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U.S. Municipal Bond Market

Rating Agencies' Questions About US Governance and Policy Gridlock

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Summary

- Talks about a fifth round of COVID-19 relief have stalled.
- Last week, Fitch Ratings lowered its outlook on the U.S. sovereign rating to "Negative" from "Stable."
- A weak U.S. reaction to the COVID-19 outbreak and ensuing political polarization could make the financial costs more expensive for the U.S. and its sub-sovereign entities.

Legislative Update – Likelihood of a Fifth Round of COVID-19 Relief Uncertain

Talks about a fifth round of COVID-19 relief have stalled. Small meetings were held at the end of last week and over the weekend, but common ground was not reached. The Senate has still not passed its Health, Economic Assistance, Liability Protection, and Schools (HEALS) Act, indicating the Republican party remains divided on what another round of aid should or could include. Democrats are unlikely to agree to a short-term extension of unemployment benefits not because they do not deem them important, but because they would rather include them in a larger combination of aid. It could be that this fifth phase is too heavy of a lift for Congress only about three months away from the 2020 presidential election. The House adjourned at the end of last week and the Senate is scheduled to remain in session only until this Friday, August 7, 2020.

Questions about United States' Governance and Policymaking

Gallup opinion poll data shows that in general confidence and trust in U.S. institutions have been dropping.[1] There is Gallup poll data that goes back decades showing some ups and downs, but for the most part confidence has been steadily falling over time.[2] This is an important backdrop as we analyze the U.S. and its sub-sovereigns' financial situations and rating agency opinions of them.

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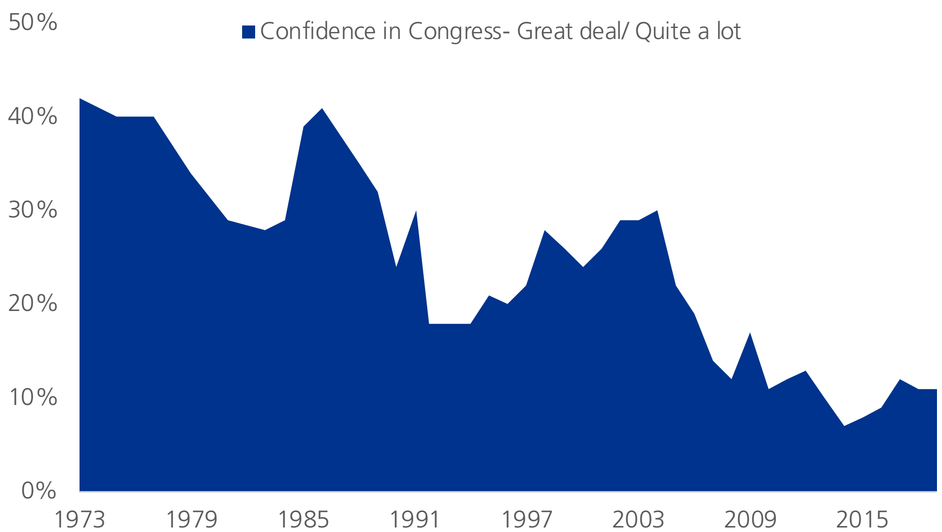
Individuals' Confidence in Congress Have Been Dropping



Source: Gallup and HilltopSecurities.

Please see disclosure starting on page 3.

Political Brinkmanship – A Potentially Unending Criticism

"The political brinkmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed,"[3] wrote S&P Global.

Some may be surprised to learn the previous passage is not referring to recent events, but is a quote when S&P Global chose to downgrade the U.S. sovereign rating to AA+ from AAA back in 2011. This downgrade followed the summer of the 2011 debt ceiling crisis and resulting Budget Control Act of 2011. This rating agency reaction goes to show that while time marches on, the driving financial and political pressures can remain the same.

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Fitch Ratings Lowered U.S. Outlook to "Negative" from "Stable," Last Week

That brings us to the important rating agency action taken last week when Fitch Ratings lowered its rating outlook on the U.S. sovereign rating to "Negative" from "Stable."

> "The Outlook has been revised to Negative to reflect the ongoing deterioration in the U.S. public finances and the absence of a credible fiscal consolidation plan… A continuation of policy gridlock is a risk. Political polarization may weaken institutions and reduces the scope for bipartisan cooperation, hindering attempts to address structural issues (including some highlighted by the pandemic and protests) but also longer-term fiscal challenges. The economic crisis has likely brought forward the point at which social security and healthcare trust funds are exhausted, demanding bipartisan legislative action to sustainably fund or reform these programs,"[4] wrote Fitch Ratings.

The financial impact of recent fiscal relief and "political polarization" are cited as key elements as to why the rating agency lowered its rating outlook. Fitch also wrote that it assumes a $1 trillion relief package is going to be agreed upon this week. This assumption could be a drawback almost no matter what outcome comes to pass.

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U.S. Sovereign Credit Ratings and Outlooks

Rating Agency	Credit Rating	Outlook	Relevant Date
Moody's	Aaa	Stable	June 30, 2020 - Periodic Review
S&P Global	AA+	Stable	June 10, 2013 - Outlook to "Stable" from "Negative"
Fitch	AAA	Negative	July 31, 2020 - Outlook to "Negative" from "Stable"

Source: Moody's, S&P Global, Fitch, and HilltopSecurities.

On the one hand, if an agreement close to $1 trillion is made by the end of the week or soon thereafter, Fitch could conclude that the country's debt-to-GDP ratio is no longer worthy of a AAA rating and a downgrade could follow. On the other hand, if a fifth phase agreement is not made, the rating agency may cite concerns or questions about the potential for future "policy gridlock." Under circumstances where no agreement is made, a downgrade could still follow. Keep in mind that similar concerns from political pressures were expressed by S&P Global almost 10 years ago when analysts cited "political brinkmanship" as a reason why they saw "America's governance and policymaking becoming less stable, less effective, and less predictable than what we [they] previously believed."[5]

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Expanded Political Polarization Pressures Now vs. Then

Reading between the lines, it could also be that there is more to the current circumstances than just the negative economic, financial, and U.S. sovereign rating impact from Congress' action or non-action. Fareed Zakaria wrote about another complicating government influence at the end of last week.[6] It can, or has been argued that America's COVID-19 policy reaction has been weak. This is a key theme in Zakaria's commentary. A weak U.S. reaction could very well make the price more financially expensive, not only at the sovereign level, but also the sub-sovereign level. The June 2020 reopening rollback may have been an initial example. How lawmakers in Washington, D.C. and states around the country react or progress from here on out will go a long way in determining if the financial costs rise sharply or just rise.

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[1] *Please see more in commentary from: Baer, Robert; Confidence and trust in institutions – critical in crises – dying. Now what?; PennLive, Patriot News; March 11, 2020.*
[2] *Confidence in Institutions; Gallup; Includes data through 2019.*
[3] *United States of America Long-Term Rating Lowered to 'AA+' On Political Risks and Rising Debt Burden; Outlook Negative; S&P Global; August 5, 2011.*
[4] *Fitch Revises United States' Outlook to Negative; Affirms at 'AAA'; Fitch Ratings; July 31, 2020.*
[5] *United States of America Long-Term Rating Lowered to 'AA+' On Political Risks and Rising Debt Burden; Outlook Negative; S&P Global; August 5, 2011.*
[6] *Zakaria, Fareed; Trump never mastered management. That's why his pandemic response has failed; Washington Post; July 30, 2020.*

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