, which is relied on by money market funds, was unchanged.
- Fitch downgraded Fannie Mae and Freddie Mac on August 2nd, a day after cutting the US sovereign rating.

IMPLICATIONS

AAA rated securities are becoming a rarity.

- Based on the index methodology of "middle of three," the average credit rating of U.S. Treasuries will fall from AAA to AA+.
- The downgrade will also impact entities tied to the credit worthiness of the U.S. Government.
    - Government-Sponsored Entities (GSEs) (Federal Home Loan Banks, Fannie Mae, Freddie Mac, etc.) and agency-backed debt (agency MBS, SBAs, and agency CMBS) will be cut to AA+, as well.
- However, investment-grade corporates and most municipals may keep their AAA ratings. While many do not have a Fitch rating, even if they did, that might not matter. For example, S&P rates many of these issuers as AAA, despite rating the US Government one notch lower.
- Unlike in 2011, there should be minimal impact to financial contracts and collateral as many of these contracts were rewritten by Dodd Frank to remove references to specific ratings (such as AAA), and instead include "debt backed by the U.S. Government."
- As of the August 1st close, over 70% of the Agg Index was comprised of AAA-rated securities. That percentage would drop to below 5% due to the downgrades of U.S. Treasuries, GSEs, and agency-backed debt. Additionally, the average rating for the index will fall from Aa1/Aa2 to Aa2/Aa3 once the downgrades are reflected for September.

MARKET REACTION (AS OF AUGUST 2ND CLOSE)

While the S&P downgrade in 2011 came as a shock to investors, Fitch's rating action appears less impactful.

- **Sentiment:** A resilient labor market – companies added 324k jobs in July – increases the probability of further Federal Reserve (Fed) action and caused a softer market tone. Equity markets fell, with the S&P 500 Index closing over 1% lower.
- **Treasuries:** Yields were higher, particularly in the long-end with the 30-year rate up 8bps, causing a steepening of the Treasury curve. The rate move was more likely driven by the Treasury announcement that higher funding needs will lead to increased supply, coupled with economic data, rather than investor selling due to the rating downgrade.
- **Investment-grade corporates:** The downgrade was not enough to keep issuers on the sidelines. Issuance totaled over $11 billion across three issuers. While spreads opened flat to slightly wider, they leaked wider throughout the day (+3bps).
- **High-yield corporates:** Two deals were announced, totaling over $1 billion, in a high-yield market that has been starved of issuance. Spreads widened by 12bps – far from the "bloodbath" experienced in the HY market after the downgrade in 2011, when spreads widened by more than 60bps day-over-day.
- **Securitized:** Both agency and non-agency securitized sectors opened unchanged to slightly tighter, outperforming many other sectors, before weakening as volatility increased.

As of: 8/2/23. Sources: Bloomberg and IR+M. Intraday spread moves are estimates based on IR+M's market observations in the market on 8/2/23. MBS = mortgage-backed securities. CMBS = commercial mortgage-backed securities. Agg Index = Bloomberg Aggregate Index. Index statistics are as of 8/1/23. Projected Agg Index statistics assume agency, agency-backed, and Treasury securities are rated AA1 instead of AAA. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions. This report is for informational purposes only and is not intended to provide specific advice, recommendations, or projected returns for any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research + Management. "Bloomberg®" and Bloomberg Indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by IR+M. Bloomberg is not affiliated with IR+M, and Bloomberg does not approve, endorse, review, or recommend the products described herein. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to any IR+M product.

INCOME RESEARCH + MANAGEMENT

IR+M SPECIAL MARKET UPDATE
August 2, 2023

IR+M'S TAKE

We remain cautious given growing market uncertainties and events such as these reinforce our vigilant stance.

- Despite the downgrade, we believe investors will be undeterred and continue relying on Treasuries as a safe haven and for their liquidity.
- While we have not meaningfully changed the risk profile of any of our strategies in reaction to the downgrade, we are closely monitoring market developments and relative value.
- Over the last few months, we have taken opportunities to monetize outperformers and moved into higher-quality, liquid positions.
- We have plenty of dry powder in our portfolios, and if spreads materially widen, we expect to deploy some funds opportunistically.

As of: 8/2/23. Sources: Bloomberg and IR+M. Intraday spread moves are estimates based on IR+M's market observations in the market on 8/2/23. MBS = mortgage-backed securities. CMBS = commercial mortgage-backed securities. Agg Index = Bloomberg Aggregate Index. Index statistics are as of 8/1/23. Projected Agg Index statistics assume agency, agency-backed, and Treasury securities are rated AA1 instead of AAA. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable but IR+M makes no guarantee as to the accuracy or completeness of the underlying third-party data used to form IR+M's views and opinions. This report is for informational purposes only and is not intended to provide specific advice, recommendations, or projected returns for any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research + Management. "Bloomberg®" and Bloomberg Indices are service marks of Bloomberg Finance L.P. and its affiliates, including Bloomberg Index Services Limited ("BISL"), the administrator of the index (collectively, "Bloomberg") and have been licensed for use for certain purposes by IR+M. Bloomberg is not affiliated with IR+M, and Bloomberg does not approve, endorse, review, or recommend the products described herein. Bloomberg does not guarantee the timeliness, accurateness, or completeness of any data or information relating to any IR+M product.