Morgan Stanley

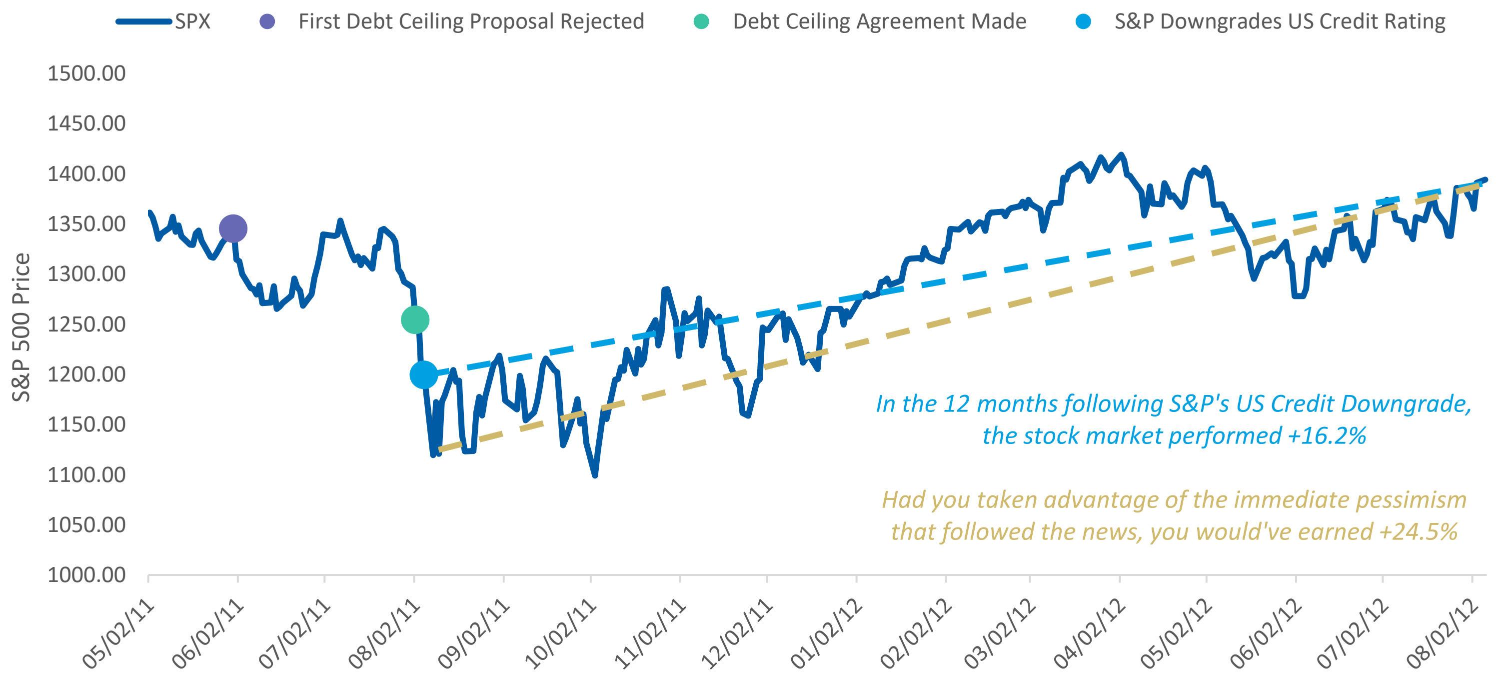
The Balog Group at Morgan Stanley

Charts of the Week – 08/07/2023

On 08/01, after the market closed, Fitch Ratings (one of the big three credit rating agencies) downgraded US Credit from AAA to AA+. This is only the second time in history one of the agencies have done this. For their reasoning they quoted fiscal deterioration due to tax cuts, increased spending, rising government debt, and repeated political standoffs over the debt limit. Furthermore, they anticipate the Fed rate hikes will cause tighter financial conditions on productivity.[1] While these are not invalid points, it came as a bit of a surprise and out of left-field for many investors as the debt ceiling debate was resolved over 2 months ago and the economy seems to be chugging along at a better-than-expected pace for economists (more on that in a future letter).[2] The last credit downgrade came only days after the 2011 debt ceiling crisis was resolved. What does a credit downgrade mean? Well, normally it would mean higher borrowing costs as lenders would see loans as a higher risk, however in 2011 yields actually went *DOWN* as people piled into treasuries. And what did this mean for the stock market? Well, there was a bout of volatility at first, dipping about 6-8% - however buying on the news would've garnered double digit returns for the following 12 months. In fact, the 12mo forward returns after the downgrade date was a solid +16%. And had you "bought the dip" the day after the news broke your return would've been an even better +24%. Now of course we must always disclose that past performance is never a guarantee of future results, and that history doesn't always repeat – but it can sometimes rhyme. See the following two charts for more details.

How Did the Stock Market Perform After the 2011 Credit Downgrade?

The market took an immediate hit of 6%+ following the news, and then proceeded to bounce around and bottomed 2 months later at -8.4%. After that the stock market recovered and performed admirably.



Source: ThomsonOne

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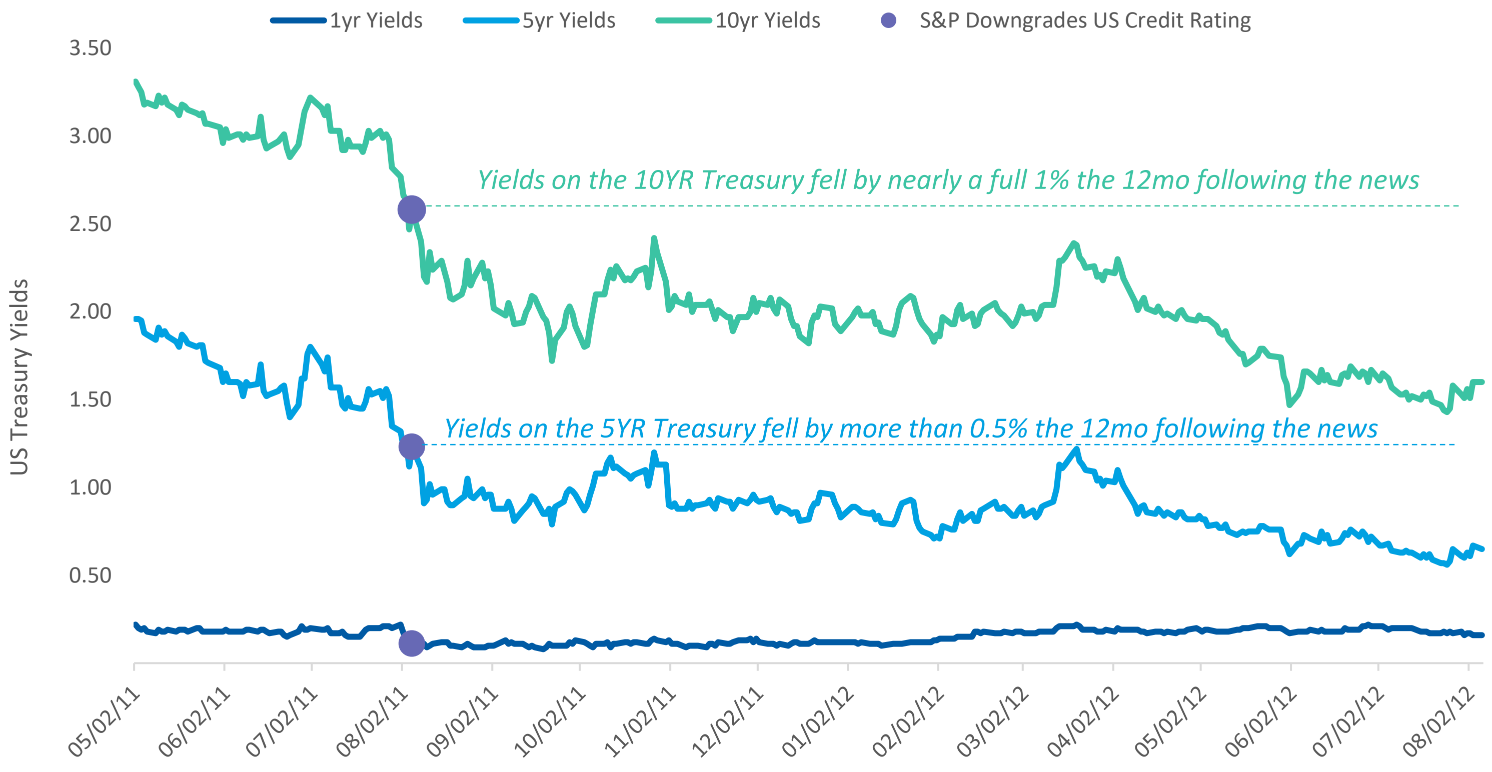
Charts of the Week – 08/07/2023 [continued]

How Did the Bond Yields React After the 2011 Credit Downgrade?

Despite the fact that credit downgrades typically increases borrowing rates, US treasuries had their rates decrease over the long-end of the curve, and remained unchanged on the short-end.



Source: ThomsonOne

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Sources:

1. Morgan Stanley
2. [Forbes – US Economy Grew Better-Than-Expected in Q2]
3. ThomsonOne

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