U.S. Municipal Bond Market

Fitch Ratings Questions U.S. Governance, Identifies a Breakdown in Political Norms

- Fitch Ratings, in a Tuesday report, warned that weakening governance and political risks in the U.S. could negatively impact their U.S. sovereign rating.
- The failure of former President Trump to concede the 2020 election and the spreading and pushing of the "Big Lie" threaten not only America's democracy, but its sovereign rating. The predictability the financial markets depends upon is also at risk.
- We review the example of when former Vice President Gore conceded the 2000 election. We also review when S&P downgraded the U.S. rating in 2011 because of political risks (and the debt burden.)

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Fitch Warns of Weak U.S. Governance, July 13, 2021

This week Fitch Ratings released a report where they reaffirmed the "AAA" rating and the "Negative" outlook they have on the U.S. sovereign. But Fitch also pointed out that "Governance" in the U.S. is weakening and that it could influence the direction of the rating. Fitch Rating specifically indicated:

> Governance is a weakness relative to the 'AAA' median, and the future direction of the rating is sensitive to the direction it takes. The failure of the former president to concede the election and the events surrounding the certification of the results of the presidential election in Congress in January, have no recent parallels in other very highly rated sovereigns. The redrafting of election laws in some states could weaken the political system, increasing divergence between votes cast and party representation. These developments underline an ongoing risk of lack of bipartisanship and difficulty in formulating policy and passing laws in Congress.

Fitch wrote Tuesday: The failure of the former president to concede the election and the events surrounding the certification of the results of the presidential election in Congress in January, have no recent parallels in other very highly rated sovereigns.

We interpret this warning from Fitch in this way: that Fitch is reinforcing the fact that American presidential candidates do not behave like this and this behavior is threatening the predictability of policy outcomes. The rating agency is also saying that this behavior does not occur in "other very highly rated sovereigns." It may happen in countries with less stable political systems, but not in highly rated places like the U.S. Therefore, if the landscape does not change, the credit rating of the U.S. sovereign could fall.

A real-life consequence of a potential U.S. rating downgrade is that the cost of servicing the U.S. debt burden could rise because of questions about credit, not just because of potential future monetary policy and the resultant movement of interest rates. As we write this lawmakers in D.C. are negotiating how to develop a smart, effective but fiscally responsible approach to infrastructure investment. Changes to the sovereign rating could also force adjustments to some municipal ratings that are notched off or directly or indirectly connected to the U.S. rating.

Threat to Political Process, Credit, Financial Markets

Fitch's warning highlights an important subject. The intersection of politics and finance has not only developed, but is likely to play an outsized role in political negotiations and outcomes in near-term elections. It is also directly threatening the near-term credit quality of the U.S. government and has the potential to impact the predictability financial markets require to operate effectively.

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The theme has to do with the fact that former President Donald Trump has not only failed to concede the 2020 election, but that he is also continuing to push the "Big Lie" as a leading political position and talking point. Some cable news programs have even "platformed" the "Big Lie."

This approach is having a political impact. Almost three out of four (74%) Republicans still believe in an effort to review the 2020 presidential election results. A little over one out of two (51%) Republicans expect the reviews to divulge facts that could reverse the results of the election, according to a recent Morning Consult/ Politico poll. And this is polling from June 11-13, 2021, not from November 2020. The fact that the former president has not conceded the 2020 election threatens, as the Economist has pointed out, one of the central fail-safe mechanisms or traditions formerly built-into American elections. That important fail-safe, or key first principal of American elections, again as the Economist points out, is that the loser concedes.

Former VP Gore Conceded in December 2000

A most important, and for a very short-time controversial, example of this occurred over twenty years ago when former Vice President Al Gore conceded the results of the 2000 election. A little over a month after Americans cast their ballots in a speech, Gore described how he was disappointed, but "partisan rancor must now be put aside." Gore also said:

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> "I accept the finality of the outcome, which will be ratified next Monday [Dec. 18] in the Electoral College," former VP Gore said. "And tonight, for the sake of our unity as a people and the strength of our democracy, I offer my concession."

S&P Downgraded U.S. Rating to AA+ on Political Risks, Aug 5, 2011

An important past example of rising political risk and how it can impact credit and the financial markets occurred about ten years ago, in the wake of the Great Recession. During the summer of 2011 lawmakers were discussing what previously had been a routine process of raising the U.S. debt ceiling. But during this particular summer a portion of the Republican party held the U.S. and the financial system hostage by threatening to not raise the U.S. debt limit. S&P lowered the U.S. sovereign rating to AA+ and wrote (in an Aug. 5, 2011 report):

> More broadly, the downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011.

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The Dow Jones Industrial average fell almost 2,000 points in a two-week period when it plummeted to 10,809 on Aug. 8, from 12,724 on July 21. The 10-Year U.S. Treasury yield plunged over 100 basis points to 2.10% on Aug 10th from a 3.18% on July 1st. This example illustrates the potential influence of national politics on sovereign credit and the stability of the financial markets.

Going Forward

We are still only in the beginning stages of the Biden administration and while rolling out COVID-19 vaccines and the unveiling of the $1.9 trillion Rescue Plan Act were political and financial wins, the toughest months could be just ahead as lawmakers prepare for the 2022 mid-terms. Tough not only in terms of an increased potential spread of COVID-19 among unvaccinated, but tough because of how national politics is intersecting with the financial world. Financial market participants are always looking for predictability, but the current approach of the former president is anything but predictable.

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