Market Insights

19 May 2025

Rapid Response

Moody's downgrades US sovereign debt rating

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Moody's cut the US rating one notch to Aa1 from Aaa, aligning it with the other major ratings agencies. This is the first downgrade since August 2023 when Fitch lowered its rating to AA+. Standard and Poor's was the first agency to cut the US below AAA, back in 2011. At Aa1, Moody's US rating is now on par with that of Finland and Austria, and below that of Australia, Canada, Germany and Switzerland, among others.

Moody's highlighted the debt and fiscal risks as the key rationale. In Moody's view, fiscal risks have risen considerably, with the United States now exhibiting much higher government debt and interest payment ratios than similarly rated sovereigns. In the absence of credible fiscal adjustment, Moody's believes that budget flexibility will remain limited, given the growing weight of mandatory spending, including interest expense. On this basis, Moody's projects the fiscal deficit to continue to widen, possibly reaching nearly 9% of GDP by 2035, up from 6.4% in 2024, driven mainly by increased interest payments on debt, rising entitlement spending and relatively low revenue generation. Meanwhile, the federal debt burden would rise to about 134% of GDP by 2035, compared to 98% in 2024.

Moody's rating action is likely to reinforce ongoing market focus on the US risk premium. To be clear, Moody's action has not told global investors anything that they did not already know. In addition, the downgrade is a late catch-up with its peers. The US risk premium has indeed risen over the past few months, reflecting the elevated trade-policy uncertainty and investor concern over the credibility of the policy framework. In the near term, it is possible that this new headline may further erode global investor appetite for US assets, albeit marginally. Since the beginning of the year, we have already observed a major rotation away from the US toward Europe and other markets, a theme that remains relevant for the remainder of 2025.

The rates and currency markets are potentially exposed to this new headline shock. In sharp contrast to the market response to S&P's surprising rating action in 2011, we do not anticipate that US Treasury yields will decline, reflecting a flight to quality. This is because that market has not been able to offer the same defensiveness as it used to in the face of a risk aversion shock. This was particularly evident in April when global market turbulence surfaced in the wake of the April 2 tariff announcement. With that in mind, we believe that the rating move may accentuate the upside risks to Treasury yields, although we do not believe that Moody's rating action will turn out to be a major market-moving event. On the currency side, the US dollar has already been under considerable downward pressure, and we anticipate that the downside risks will continue to predominate in the period ahead. Finally, should Treasury yields happen to settle at a higher level, this may represent a risk for equity market valuations, but we believe that we are still far away from the potential pain threshold.

A reminder to policymakers. Perhaps the greatest upshot of the ratings downgrade is that it comes at a critical juncture in the negotiations over the reconciliation bill working its way through the US Congress. Until now, lawmakers have been reluctant to cut spending too deeply, fearing political fallout. The ratings action may give them incentive to embrace additional fiscal discipline.