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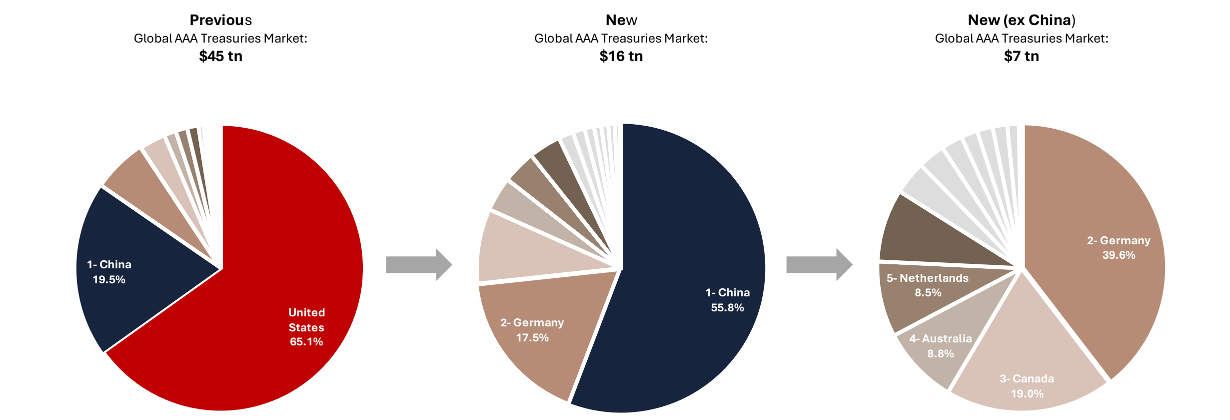
"AFTER THE 'AAA', IT'S THE 'BBB' THAT'S CAUSING CONCERN"

- The downgrading of the US 'AAA' rating was expected
- ... even if the long-term consequences are probably underestimated
- From now on, investors will be focusing on the *Big Beautiful Bill*, the 'BBB'
- ... because if the draft budget passes in its entirety, it will cause turmoil

CHART OF THE WEEK: "Risk-free assets are becoming increasingly rare"



Source: Bloomberg, Altitude IS

FINANCIAL MARKETS ANALYSIS

Moody's has finally stripped the United States of its latest 'triple A' rating. By lowering the sovereign rating by one notch, the agency has followed in the footsteps of Fitch, which had already made this adjustment in 2023, and Standard & Poor's in 2011. For investors, the 'AAA' label means that there is virtually no risk of default. Losing it means admitting that in the event of a shock, the country's resilience is no longer considered absolute. Moody's points out that the 36,100 billion dollars of US public debt (122% of GDP, see Fig. 2), and the associated interest charges (see Fig. 3), are rising faster than in comparable countries. This key factor is compounded by the chronic inability of the US Congress to agree on a balanced budget path. Treasury Secretary, Scott Bessent, sought to relativise the significance of the warning shot, describing the rating agency's decision as 'a lagging indicator'. This argument is reminiscent of the controversies of August 2011, when Standard & Poor's dared to make its first ever downgrade.

Fig. 2 - World public debt

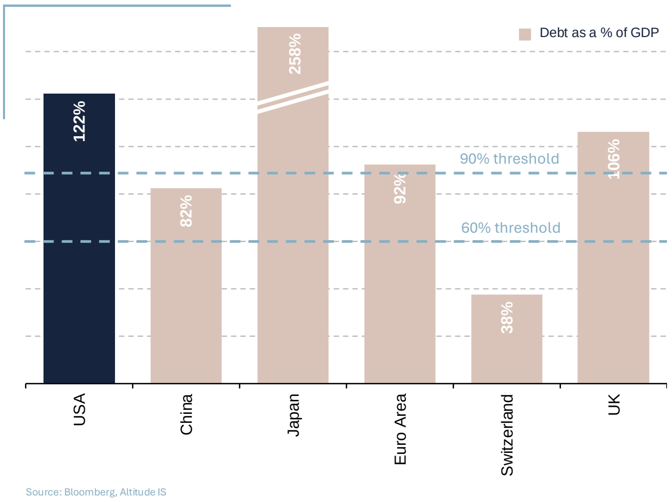
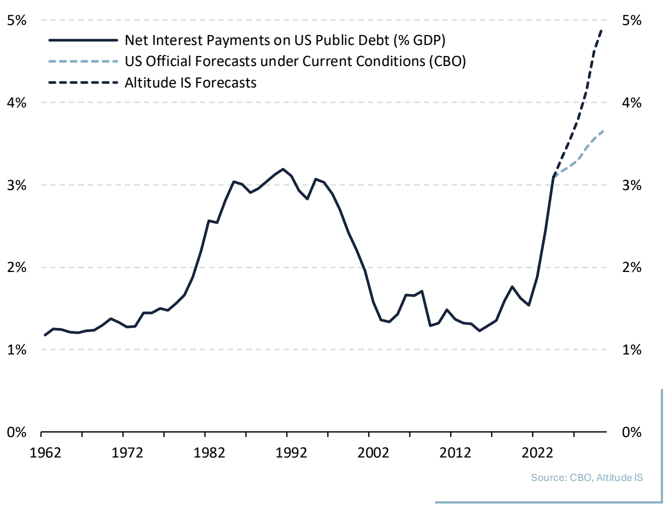


Fig. 3 - Interest charges on US public debt



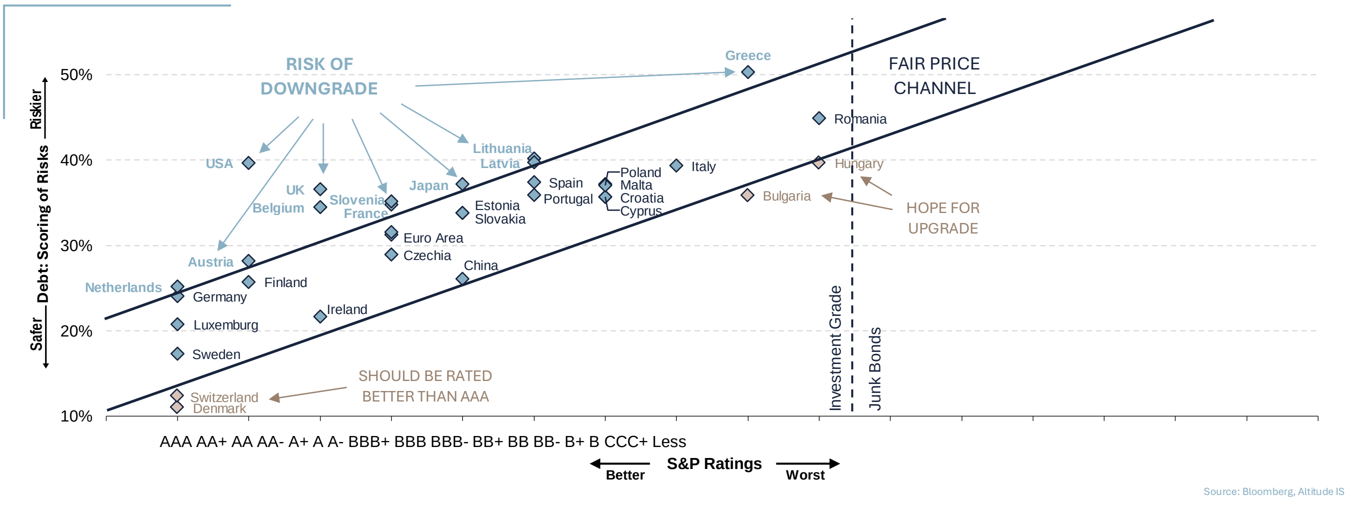
Investors were not at all surprised by this third downgrade of the US credit rating. However, they should not underestimate it, as it will automatically mean billions of dollars in additional annual interest payments for the Treasury. This will feed the vicious circle of public finances... **the famous 'grey rhino' to which we have regularly referred** (see WIF of 30/01/2023, 27/03/23, 16/10/23). Unlike the black swan, popularised by Nassim Taleb, which refers to an extreme event with a very high cost but very low probability, the grey rhino, mentioned by Michele Wucker, also refers to a high-impact threat, although this is one that is highly predictable but neglected. The grey rhino is not a surprise. It is charging at investors after a series of warnings whose consequences have been too mild to worry them. On the contrary, they have ended up reassured that they are capable of dealing with the danger to which they are exposed.

For several years now, we have been developing a proprietary method for evaluating public debt. The approach is simple and mathematical, based on a scoring of economic and financial ratios: primary balance, interest charges, average coupon, dispersion of maturities, national savings rate, foreign ownership, central bank intervention, cost of insurance against default, and so on. In all, 13 criteria are compiled. This scoring does not represent a probability of default, but seeks to fulfil two functions:

- The first objective is to rank the risk of the main public debts. The higher the score, the greater the risk.
- The second objective is to compare the results of this scoring with the ratings assigned by the main rating agencies (see Fig. 4) and the yields demanded by bond investors.

Some sovereign debts appear to be 'high risk' or, on the contrary, 'cheap'. Among the countries whose ratings could be downgraded and whose interest rates could rise are several European countries, but they are not necessarily the ones you might expect. Greece is one of them, but it is joined by the United-Kingdom, France, Belgium and the unsuspected Netherlands. This basket of debts to watch also includes the world's two largest bond markets, the United States and Japan.

Fig. 4 - Comparison between credit rating and bond risk scoring



Of course, Uncle Sam has incomparable advantages: the world's largest economy, a significant technological lead, high productivity, a hegemonic currency for commercial transactions, a powerful military force and, as a result of all this, a massive influx of international capital into its sovereign debt. As proof of this, US Treasury bonds are regarded by investors the world over as the 'risk-free asset'. They are buying them on a massive scale, notably via Money Market Funds whose volumes have just reached 7,000 billion dollars, favouring low interest rates.

Fig. 5 - List of countries with at least 'AAA' from the rating agencies

Countries with "at least one AAA"	Treasuries (bns USD)	Percentage	New	Percentage ex China	New	S&P	Fitch	Moody's	Dagong
TOTAL (bn USD)	45 162		15 740		6 955				
United States	29 422	65.1%		80.9%		AA+	AA+	Aa1	A
1- China	8 784	19.5%	55.8%			A+	A	A1	AAA
2- Germany	2 752	6.1%	17.5%	7.6%	39.6%	AAA	AAA	Aaa	AA+
3- Canada	1 318	2.9%	8.4%	3.6%	19.0%	AAA	AA+	Aaa	AA+
4- Australia	609	1.3%	3.9%	1.7%	8.8%	AAA	AAA	Aaa	AA+
5- Netherlands	590	1.3%	3.7%	1.6%	8.5%	AAA	AAA	Aaa	AA+
6- Singapore	570	1.3%	3.6%	1.6%	8.2%	AAA	AAA	Aaa	AAA
7- Hong-Kong	261	0.6%	1.7%	0.7%	3.7%	AA+	AA-	Aa3	AAA
8- Finland	212	0.5%	1.3%	0.6%	3.1%	AA+	AA+	Aa1	AAA
9- Sweden	168	0.4%	1.1%	0.5%	2.4%	AAA	AAA	Aaa	AA+
10- New Zealand	128	0.3%	0.8%	0.4%	1.8%	AAA	AA+	Aaa	AA+
11- Norway	122	0.3%	0.8%	0.3%	1.8%	AAA	AAA	Aaa	AAA
12- Switzerland	114	0.3%	0.7%	0.3%	1.6%	AAA	AAA	Aaa	AAA
13- Denmark	90	0.2%	0.6%	0.2%	1.3%	AAA	AAA	Aaa	AAA
14- Luxembourg	20	0.0%	0.1%	0.1%	0.3%	AAA	AAA	Aaa	AAA
15- Liechtenstein	0	0.0%	0.0%	0.0%	0.0%	AAA		Aaa	

Source: Bloomberg, Altitude IS

Nevertheless, in recent years, the United States has begun to experience difficulties in allocating its public borrowing as it should. The breakdown of US debt is worse than that of Japan: 40% of bonds have maturities of less than 18 months (see WIF 23/03/2025). The situation is not yet critical, but it is becoming worrying.

Whatever the angle of analysis, **the 'AA+' rating** proposed by the three major US agencies **does not seem justified and is likely to be downgraded further.** In this respect, it is interesting to note that the Chinese agency Dagong, which is undoubtedly more impartial than the American Big Three, only gives the United States a meagre 'single A' (see Fig. 5). This also corresponds to the rating awarded by our proprietary evaluation method.

In the near future, two issues will keep Treasuries holders on their toes: the raising of the debt ceiling and the tax cuts promised by Donald Trump.

- **The public debt limit, set at $36,100 billion,** resurfaced last January (see Fig. 6). Since then, the Ministry of Finance has not authorised any new spending and has resorted to extraordinary measures to pay its bills. In a letter to Congress dated 9 May, Treasury Secretary, Scott Bessent, warned that this extraordinary capacity would be exhausted by August. The debt ceiling therefore needs to be raised or suspended before the parliamentary recess in July. All that is needed is a bill passed by both houses and then signed by the President. At present, each party is using the ceiling as leverage to extract budgetary or political concessions. There are still a few months to bring the negotiations to a successful conclusion and avoid the risk of a technical default becoming a reality.
- Despite internal dissension and Democratic opposition, **the Republican majority is attempting to pass the *Big Beautiful Bill* (BBB).** Last Wednesday, after more than 22 hours of debate, the House Rules Committee approved the budget bill by 8 votes to 4. There are still two procedural votes to be passed before it goes to the Senate, where a prolonged review has already been announced. The 'BBB' intends to make the 2017 tax cuts permanent, cap taxes on new industrial investment at 15%, fund a tougher immigration policy and drastically cut social spending such as Medicaid. This budget proposal is so unbalanced that it will increase the public deficit by an additional 2,500 to 3,800 billion dollars over the next ten years. In 2026 and 2027, it should increase the public deficit by 1.3% and 1.8% of GDP respectively, keeping it above 6%.

Fig. 6 - Total outstanding US public debt

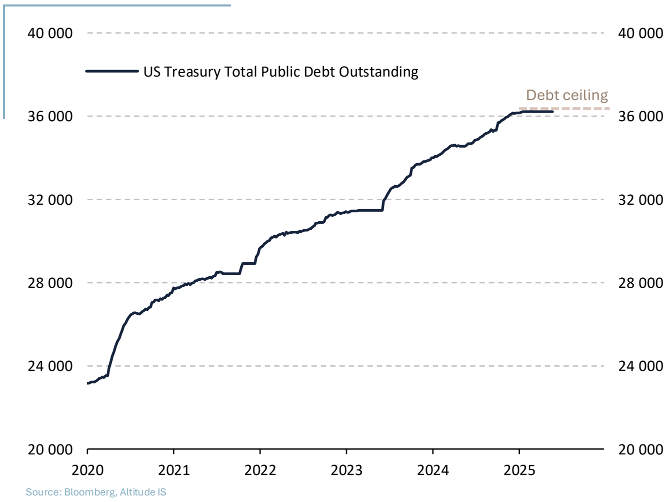
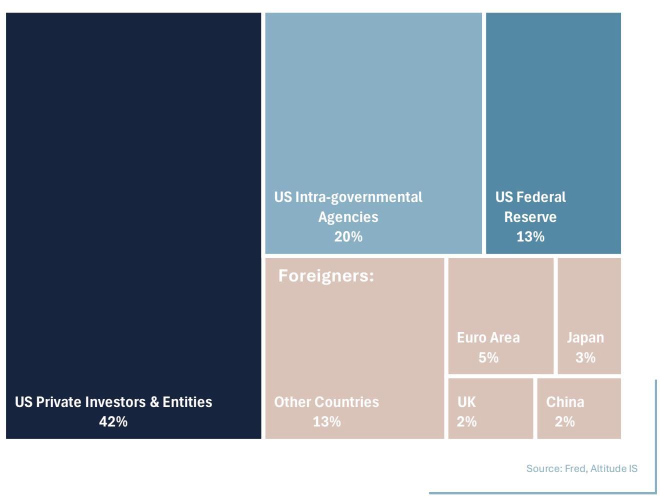


Fig. 7 - US sovereign bond holdings



Investors see the consequences very clearly. A swift agreement on the debt ceiling is needed if Treasury auctions are to run smoothly this summer. Similarly, passage of the *Big Beautiful Bill* must be minimal, so as not to increase the deficit too much, and hence the supply of Treasuries. **If one or other of these two issues were not resolved, there would be a risk of a sustained rise in long-term interest rates,** reinforcing doubts about the sustainability of the debt and **triggering a turmoil on the markets.** In recent weeks, whenever debt expectations have been unfavourable, interest rates have risen and stock markets have fallen.

The question of who holds Treasuries is also interesting. **Contrary to popular belief, US sovereign debt is not overwhelmingly held by foreigners, and even less so by the Chinese.** In fact, 75% of the $36,100 billion of outstanding debt is held by Americans themselves: banks, insurance companies, pension funds, investment funds and also the central bank (see Fig. 7). Among foreign holders, the Eurozone countries are in the lead, followed by Japan and the UK, then China. The rest is split between oil producers, emerging countries and a few offshore centres. Concerns about future mistrust among foreign investors therefore seem exaggerated. Admittedly, the United States has every interest in retaining its ability to attract capital, but it is not dependent on it. The main caveat to this analysis is that some US-domiciled investment vehicles can be used by foreign investors. This is the case, for example, with some of the billions of dollars managed by the Money Market Funds offered by Fidelity, JPMorgan, Vanguard, Charles Schwab and BlackRock.

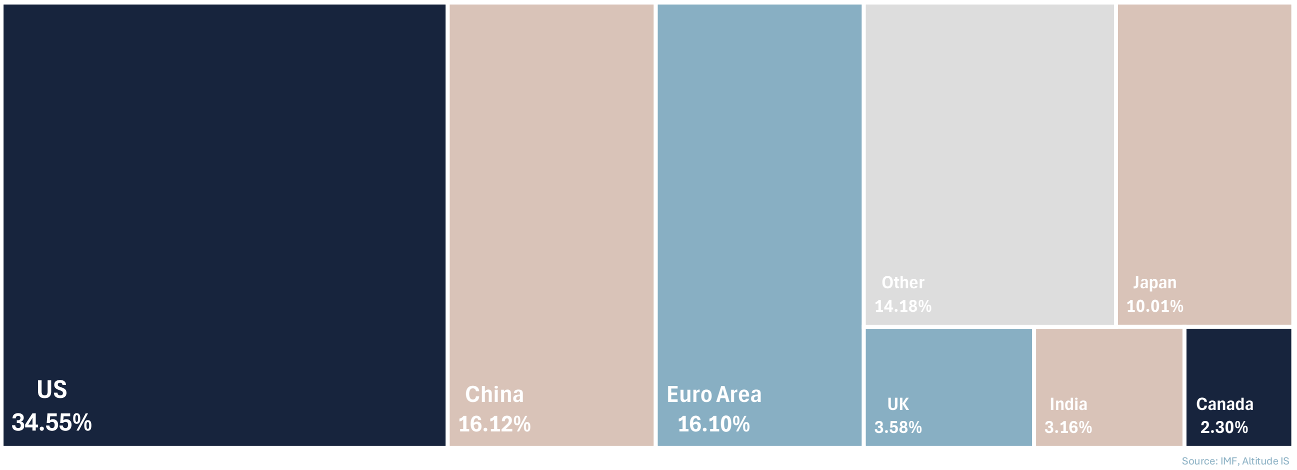
Will financial companies have to sell their US bonds? The many and varied prudential rules implemented over the last few decades have forced banks, insurers, pension funds and other financial institutions to hold 'AAA' sovereign bonds. Banks, for example, are seeking to improve their liquidity ratio (LCR) with 'tier 1 assets', weighted 0% according to the Basel III standard. European insurers, meanwhile, are optimising their solvency ratio (SCR) by preferring these securities, which have a virtually zero capital charge under Solvency II. Pension funds and money market funds, governed by IORP II or the MMF regulation, reserve a pocket of top-quality government bonds to reduce volatility and meet daily redemption requirements. Finally, central banks use these bonds as their main collateral, a guarantee of liquidity and security. **Fortunately, the downgrading of the United States should trigger very few forced sales.** In most prudential frameworks, the regulatory bar is set not at 'AAA' but at 'AA-', so Treasuries will retain their status as very high-quality assets. Banks, insurers and pension funds will therefore not have to adjust their portfolios. Instead, sales will come from so-called 'AAA-only' mandates. These money market funds will have to move a fraction of their assets to the small club that still holds the highest rating.

In the future, if Uncle Sam encounters major difficulties in selling its Treasuries, it will still have two tools, unconventional but very powerful, to avoid the spectre of default:

- **Financial repression.** Inspired by the terminology used by Shaw and McKinnon in 1973, and more recently popularised by Reinhart & Sbrancia, this consists of channelling national savings into public debt. This keeps bond yields artificially low. In this way, the government does not have to pay excessive interest charges. For example, the US administration could choose to exempt households holding US bonds from tax. It could also propose, following the example of Stephen Miran, the President's main economic adviser, to include a 'treasury floor' of 15% to 20% in the prudential ratios of banks, life insurers and pension funds.
- **Debt monetisation.** This involves the central bank financing part of a government's budget. By creating more money (QE), the Fed could buy a substantial proportion of government debt. In this way, it can prevent interest rates from rising. In most cases, this policy leads to a depreciation of the currency and, ultimately, to a period of high inflation. Debt monetisation, which is normally prohibited by law, may be unavoidable in a system of fiscal dominance. Fiscal dominance occurs when monetary policy is subordinated to fiscal policy in order to avoid default or even a systemic crisis.

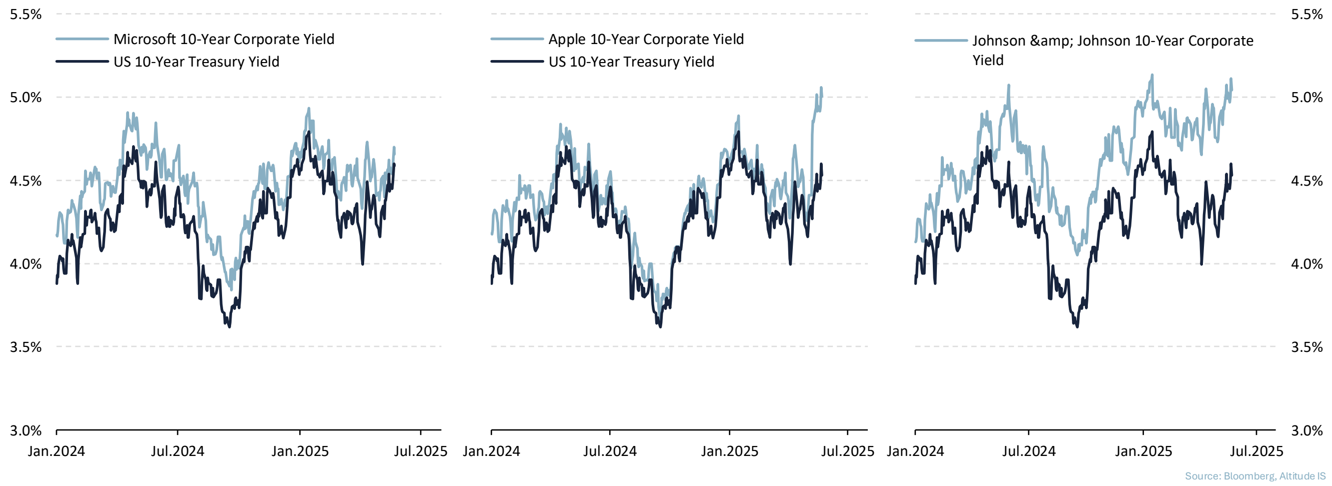
<u>These two strategies differ in their channels, but converge towards a single objective: to remunerate bondholders at an interest rate that is lower than it should be</u>. For them to be activated, the stress on the bond market would have to become severe. This is unlikely to be the case as long as yields remain below 6%. Beyond this psychological level, and given the importance of the US bond market in the world (see Fig. 8), all solutions will be considered to avoid a default.

Fig. 8 - Breakdown of global sovereign debt



It is unlikely that US Treasuries will lose their safe-haven status, or even their designation as a 'risk-free' asset. However, investors could end up questioning US exceptionalism and **looking for a few alternatives.** Diversification is always powerful in portfolios, including for risk-free assets. Until now, only 16 countries had the top 'triple A' rating, awarded by the three major agencies Standard & Poor's, Moody's and Fitch, as well as by the Chinese agency Dagong. This represented around $45,000 billion in bonds (see Chart of the Week). Without the United States, this amount has been reduced by 65%, to USD 16,000 billion, more than half of which are Chinese bonds. As some investors cannot consider Chinese bonds to be a 'risk-free' asset, only USD 7,000 billion of safe-haven bonds remain. **Among the countries still rated 'AAA', only four are large enough for their bond markets to become viable alternatives to US Treasuries: the two European countries, Germany and the Netherlands, and the two English-speaking countries, Canada and Australia.**

Fig. 9, 10 & 11 - 10-year yield on AAA corporate debt



It is sometimes forgotten, but there are also a few 'AAA' ratings outside sovereign debt, **in the corporate bond universe.** These companies, all American, can be counted on the fingers of one hand: Microsoft, Apple, Johnson & Johnson. In the future, this winning trio will certainly serve as alternatives to US Treasuries. If economic theory holds, then their bonds should offer lower yields than those offered by the US government. However, this is not yet the case, as they are retaining a premium: spreads remain positive (see Figs. 9, 10 & 11). In Europe, no company has the highest rating. The last to lose it were Nestlé in 2007 and Shell in 2004. The only one to come close is L'Oréal, with an 'Aa1'.

The end of America's 'AAA' rating marks a historic turning point. Although it comes as no surprise to investors, it will ultimately have a decisive impact on the main asset classes:

- The Treasuries bond market quickly became tense. The 10-year yield rose to 4.56%, while the 30-year maturity broke through the psychological 5% barrier, a peak not seen since the end of 2023. This bear steepening reflects the additional risk premium demanded by investors to finance Washington over the long term. These tensions are likely to persist, against the backdrop of the key question: how far will the market demand that Treasuries be 'depreciated' before it deems the risk premium to be sufficient? The central scenario is that **yields will stabilise and then fall,** in line with the coming economic slowdown and the ensuing easing of monetary policy. Yield **curve steepening strategies** will continue to deliver returns and decorrelation.
- The equity market has been contaminated. In the United States, the S&P 500 has fallen slightly since Moody's announcement. Growth stocks, starting with IT sector, which are highly sensitive to rising interest rates, contracted further. Investors, already burned by the trade war between the US and China, are turning to non-US equities and the value style. The central scenario is that of a **second leg down, fuelling the bear market that began on 19 February. Europe and the emerging countries could continue to hold up much better, as could defensive stocks.**
- Among commodities, all those perceived as cyclical tended to stagnate. In contrast, gold took advantage of this new defensive inflow to break through the USD 3,340 an ounce level. The central scenario is that **this dichotomy of trends could persist.**
- On the foreign exchange market, the dollar fell by around 1.6% against its main counterparts, while the euro easily exceeded $1.13. The central scenario remains that of a **depreciation of the greenback against all currencies, with the exception of the yen.**
- Last but not least, the property market could pay a heavy price. The surge in the 30-year rate, now 60 basis points above its average of last year, changes the picture radically. This rate is used as a benchmark to define both fixed-rate residential mortgages and the rental discount rate. With banks and brokers applying an average margin of 200 basis points above the 30-year rate, the average fixed rate for mortgages has risen above 7%. Under these conditions, very few households will have the financial capacity to invest in a new mortgage, even to move to take up a new job in a new state. Most will give up. The central scenario is the formation of **a new wave of falling house prices.**

Conclusion:

The 'risk-free' asset is no longer really without risk. Investors will be looking for other ways to ensure sustainable returns. As for the Americans' ability to honour their debt, this will soon be put to the test. Not only will the debt ceiling have to be raised, but the full version of the *Big Beautiful Bill* will have to not see the light of day. Otherwise, prepare for turmoil.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2025 Year-to-Date (%)	2024 (%)	2023 (%)
Equities							
World (MSCI)	868.2	61.69	-1.4%	7.7%	4.1%	18.0%	22.8%
USA (S&P 500)	5 803	56.10	-2.6%	8.1%	-0.8%	25.0%	26.3%
USA (Dow Jones)	41 603	51.15	-2.4%	5.2%	-1.6%	15.0%	16.2%
USA (Nasdaq)	18 737	59.53	-2.5%	12.2%	-2.7%	29.6%	44.7%
Euro Area (DJ EuroStoxx)	561.2	56.45	-0.9%	7.1%	13.6%	10.2%	19.5%
UK (FTSE 100)	8 718	62.31	0.4%	4.2%	8.6%	9.6%	7.7%
Switzerland (SMI)	12 199	50.85	-0.9%	3.7%	8.4%	7.5%	7.1%
Japan (Nikkei)	37 471	55.34	-1.6%	6.6%	-6.0%	21.3%	31.0%
Emerging (MSCI)	1 171	66.64	-0.1%	7.2%	10.1%	8.0%	10.2%
Brasil (IBOVESPA)	137 824	59.85	-1.0%	4.2%	14.6%	-10.4%	22.3%
Mexico (IPC)	58 410	63.70	0.8%	5.9%	19.8%	-11.0%	22.4%
India (SENSEX)	82 334	58.43	-0.7%	2.1%	4.9%	9.6%	20.3%
China (CSI)	3 854	54.37	-0.1%	2.7%	-0.8%	18.2%	-9.1%
Com. Services (MSCI World)	131.9	66.51	0.0%	10.3%	6.1%	31.9%	38.1%
Cons. Discretionary (MSCI World)	413.1	59.05	-2.2%	9.1%	-1.5%	20.7%	29.5%
Cons. Staples (MSCI World)	297.7	57.30	0.7%	0.8%	10.4%	4.7%	3.2%
Energy (MSCI World)	237.5	47.26	-2.4%	2.0%	0.5%	2.9%	6.0%
Financials (MSCI World)	198.0	63.47	-1.0%	6.6%	11.8%	25.1%	16.4%
Health Care (MSCI World)	339.4	42.95	-0.7%	-1.6%	-1.9%	1.5%	4.1%
Industrials (MSCI World)	419.2	69.65	-0.5%	10.6%	12.3%	12.8%	22.5%
Info. Tech. (MSCI World)	748.9	60.31	-3.0%	14.3%	-2.3%	31.9%	51.4%
Materials (MSCI World)	330.2	64.45	0.5%	5.0%	9.1%	-7.7%	12.6%
Real Estate (MSCI World)	970	48.11	-2.0%	0.9%	1.9%	-0.4%	5.3%
Utilities (MSCI World)	179.5	59.88	0.4%	3.7%	13.2%	13.0%	1.6%
Bonds (Bloomberg)							
World (Aggregate)	3.64%	55.20	0.5%	0.0%	4.7%	-1.7%	5.7%
USA (Sovereign)	4.29%	42.60	-0.3%	-0.5%	1.7%	0.6%	4.1%
Euro Area (Sovereign)	2.72%	52.98	0.0%	-0.1%	0.1%	1.9%	7.1%
Germany (Sovereign)	2.26%	50.81	0.1%	-0.5%	-0.8%	0.6%	5.6%
UK (Sovereign)	4.59%	45.44	-0.3%	-0.6%	1.6%	-3.0%	5.6%
Switzerland (Sovereign)	0.43%	57.72	0.0%	1.2%	0.4%	5.4%	7.9%
Japan (Sovereign)	1.26%	33.53	-0.6%	-1.3%	-2.0%	-2.1%	0.9%
Emerging (Sovereign)	6.95%	53.68	-0.3%	0.1%	2.4%	7.0%	11.0%
USA (IG Corp.)	5.35%	46.14	-0.5%	-0.9%	1.1%	2.1%	8.5%
Euro Area (IG Corp.)	3.15%	60.95	0.1%	0.0%	1.1%	4.7%	8.2%
Emerging (IG Corp.)	6.74%	56.85	-0.1%	0.3%	2.1%	7.0%	6.7%
USA (HY Corp.)	7.69%	57.65	-0.5%	0.8%	1.9%	8.2%	13.4%
Euro Area (HY Corp.)	5.79%	64.01	-0.1%	0.8%	1.8%	8.2%	12.1%
Emerging (HY Corp.)	8.49%	63.83	-0.3%	1.1%	2.7%	14.9%	13.1%
World (Convertibles)	468.9	67.90	-0.4%	5.1%	6.5%	9.4%	12.3%
USA (Convertibles)	615.8	59.29	-1.4%	5.1%	2.9%	10.1%	14.6%
Euro Area (Convertibles)	278.7	78.92	1.6%	7.3%	19.7%	14.7%	7.3%
Switzerland (Convertibles)	280.6	67.01	2.3%	5.7%	16.5%	-10.5%	5.8%
Japan (Convertibles)	228.1	58.91	-0.2%	1.7%	0.6%	6.4%	7.6%
Hedge Funds (Bloomberg)							
Hedge Funds Industry	1 600	74.42	n.a.	0.0%	-0.6%	11.1%	7.8%
Macro	1 326	62.00	n.a.	-1.5%	-1.2%	7.4%	1.6%
Equity Long Only	2 140	61.89	n.a.	0.6%	-3.2%	12.0%	15.9%
Equity Long/Short	1 666	71.42	n.a.	0.7%	-0.6%	14.0%	7.7%
Event Driven	1 704	70.94	n.a.	-0.6%	-1.2%	8.7%	7.3%
Fundamental Equity Mkt Neutral	1 655	91.07	n.a.	-0.1%	0.2%	12.4%	6.6%
Quantitative Equity Mkt Neutral	1 668	79.44	n.a.	-1.8%	0.2%	9.8%	7.8%
Credit	1 621	95.69	n.a.	0.2%	1.5%	8.5%	8.1%
Credit Long/Short	1 659	99.85	n.a.	1.1%	1.9%	10.0%	11.2%
Commodity	1 862	92.68	n.a.	2.0%	4.1%	14.7%	7.3%
Commodity Trading Advisors	1 286	49.47	n.a.	-2.9%	-4.1%	7.9%	-3.6%
Volatility							
VIX	22.29	49.39	29.3%	-21.7%	28.5%	39.4%	-42.5%
VSTOXX	22.48	54.53	37.4%	-8.4%	32.2%	25.3%	-35.0%
Commodities							
Commodities (CRB)	559.2	n.a.	0.3%	2.2%	4.2%	5.1%	-8.0%
Gold (Troy Ounce)	3 349	n.a.	3.7%	0.9%	27.6%	27.2%	13.1%
Silver (Troy Ounce)	33.52	n.a.	3.6%	1.1%	16.0%	21.5%	-0.7%
Oil (WTI, Barrel)	62.18	n.a.	-0.5%	-1.3%	-13.3%	0.1%	-10.7%
Oil (Brent, Barrel)	65.53	n.a.	0.7%	-2.1%	-11.6%	-4.6%	-4.5%
Currencies (vs USD)							
USD (Dollar Index)	98.80	38.06	-1.6%	-0.7%	-8.9%	7.1%	-2.1%
EUR	1.1408	60.78	1.5%	-0.1%	10.2%	-6.2%	3.1%
JPY	142.64	58.45	1.6%	-0.4%	10.2%	-10.3%	-7.0%
GBP	1.3580	67.81	1.6%	1.0%	8.5%	-1.7%	5.4%
AUD	0.6522	61.12	1.0%	1.4%	5.4%	-9.2%	0.0%
CAD	1.3705	68.31	1.8%	0.9%	5.0%	-7.9%	2.3%
CHF	0.8206	59.70	1.7%	-0.1%	10.6%	-7.3%	9.9%
CNY	7.1735	71.57	0.6%	1.6%	1.8%	-2.7%	-2.8%
MXN	19.201	64.82	0.6%	2.0%	8.5%	-18.5%	14.9%
EM (Emerging Index)	1 825.8	82.63	0.6%	2.9%	5.7%	-0.7%	4.8%
XBT	109 565	n.a.	1.2%	16.4%	16.9%	120.5%	157.0%

Source: Bloomberg, Altitude Investment Solutions   Total Return by asset class (Negative \ Positive Performance)

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