Asas Capital
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Weekly Newsletter

August 4th 2023

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Musings

"If you put the federal government in charge of the Sahara Desert, in 5 years there'd be a shortage of sand."

-Sir Milton Friedman

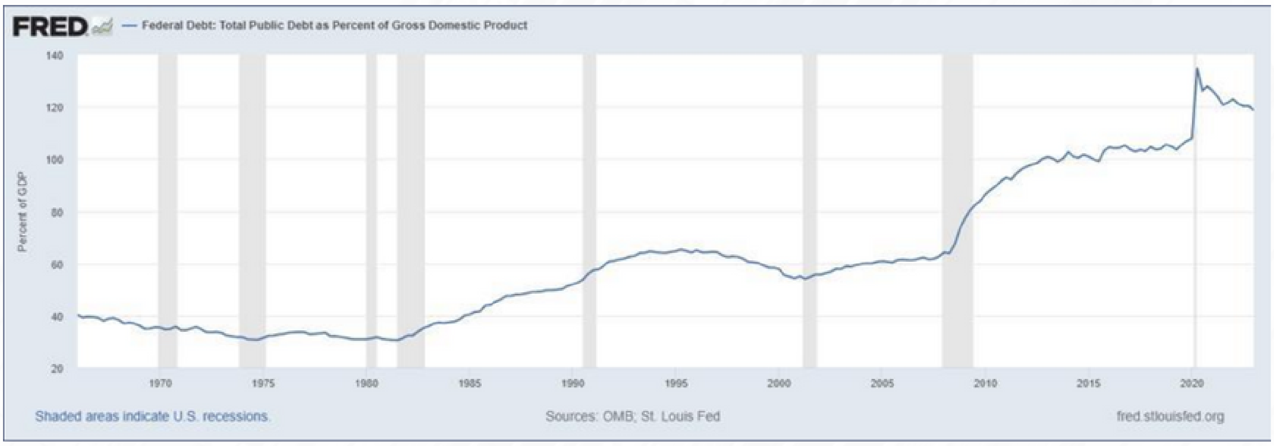
Last week in the markets

U.S. loses AAA credit rating for the second time.

On August 2nd Fitch Ratings issued an unexpected announcement that the United States' sovereign credit rating was being downgraded from its top-tier level of AAA to AA+. In its statement, Fitch Ratings rationalized the downgrade as follows:

"The rating downgrade of the United States reflects the **expected fiscal deterioration** over the next three years, a **high and growing general government debt burden**, and the **erosion of governance relative to 'AA' and 'AAA' rated peers over the last two decades** that has manifested in repeated debt limit standoffs and last-minute resolutions."

Dissecting that statement, we can see that Fitch has several reasons for downgrading the US.



- A high debt burden is expected to worsen. As the above chart shows, the ratio of Debt to Gross Domestic Product increased sharply following the last two major crises, the 2008 Financial Crisis and the 2020 COVID Pandemic.

- The cost of servicing that debt has risen due to the Fed's aggressive rate hikes. The cost of servicing the US debt has increased by 25% in the last 9 months, through June. Over the next 30 years, the interest costs will total nearly $70 trillion.

- The political brinksmanship we saw in the spring during the debt limit standoff.

In other words, precisely the sort of thing we have been talking about for the past several months.

This represents only the second time in U.S. history that a ratings agency has downgraded the country's debt, the first time being when Standard & Poor's lowered its rating in response to the government's handling of the 2011 debt-ceiling crisis.

Losing the AAA rating further removes the U.S. from a small group of countries that still maintain the top-notch rating from all three major agencies. The group of nine is Australia, Denmark, Germany, Luxembourg, Netherlands, Norway, Singapore, Sweden, and Switzerland.

Most U.S financial markets finished the week lower.

The major market indices finished down this week. The Dow Jones Industrial Average lost 1.11%. The S&P 500 Stock Index fell 2.27%, while the Nasdaq Composite fell 2.85%.

The 10-year Treasury bond yield rose 8 basis points to 4.038%.

What happens now?

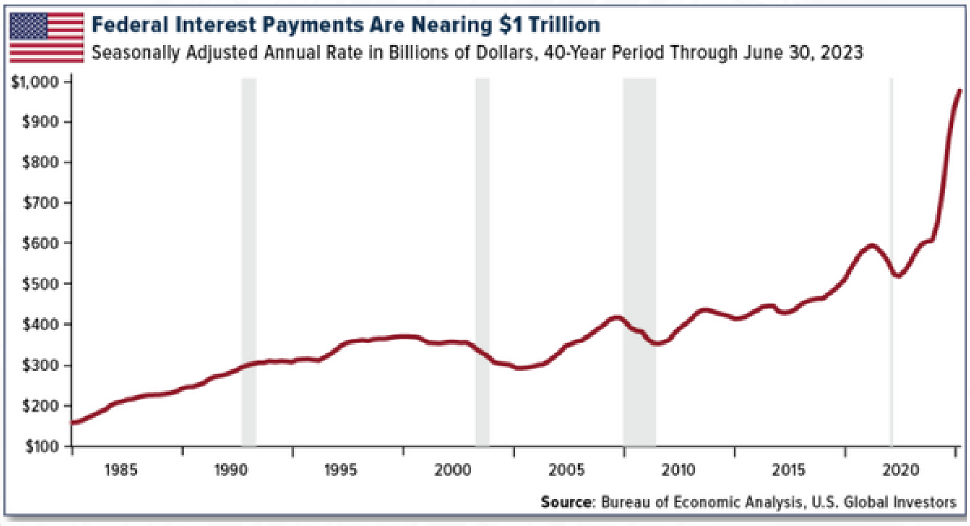
The first time a sovereign credit downgrade happened in 2011, the U.S. took it pretty badly.

The markets slumped (although they eventually recovered) and President Obama addressed the downgrade in a news conference, with then Treasury Secretary Tim Geithner angrily denouncing the S&P decision as flawed.

On August 5th, 2011, the first trading day after the announcement, the S7P 500 fell by almost 7%.

The VIX jumped to as high as 48.3 from 22.5 at the beginning of the month.

This time around, the reaction has been somewhat more muted so far.



The downgrade has had an impact on Treasuries and stocks, in particular complicating investor sentiment about Treasury debt. Yields pushed higher post-decision, with the 30-year yield exceeding 4.3% on Thursday for the first time since November. These changes have left Treasuries on the verge of wiping out their gains for the year, frustrating those who may have expected a rally following the potential end of the Federal Reserve's tightening cycle. A credit rating downgrade can lead to a number of consequences, perhaps the most obvious being an increase in the country's borrowing costs due to a perceived greater risk of default. As a result, the U.S. government may end up having to pay more interest on its new debt issues, further deepening its debt burden.

Currently, the government pays nearly $1 trillion in interest alone, or roughly a full third of what it collects in taxes. Meanwhile, the Treasury Department just announced it expects to issue over $1 trillion in new debt in the third quarter.

The downgrade could also lead to currency devaluation if foreign investors opt to sell off their holdings, thereby increasing the supply of the currency in foreign exchange markets.

We may also see short-term volatility in stock markets

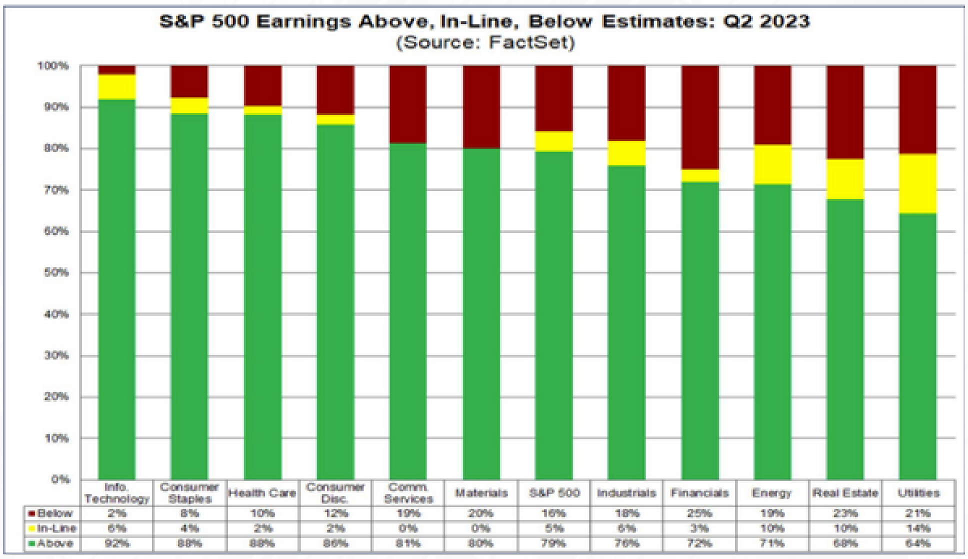
Over the medium-term, we expect that economic factors will determine the direction of markets more significantly than the credit downgrade.

Equity risk premium is at a two-decade low

With yields heading higher, the equity-risk premium, a measure of the extra reward investors get for holding stocks over bonds, has also dropped to its lowest in two decades. According to the Wall Street Journal, the spread between the earnings yield of the S&P 500 and the 10-year Treasury yield has shrunk to approximately 1 percentage point, the narrowest reading since 2002.

Earning Update

S&P 500 companies exceeded expectations in Q2 earnings, with a 79% beat rate. While earnings' performance improved, revenue growth was weaker, with 64% exceeding estimates, the lowest since Q1 2020. Tech giants like Meta, Amazon, and Alphabet cut jobs for margin enhancement while sustaining revenue.



	Info. Technology	Consumer Staples	Health Care	Consumer Disc.	Comm. Services	Materials	S&P 500	Industrials	Financials	Energy	Real Estate	Utilities
Below	2%	8%	10%	12%	19%	20%	16%	18%	25%	19%	23%	21%
In-Line	6%	4%	2%	2%	0%	0%	5%	6%	3%	10%	10%	14%
Above	92%	88%	88%	86%	81%	80%	79%	76%	72%	71%	68%	64%

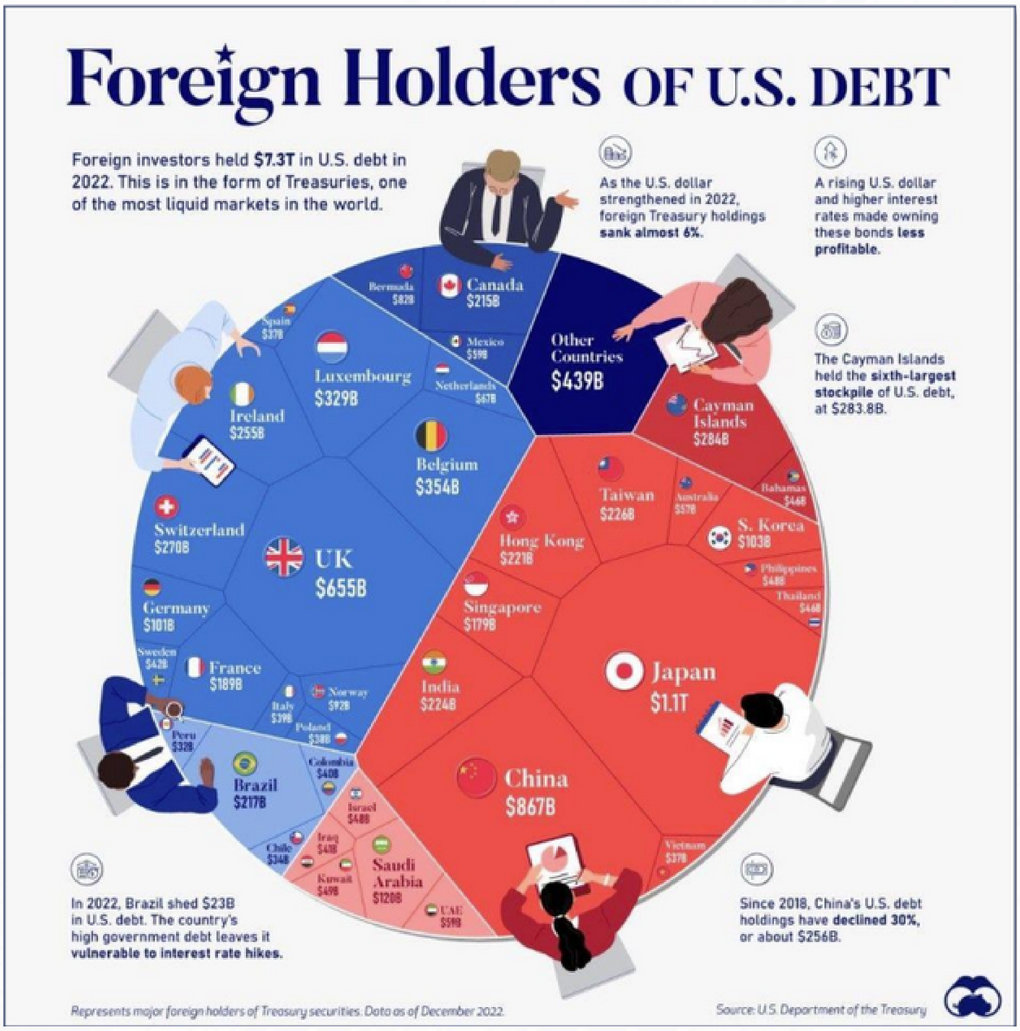
Amazon's stock surged 8% due to e-commerce and cloud success, in contrast to Apple's 4.8% drop from iPhone sales.

Positive Q2 trends benefited major tech firms, including Alphabet and Meta, from a better digital ad market and cloud demand. Amazon's robust earnings boosted peers like Microsoft and Alphabet, driven by retail and AWS synergy. Apple's services offset falling iPhone sales.

Though Q2 earnings mostly beat estimates, a projected 4.2% YoY decline looms. Excluding energy, S&P 500 earnings grew by 2.0%, marking the first growth in four quarters. Second-quarter revenue rose 0.2%, or 4.0% excluding energy companies.

Chart of the week

Foreign ownership of U.S. debt has risen notably in the past 50 years. In 1970, it was 5% ($14.0 billion) of DHBP, but by December 2022, it grew to 30% ($7.3 trillion), with foreign governments owning 54% and private investors 46%. **China's holdings decreased, but Japan increased U.S. Treasury securities. Additionally, the UK, Switzerland, and Ireland also raised their U.S. debt holdings.**



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