U.S. Municipal Bond Market

Another Warning, Not a Shock: U.S. Downgraded by Moody's Ratings

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- Moody's downgraded the U.S. rating to Aa1 from Aaa, citing persistent deficits and a deteriorating fiscal outlook—echoing concerns previously raised during downgrades by S&P (2011) and Fitch (2023).
- The Moody's downgrade comes as no surprise—it serves as yet another warning to markets and policymakers. More importantly, it reinforces that fiscal strain is no longer a distant concern; it is unfolding in real time, with significant implications for investor sentiment and policy discussions.
- Top-rated municipal bonds could gain renewed appeal post-downgrade, as some state, local, and public entities maintain Aaa/AAA ratings—making them increasingly valuable to investors.
- The Moody's downgrade amplifies the unprecedented threat to the municipal bond tax-exemption, as rising deficits and fiscal pressures may push lawmakers to reconsider this important infrastructure financing tool in search of new revenue sources for 2025 tax policy or during future deficit reduction negotiations.

U.S. Downgraded Again Due to Fiscal Weakness

The skies over the U.S. credit landscape have darkened once again. Amid mounting deficits, political gridlock, and deepening fiscal weakness, Moody's Ratings downgraded the U.S. sovereign credit rating to Aa1 from Aaa late Friday afternoon—nearly 14 years after S&P took a similar step.

This most recent downgrade is not just about a single storm, but a convergence of major risks: rising debt, eroding governance, and a fiscal trajectory increasingly misaligned with long-term sustainability. For investors and policymakers alike, the message is clear—this is not a hypothetical warning. The early signs of fiscal strain are already materializing, and the downgrade confirms that the deterioration is no longer a distant threat, but a present and accelerating reality.

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Moody's stated that 'successive administrations and Congress' have failed to rein in deficits, with further fiscal deterioration expected. S&P raised similar concerns in 2011, citing long-term fiscal sustainability and highlighting the uncertainty surrounding the policymaking process, particularly during the debt ceiling standoff that year. More recently, in August 2023, Fitch downgraded the U.S. rating to AA+, also pointing to governance challenges and persistent fiscal weakness.

While the market reaction to Moody's downgrade may be negative, we expect it to be more muted and contained than the response seen in 2011. This move doesn't introduce new information; rather, it represents the latest step in a ratings process that began roughly 18 months ago. For investors, the downgrade serves more as a warning—or even a confirmation—than a surprise, with some fiscal concerns likely already priced into the market compared to 14 years ago. However, from a broader public and political perspective, the downgrade could reignite debate over U.S. fiscal policy and governance, potentially heightening political tensions in the near term.

Downgrade Timing Reinforces Procedure

Many have asked—and are likely still wondering—why Moody's chose to assign a downgrade now. The timing is neither suspicious nor political; it's a financial decision rooted in process. This downgrade reflects the next step in a ratings trajectory that began when Moody's assigned a "Negative" outlook to the U.S. sovereign rating in November 2023, about a year ahead of the 2024 elections. Moody's typically follows up on such outlook changes within 18 months, allowing analysts time to assess whether the issuer's credit profile has improved, deteriorated, or remained stable. In this case, the downgrade comes just over 18 months after the initial outlook shift, signaling both a procedural conclusion and a broader message to lawmakers about fiscal responsibility.

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The timing of Moody's downgrade is politically inconvenient, particularly as Republicans struggled last week to rally support for Speaker Johnson's and President Trump's "Big Beautiful Bill." However, the downgrade should not be viewed through a political lens—it is a financial message underscoring the uncomfortable reality of the U.S. deficit. Moody's action serves as a warning to investors and some lawmakers that fiscal imbalances have reached if not surpassed unsustainable levels.

If enacted in its current form, the 'Big Beautiful Bill' is projected to add approximately $3.3 trillion to the national deficit through 2034, according to the Committee for a Responsible Federal Budget—moving the country in precisely the opposite direction of what rating agencies and financial markets are calling for.

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Causes of U.S. Deficits

For those seeking to understand the roots of today's ballooning deficit, the Committee for a Responsible Federal Budget (CRFB) offers a clear diagnosis. In its report From Riches to Rags: Causes of Fiscal Deterioration Since 2001, the CRFB attributes the rise in deficits to three primary drivers:

- **37%** major tax cuts,
- **33%** net discretionary spending increases, major Medicare expansions, and
- **28%** Great Recession and the COVID-19 (mostly) response measures.

These figures paint an important and sobering picture—deficits didn't emerge from a single policy misstep, but from a series of deliberate choices over time and across administrations and crises. The result is a structural imbalance that now underpins the rationale behind Moody's and the other rating agencies' downgrades and potentially casts a long shadow over near-term and future fiscal policymaking.

Increased Value of Aaa/AAA/AAA Municipal Ratings

Despite the U.S. sovereign downgrade, many U.S. state and local government and public entity issuers can—and do—retain Aaa/AAA/AAA ratings or some combination. These top-tier ratings reflect very strong fiscal management, stable revenue streams, and prudent debt practices. In fact, in this post-downgrade environment, such high ratings can become even more valuable, signaling exceptional credit quality in a market where top ratings are increasingly scarce. For investors, Aaa/AAA/AAA-rated municipal bonds may now stand out even more as safe, high-quality options amid broader fiscal uncertainty.

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Reinforces the Unprecedented Threat to the Municipal Bond Tax-Exemption

The Moody's Ratings downgrade of the U.S. sovereign rating adds weight to the ever-growing fiscal narrative that could increase the already unprecedented threat to the municipal bond tax-exemption. As federal deficits swell and pressure mounts to find new sources of revenue, proposals to eliminate or limit the municipal bond tax-exemption could find renewed appeal in Washington as lawmakers search for pay-fors or reduce spending. The U.S. downgrade underscores the urgency of fiscal reform, making the cost of the tax-exemption a tempting target for lawmakers seeking offsets. The last five or so months have illustrated bipartisan support for this important infrastructure financing tool, however the downgrade may shift the political calculus, reinforcing the perception that no revenue stream is off-limits. For investors and issuers alike, this elevates the risk that a once-sacrosanct pillar of infrastructure and municipal finance could be restructured or repealed in the years ahead.

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