

US Sovereign Credit Risk

Economic dynamism, deterrence and fiscal responsibility

CNBV REGISTERED · SEC REGISTERED NRSRO · ESMA CERTIFIED CRA · FCA CERTIFIED CRA

\$697bn

FY26 Federal Deficit
(Oct – Jan)

\$143bn

Lower Than Same
Period FY25

4–5%

Defense Spending
(% of GDP) Needed

2027

Speculated China
Taiwan Deadline

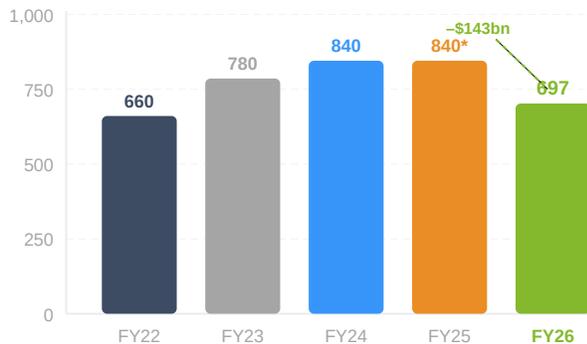
OVERVIEW

Fiscal Balance Improvement

The first four months of Fiscal Year 2026 (FY26) show an improvement in the US Federal fiscal balance. The federal deficit totaled US\$697 billion (bn) between October and January, US\$143bn lower than in the same period of FY25. Revenue growth, particularly from income taxes and tariffs, outpaced spending growth, resulting in a narrower year-to-date deficit.

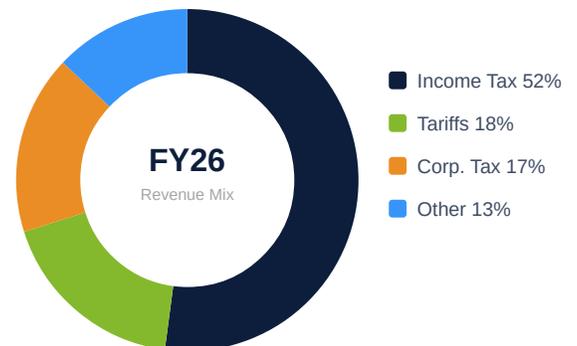
Global political factors are becoming increasingly important in our analysis of US sovereign debt. The US is particularly sensitive to political considerations as its rating is significantly higher than what it would otherwise be given traditional metrics, such as deficit and debt to GDP ratio. This rating boost is due to the position of the US dollar (USD) as the world's premier reserve currency.

Figure 1. US Federal Deficit, Oct–Jan (US\$ bn)



Source: HR Ratings.

Figure 2. Revenue Composition (FY26 YTD)



Source: HR Ratings.

CREDIT DRIVERS

Three Factors Driving the US Credit Position



Economic Dynamism

Continued economic dynamism of the American economy, including a degree of manufacturing revitalization, attracting global capital.



Military Deterrence

The ability to maintain deterrence in a complicated strategic environment involving the western Pacific and the Middle East.



Fiscal Stability

Maintaining a reasonable degree of fiscal stability, thus supporting USD as the world's dominant reserve currency.

Source: HR Ratings.

Tariff Policy & Trade Dynamics

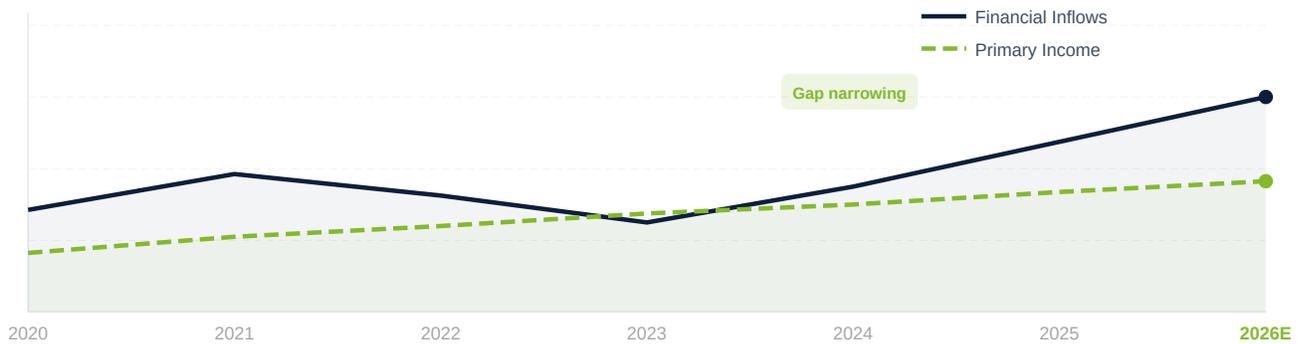
A key element is the tariff policy of the Trump administration. As the world's largest import market, the tariff policy is unsettling. However, its durability is a major question. The declaration of unconstitutionality of the IEEPA tariffs by the US Supreme Court suggests that much of the instability caused by tariffs may in retrospect have been a temporary factor. We expect that the section 122 tariffs will be lifted after their 150-day period.

However, there is a strong possibility that a consensus has been established in favor of a more protectionist policy stance going forward. This tendency may lead to the movement of productive capacity to the United States in areas such as chip production and shipbuilding.

Current Account Concern

The trend in "primary income" within the current account is a matter of some concern. The US investment position has become increasingly negative, and returns on ever larger US investments by non-residents could lead to sustained negative net primary income flows and even larger current account deficits. It is important that investment flows go into industrial projects that help mitigate the trade deficit.

Figure 3. Illustrative US Financial Flows & Primary Income Trend (Index)



Source: HR Ratings.

STRUCTURAL FACTORS

Growth Drivers & Risks



AI Investment

Substantial investments in AI promise to lift productivity and economic growth. Downside: possible impact on employment.



Energy Deregulation

Lifting regulatory restrictions especially in the energy area, both promise to lift productivity and represent a magnet for capital.



Capital Inflows

The US continues to attract substantial financial flows that offset its large current account deficit, but trends require monitoring.



Manufacturing Revival

Movement of productive capacity to the US in areas such as chip production and shipbuilding driven by trade policy.

Source: HR Ratings.

The consequence of lower fertility rates (in the medium term) and out-migration (in the short-term) due to deportation efforts are complicating factors. There is likely to be considerable friction in the movement of labor from areas impacted by AI to those less vulnerable to that impact.

Overall Economic Conclusion

The economic environment will continue to support the United States' dominant position in the world economy as a recipient of the world's capital and with it the dollar's preeminent position.

Western Pacific & Taiwan

The overriding question is the viability of an independent Taiwan, and the role of its productive capacity given China's ambitions to obtain control and sovereignty over the island. There is speculation that Chinese leader Xi has given 2027 as the year in which Taiwan will become part of the PRC. Given the importance of Taiwan in the semiconductor industry, its annexation by China could have significant negative political and economic consequences for the United States.

Strategic Ambiguity

The uncertainty is heightened given that the official US policy has been called one of "strategic ambiguity." A declaration of total support for Taiwan would anger China; a declaration of non-intervention would make an invasion more likely. Even if Taiwan were willing to spend for its defense, it might not be able to purchase US weapons systems, making the US policy perhaps less ambiguous, but in favor of China.

Possible Taiwan Scenarios

● Full-Scale Invasion

Extreme option with massive global economic and military disruption.

● Naval Blockade

Less kinetic but severe impact on global semiconductor supply chains.

● Non-Kinetic Operations

Cyber, economic, and political pressure campaigns against Taiwan.

● Negotiated Surrender

A Hong Kong-type gradual takeover under sustained coercive pressure.

Source: HR Ratings.

Middle East Conflict & Defense Spending Dilemma

The Iranian confrontation has significant implications for the US-Sino military relationship. It highlights Chinese dependence on Middle East oil and how easily it can be disrupted. The conflict also demonstrates US military strength and, simultaneously, its weakness given deficiencies in weapons replenishment and maintaining a strong naval presence in multiple theaters.

Figure 4. Defense Spending — Credit Impact Flow



Source: HR Ratings.

At this point in time, we see little likelihood that any significant increase in defense spending will be accompanied by spending cuts in other areas. Indeed, in order to obtain legislative support for higher defense outlays, it may be necessary to increase non-defense expenditures. The relevant question is at what point are the gains derived from increased defense spending more than offset by a deteriorating fiscal situation.

Forward-Looking Credit Position

Going forward, the credit position of the US federal government will depend upon at least three factors: (1) the continued economic dynamism, including manufacturing revitalization; (2) the ability to maintain deterrence in a complicated strategic environment; and (3) maintaining fiscal stability to support USD as the world's dominant reserve currency.

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