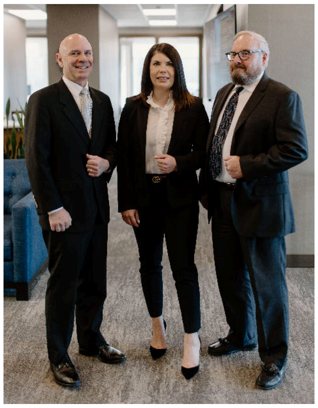

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Moody's Downgraded U.S. Debt: Does It Matter?

On Friday, May 16, 2025, Moody's Ratings downgraded its rating on U.S. government long-term debt from its highest rating of Aaa to the next highest rating of Aa1. The move was particularly significant because Moody's was the last of the Big Three credit rating agencies to maintain the triple-A rating for U.S. debt. S&P Global Ratings made a similar downgrade in 2011, and Fitch Ratings did so in 2023.[1]

The reason for the downgrade was the same for all three agencies — excessive, growing debt in relation to revenues. Moody's indicated that its recent action was driven by the long-term trend of "large annual fiscal deficits and growing interest costs" coupled with the lack of potential relief in sight. "We do not believe that material multi-year reductions in mandatory spending and deficits will result from current fiscal proposals under consideration." The agency pointed specifically to the current effort in Congress to extend provisions of the 2017 Tax Cuts and Jobs Act, which it estimated would add about $4 trillion to the federal primary deficit (excluding interest payments) over the next decade.[2]

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For perspective, the Congressional Budget Office projected in January 2025 that federal debt held by the public would grow from 100% of gross domestic product (GDP) in 2025 to 118% in 2035, the largest percentage in U.S. history. This projection assumed that the 2017 tax cuts would *not* be continued and would thus *increase* revenue, which does not appear likely.[3]

Still-stable securities

The Moody's announcement drove Treasury yields higher temporarily, because in theory bond investors demand higher interest rates in return for taking on more risk.[4] However, despite the downgrade, there is no expectation of default, because the federal government guarantees U.S. Treasury securities as to the timely payment of principal and interest. The U.S. dollar will likely remain the world's dominant reserve currency for the foreseeable future, meaning that nations, organizations, and individuals will continue to need and/or want to hold U.S. Treasury securities.[5]

As Moody's pointed out: "The U.S. economy is unique among the sovereigns [nations] we rate. It combines very large scale, high average incomes, strong growth potential and a track record of innovation that supports productivity and GDP growth. While GDP growth is likely to slow in the short term as the economy adjusts to higher tariffs, we do not expect that [U.S.] long-term growth will be significantly affected."[6]

Some experts believe that U.S. government debt is so unique that credit ratings are irrelevant, and an analysis of the rules for holding securities in certain types of funds or other financial situations suggests that this is true. Whereas a downgrade of another country's debt might prevent that country's bonds from being utilized in a fund or as collateral in a particular situation, U.S. government securities are generally considered a class of their own regardless of credit rating.[7]

Higher yields

Even so, some investors might be more cautious about buying U.S. securities, which could keep yields slightly higher than they might have been without the downgrade. Yields were already on the high side in response to other factors, including the elevated federal funds rate and economic uncertainty due to changing tariff policies. These factors, along with budget developments, will likely continue to be the primary drivers of Treasury yields.

Higher Treasury yields, for whatever reason, are good for investors who want stable income. But they can be bad for consumers, because rates on some consumer loans — notably 30-year fixed mortgages — are tied to Treasury yields.[8]

The U.S. government may be hardest hit, because it must use a larger percentage of revenues to pay interest. Due to higher rates as the Fed has battled inflation, federal interest payments have risen from about 9% of revenues in 2021 to 18% in 2024 and are projected to require as much as 30% of revenues by 2035.[9]

Good news and bad news

The good news is that the Federal Reserve can generate funds, essentially "printing money" electronically, to ensure the government can pay its debts. This is why Treasury securities are still considered the world's most stable investment. But the current path of ever-higher deficits is a slippery slope, and lawmakers face hard choices to steady the U.S. fiscal outlook.

There is always talk about cutting spending, and the Trump administration is making some efforts to do so. However, the impact of these cuts on the deficit and debt should be relatively small. About 60% of the U.S. budget in fiscal year 2025 is mandatory spending, including Social Security and Medicare. Only 26% is discretionary spending, including 12% for defense, which few want to cut. That leaves 14% for possible budget cuts, much of which pays for programs that many Americans value. The rest of federal spending pays interest on the national debt.[10]

Any substantive fiscal fix will have to include additional revenues, but raising taxes is always difficult politically, and a major economic boom that would bring in more revenue at current tax rates seems unlikely, based on current projections.[11] The new tariff program is intended in part to help raise revenues, but it is too early to know whether that will happen.

For now, the credit downgrade should have little or no effect on the U.S. economy and is unlikely to require changes to your investment strategy. Other factors will continue to drive the economy. As always, a wise investment strategy would be designed to weather economic changes and focus on personal goals, time frame, and risk tolerance.

The principal value of Treasury securities fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid. Projections are based on current conditions, subject to change, and may not come to pass.

1) *The Wall Street Journal,* May 16, 2025

2, 5–6, 9) Moody's Ratings, May 16, 2025

3, 10–11) Congressional Budget Office, January 2025

4, 8) CNBC, May 19, 2025

7) Bloomberg, May 19, 2025

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