Special Focus – rates, credit and FX
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Implications of US rating downgrade: rates, credit and FX

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- **Rates**. After initial reactions, we expect further response in USTs to Moody's rating downgrade *per se* to be muted. UST performances to past downgrades suggest economic fundamentals and the monetary policy cycle were the major drivers. Looking ahead on a multi-month horizon, investors have a lot to watch out for, including Fed policy (Fed funds rate and QT), tariff development, and bond sales.

- **Credit**. We expect a limited impact to credit markets from the US sovereign rating change with implications to be indirect at best. Credit markets will continue to be driven by fundamental influences in our view rather than any direct impact from the sovereign rating action. Indirect influences may rise through FX risks and higher funding costs although we expect such impacts will likely be softened by recent structural developments within regional credit markets.

- **FX.** FX reaction was largely contained in reaction to Moody's downgrade. But it comes as a timely reminder that rising US debt and deficits further question USD's status as a safe haven and primary reserve currency. A continuation of diversification flows out of US assets, including the USD, as well as more proactive hedging (to reduce USD exposure) can weigh on USD over time. We retain a long bias in JPY, CHF and EUR and favour selling USD spikes if any.

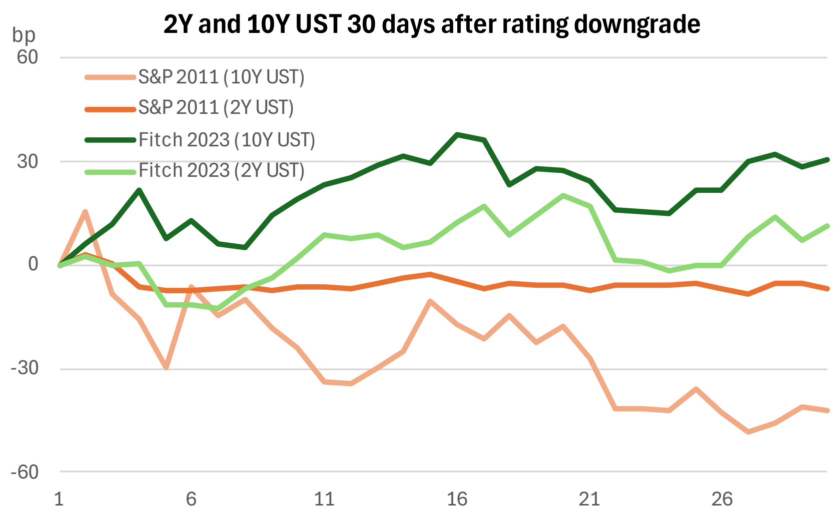
- **Macro**. At this juncture, we maintain our 2025 US GDP growth forecast of 1.3%, pending the outcome of the 90-day suspension of reciprocal tariffs, the 90-day truce on Chinese tariffs, and ongoing tariff negotiations.

Rates implications

- UST yields rose upon the credit downgrade by Moody's. Moody's Ratings has downgraded US' long-term issuer and senior unsecured ratings to Aa1 and changed the outlook to stable from negative. The downgrade represents a catch-up with those by other rating agencies (by S&P in 2011 and by Fitch in 2023). The reasons cited for the downgrade, including sharply rising debt over the past decade, and "large annual fiscal deficits and growing interest costs", were not something that the market hadn't taken note of. Just that upon the decision of downgrade after Moody's had put the credit outlook for the US on negative since November 2023, market reacted to some extent. **After initial reactions, we expect further response in USTs to Moody's rating downgrade *per se* to be muted**. Looking ahead on a multi-month horizon, **investors**

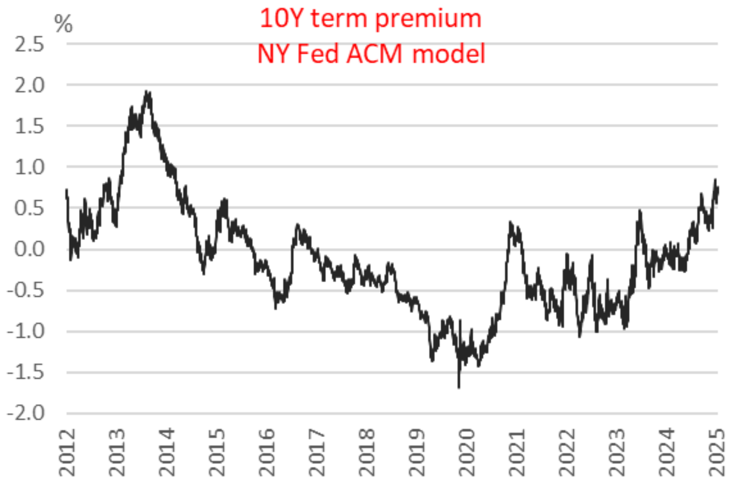
have a lot to watch out for, including Fed policy (Fed funds rate and QT), tariff development, and bond sales.

- **Past downgrades**. USTs had different performances around the previous episodes of credit rating downgrades. After S&P 2011 downgrade, the UST curve largely bullish flattened, as that coincided with a weak economy (Q3-2011 GDP growth at 0.9% YoY or -0.1% QoQ saar) and the subsequent operation twist. The Fitch 2023 downgrade happened shortly after FOMC hiked Fed funds rate to a peak of 5.25-5.50%, and the economy was growing decently (Q3-2023 GDP growth at 3.2% YoY or 4.4% QoQ saar); UST yields mostly rose in a steepening manner. The 10Y yield rose further until mid-October and then fell back steadily on other factors. These performances suggest that the economic fundamentals and monetary policy cycle were the major drivers of UST performances. The latest downgrade is even less relevant being a laggard.

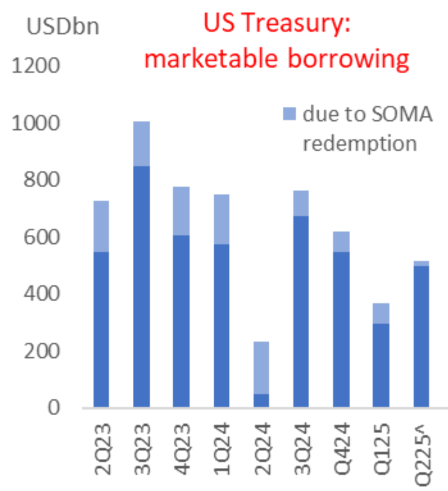


Source: Bloomberg, OCBC Research

- **US fiscal position.** Regardless of the credit rating change, US fiscal position has been a risk factor. The often-cited number is US CBO's projection that net interest payment will constitute more than 60% of fiscal deficits by 2027 and further to 70% by 2035. The key is, to what extent market has already priced such fiscal outlook. Both nominal yields and the term premium are well above multi-year averages. The 10-year and 20-year averages for the 10Y UST yield was 2.57% and 2.90% respectively, for example. The term premium is another indicator suggesting that market has already priced the fiscal outlook to some extent. 10Y term premium, according to the NY Fed's ACM model estimates, was last at 0.74%; this compared to its 10-year average of -0.38% and 20-year average of 0.40%. And to be sure, US' rating remains high and Moody's justify the new rating of Aa1 by the opinion that "the US retains exceptional credit strengths such as the size, resilience and dynamism of its economy and the role of the US dollar as global reserve currency".



Source: Bloomberg, OCBC Research



Source: US Treasury, OCBC Reseasrch
^estimates by US Treasury

- **Potential policies to watch**. There are potential support factors to USTs that we can look forward to over the coming months, including 1/ potential exemption of USTs from SLR calculation and 2/ a complete stop in QT. On the former, exemption of USTs from SLR has been called for and under discussion for some time. On QT, the pace has slowed since April: the monthly redemption cap on Treasury securities will be reduced from USD25bn to USD5bn starting 1 April (cap on MBS stayed the same at USD35bn). Although the decision at that time was understood to be in reaction to the debt ceiling issue, we suspect there may not be a re-acceleration in QT pace before a complete stop. The impact of slower QT pace is already reflected in US Treasury refunding plan.

- **Supply outlook.** According to the latest US Treasury Quarterly Refunding documents, for Q1 and Q2 together, borrowing (including estimates) are USD55bn lower than previous estimates, roughly equalling the USD60bn impact of the slower QT pace. There is still a final step to completely stop QT and even re-invest MBS redemptions into Treasury securities – while the plan appears to be more on T-bills, on a net basis that would mean lower refunding pressure, all else equal. US Treasury continue to anticipate "maintaining nominal coupon and FRN auction sizes for at least the next several quarters". **The multi-month supply outlook is neutral. That said, the next test is the auction of USD16bn of 20Y coupon bond** on Wednesday.

- **Our base-case for USD rates**. Our base-case remains for three 25bp Fed funds rate cuts this year, but we have recently pushed the expectation for the next cut to Q3 from Q2. We expect one 25bp Fed funds rate cut in Q3, and two 25bp cuts in Q4. Market has recently turned less dovish than our base-case. At the longer end, 10Y real yield at 2.11% appears elevated compared to the subdued growth outlook, although the term premium is at play. With potential supportive factors coming through over the coming months, a neutral supply outlook and the growth impact of tariffs, we have a mild downward bias to UST yields. We expect

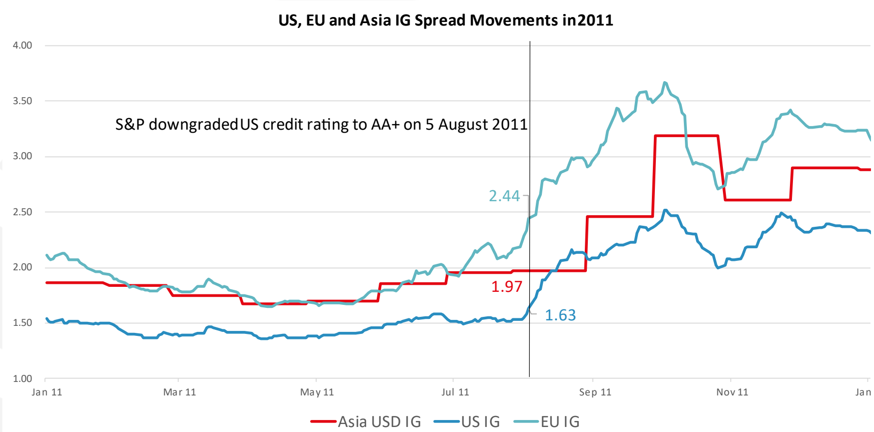
10Y yield to edge towards 4.35% as the first target. On the other hand, lingering fiscal concerns will constrain how much USTs can rally.

Credit implications

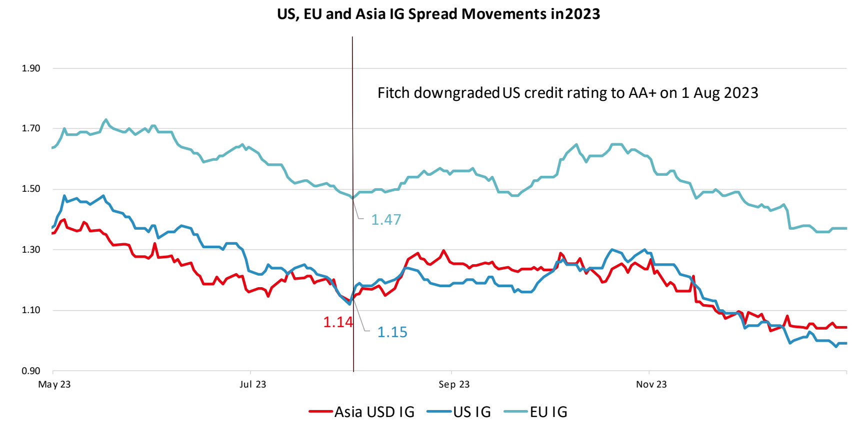
- There are three influences in our view from the US sovereign rating action on credit markets – fundamentals, funding and foreign exchange risk. We see direct fundamental impacts as contained – this would mostly be through exposure to country risks which in our view are limited. Per Moody's release, the US still "retains exceptional credit strengths such as the size, resilience and dynamism of its economy" and the US' sovereign rating is still at a relatively high level. Country risk in the context of corporate credit does not appear to be altered as opposed the US sovereign's fiscal position.

- In our view, influences on credit markets will be indirect, firstly through funding costs and the potential transmission of higher treasury yields (reflecting a lower credit profile) to corporate financing costs. This in turn however are also influenced by an issuer's own business and/or financing risk characteristics. Our house view remains for three 25bps Fed funds rate cuts this year, albeit with a shift in timing. As such, higher funding costs will continue to be influenced more by idiosyncratic credit drivers at the issuer level.

- We studied the prior two instances when the US sovereign rating was downgraded, firstly by S&P Global in 2011 and Fitch Ratings in 2023. While credit spreads did increase in 2011 following S&P Global's downgrade, this was likely more influenced by the unfolding European sovereign debt crisis affecting countries such as Greece and Ireland at the time. Another influence on credit spread movements was a fall in US Treasury yields, something that contradicts a hypothesis that the US sovereign rating downgrade had a direct negative impact on credit markets. In contrast, when Fitch announced a similar rating downgrade in 2023, which was a relatively benign operating environment, we observe limited immediate impacts to credit spreads in 2023.

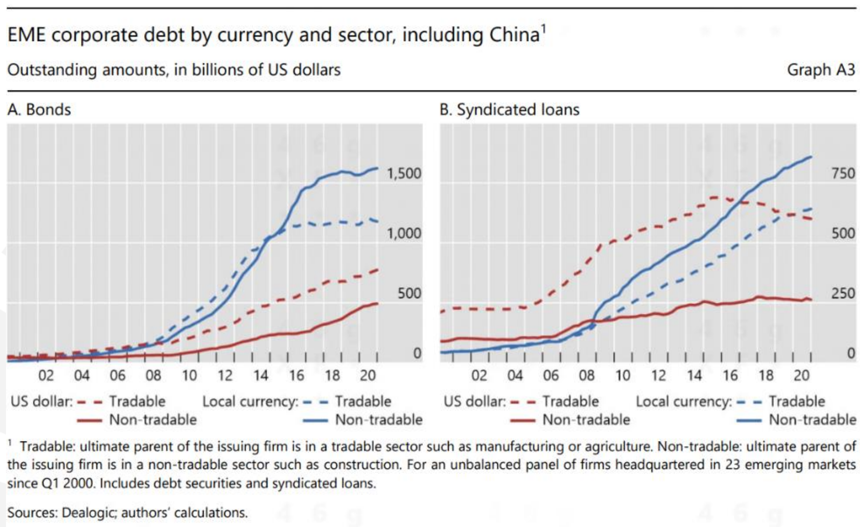


Source: Bloomberg, OCBC Research



Source: Bloomberg, OCBC Research

- We also see contained spillover impacts from the foreign exchange market to the credit markets. According to a Bank for International Settlements ("BIS") working paper dated July 2024 titled "New spare tires: local currency credit as a global shock absorber," emerging market economy ("EME") financial systems have grown noticeably in the last 20 years, leading to higher use of local currency debt. While the use of USD debt for EME non-financial corporates has also increased noticeably over the past 20 years, it has been mostly for corporates where USD is their functional currency. Per the working paper, the "increase in local currency debt was most pronounced in Asian EMEs." This expansion in local currency debt markets means EME corporates are largely less susceptible for foreign exchange risks, both directly but also indirectly with improved access to local currency credit that may be insulated from global financial market developments. The improved diversity of access to credit markets for EME corporates, and the ability to possibly move across currencies as global market conditions change highlights how the recent development of local currency credit markets provides somewhat of a cushion or shock absorber for global financial market volatility.



Source: BIS Working Papers No 1199, July 2024.

FX implications

- **FX markets are largely well-behaved in Asia** this morning, following Moody's downgrade late Fri NY hours. Safe haven proxies including JPY, CHF, gold and SGD firmed in varying degrees. DXY gapped down modestly (-0.3%) in the open but partially pared losses. On net, FX reaction was largely contained in reaction to Moody's downgrade.

- **Going back in history**, S&P was the first rating agency to downgrade the US credit rating on 5 Aug 2011 (8pm Eastern Daylight Time after NY market closed) from AAA to AA+, citing concerns about the government's budgetary and fiscal outlook. Back then, safe haven proxies including gold, JPY and CHF rose (the following session). Over a broader period, gold surged to $1,920 in early Sept 2011 while the rise in CHF and JPY prompted SNB and BoJ to intervene. SNB pegged EURCHF at a minimum of 1.20, calling CHF appreciation a threat to Swiss economy. USDJPY also fell to record low of 77, leading to BOJ intervention (sell JPY). DXY initially dipped post S&P downgrade in 2011 but subsequently rose, in absence of no quality alternative safe haven assets and issues in Euro-area.

FX Implications Post-S&P Downgrade in Aug 2011

	T + 1 day	T + 1month	T + 3months
DXY	Fell as much as –0.74% before reversing all losses to close 0.26% higher.	+0.7%	+3.2%
USDJPY	Fell as much as 1.1% before partially retracing losses to -0.8%.	-1.9%	-0.2%
USDCHF	Fell as much as 2.5% before partially retracing losses to -1.6%.	+2.6%	+15%
USDSGD	Fell as much as -0.6% before retracing losses to close +0.5% higher.	-0.8%	+4%
Gold	Gold strengthened throughout the session. +3.3%	+14%	+5.5%
EURUSD	Rose as much as 1% in the open but turned lower to close -0.72%.	-1.3%	-3.4%

Note: Time T was 5 Aug 2011 close when US rating was lowered by S&P.
Source: Bloomberg, OCBC Research

- **FX is often driven by a wide range of factors** and to set things in context, the period (Jul-Oct 2011) also saw a confluence of events, ranging from worries of Greek default to contagion fears in other Euro-area member countries such as Portugal, Italy, etc, including political uncertainty in Italy and US debt ceiling turmoil (where there was political gridlock over raising the debt ceiling). Over a broader period from late-2010 to 2012, not only was the Euro-area confronted with sovereign debt crisis but there were fears of Euro-area breakup, leading to concerns about the stability of EUR. Its share of global FX reserves also fell from over 28% (in 2009) to sub-20% in 2016. USD's rise back then was due to other factors.

Room for EUR % share of FX reserves To Pick Up from Decade Low?

Source: Bloomberg, OCBC Research

- This time however, those issues are less of a hurdle for the Euro-area and EUR may be in a better position than before to benefit from any USD fallout. Furthermore, over the weekend, ECB's Lagarde noted that *rise in EURUSD is counterintuitive, but justified by the uncertainty and loss of confidence in US policies among certain segments of the financial markets*. She also took the opportunity to emphasise *the importance of EUR's stability and called for leaders to accelerate the process of deepening the European Union*. She also added *at a time when we see the rule of law, the judicial system, and trade rules being called into question in the US, where uncertainty is permanent and renewed daily, Europe is rightly perceived as a stable economic and political area, with a sound currency and an independent central bank*.

- **Room for EUR to strengthen.** In our view, Lagarde's remarks may reflect a more assertive stance in attempting to position the EUR as a credible alternative reserve currency. By highlighting the euro's recent appreciation as 'counterintuitive but justified,' she implicitly acknowledges a shift in global capital preferences—driven not just by macroeconomic fundamentals, but also by waning confidence in US governance and policy predictability. Her emphasis on judicial integrity and rules-based order serves to reinforce the euro's strategic appeal in a world increasingly characterized by geopolitical fragmentation. To some extent, this may also signal a growing tolerance for euro strength — so long as it reflects underlying fundamentals. Room for further gains in EUR can have positive spillover effects for SGD, RMB.

- Nevertheless, **Moody's downgrade comes as a timely reminder that rising US debt and deficits should not go unnoticed**. A rise in budget deficit in the absence of fiscal discipline and heightened policy uncertainty (owing to Trump tariffs) further question USD's status as a safe haven and primary reserve currency. A continuation of diversification flows out of US assets, including the USD, as well as more proactive hedging (to reduce USD exposure) can weigh on USD over time. Elsewhere, while US bilateral trade talks with some partners was a good start, but Trump has also said that the US will send letters to some of its trading partners to unilaterally impose new tariff rates over the next 2-3 weeks. It was not immediately clear if the new tariffs would be in addition to what is already in place or, if these adjustments supersede previous tariff rates. Fresh threats or renewed uncertainty on tariff may further support the appeal of safe haven plays, at the expense of a softer USD.

Our US GDP forecast

- Moody's downgrade of US sovereign credit rating from Aaa to Aa1 marks the first time that the US has lost the top-tier rating from all three major rating agencies. Moody’s expect the federal deficits to widen to nearly 9% of GDP by 2035, from the 6.4% of GDP in 2024. With the rising US national debt (now in excess of US$36 trillion), and the inability of successive administrations to address and implement effective fiscal reforms to curb this trend, the question is whether higher borrowing costs going forward may constrain government spending and private investment. Rising entitlement spending and low revenue generation are key constraints. Given the upcoming mid-term elections, political gridlock may further hamper the current administration's ability to implement longer-term fiscal responses. Any political uncertainty could dampen business confidence and corporate investment decisions. On the inflation front, the clear and present danger is from tariffs, so while the immediate impact on inflation from the Moody's rating downgrade is limited, persistent fiscal deficits and higher interest payments could be a potential catalyst for investors to demand higher yields to compensate for perceived risks. If borrowing costs rise over time, then it could exacerbate inflationary expectations. At this juncture, we maintain our 2025 US GDP growth forecast of 1.3%, pending the outcome of the 90-day suspension of reciprocal tariffs, the 90-day truce on Chinese tariffs, and ongoing tariff negotiations.

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