Creditreform Sovereign Rating

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Rating Object	Rating Information	
UNITED STATES OF AMERICA	Assigned Ratings/Outlook: **AAA /stable**	Type: Initial Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Publication Date: 31-03-2017 Rating Date: - Rating Renewal: - Rating Methodologies: “Sovereign Ratings”	

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Rating Action

Neuss, 31 March 2017

Creditreform Rating has published the unsolicited long-term sovereign rating of “AAA” for the United States of America. Creditreform Rating has also published the United States' unsolicited ratings for foreign and local currency senior unsecured long-term debt of “AAA”. The outlook is stable.

Key Rating Drivers

1. World's biggest economy and one of the most prosperous economies in the world, complemented by a very flexible product and labor market
2. Very high degree of competitiveness and very high quality of its institutional set-up; the same holds for the conduct of monetary policy of the highly credible Federal Reserve, which we view as a paragon of stability
3. Heavy debt burden which has been stabilizing in recent years; very high degree of affordability, mainly due to status as global safe haven and very large and liquid government bond market
4. High degree of uncertainty regarding perspectives of economic growth, the path of inflation and the debt trajectory due to ambiguity surrounding timeline, size and composition of prospective government policy changes

Reasons for the Rating Decision

Our assessment of the United States of America's exceptionally high creditworthiness is based on its very strong macroeconomic performance and very high quality of its institutional set-up, while fiscal sustainability risks are balanced by the United States' role as the issuer of the world's principal reserve currency and extraordinarily broad and deep financial markets.

The United States is by far the biggest economy in the world, recording an economic output which amounts to roughly USD 18.6tr (2016) and thus accounting for approximately 25% of the global GDP. According to IMF data, GDP per capita stands at USD 57,294 – the 13th highest per capita income (2016). Moreover, the very wealthy US economy is highly diversified. The very productive service sector, with a gross value added in the

amount of 79.7% of GDP (2015), rests on multiple pillars – the most salient industries being the financial, real estate, professional business services, information, and health sectors.

The Unites States' highly competitive economy is characterized by a very high degree of market flexibility, efficiency and development, as well as of business sophistication and extensive innovative capacity. The high level of competitiveness is underlined by the World Economic Forum's global competitiveness index, which has placed the sovereign at rank 3 of 138 economies for the third consecutive year; labor market efficiency (rank 4), financial market development (3), business sophistication (4) and innovation (4) stand out in particular. The high quality of the US business environment is confirmed by the World Bank's Doing Business report, which lists the US economy at rank 8 out of 190 economies world-wide and rank 6 among the OECD high-income countries. It is noteworthy that the US ranks at 2 and 5 with regard to getting credit and resolving insolvency, respectively. The United States' high governance standards are conducive to its business environment, as indicated by the World Governance Indicators (WGI). According to the World Bank's assessment, the sovereign exhibits a high quality of policy formulation and implementation (Government Effectiveness rank 22/209), as well as a high degree of confidence in contract enforcement, property rights and courts (Rule of Law rank 21/209). Furthermore, its very strong institutional conditions are underpinned by the conduct of monetary policy by the highly credible and accountable Federal Reserve.

We view the prudent and effective policies demonstrated by the Federal Reserve in the past as highly supportive to the sovereign's creditworthiness. In March 2017, the Fed raised the target rate for the federal funds rate to 0.75-1.00% – the third rate-hike since Dec-15, after having kept the fed funds rate stable in the range of 0 to 0.25% for seven years. The FOMC's median assessment, as well as communication from Fed officials, indicates that the Fed continues to follow its gradual, data-dependent approach and points to three rate increases this and next year, respectively. Thus, the fed funds rate could increase to 1.38% at the end of 2017 and 2.13% at the end of 2018.

We assess the tighter monetary policy stance as in line with the development of the US economy, which has proven to be fairly resilient and posted stable economic growth, despite facing bouts of financial market volatility, a strengthening US Dollar (USD) and subdued global output growth. Owing to a weak first half of the year, during which weak private domestic investment and anemic export growth dampened output growth, GDP expanded by a modest 1.6% in 2016 – significantly lower than in the previous two years when GDP expanded by 2.4 and 2.6%, respectively. Growth in the US continued to be driven mainly by personal consumption expenditures (PCE), which contributed 1.8 p.p., while private investment and net exports subtracted 0.3 and 0.1 p.p. from GDP growth. Nonresidential investment was held down by a strong USD, subdued external demand, and the downbeat energy sector, but picked up somewhat in the second half of the year (Q3-16: +1.4%, Q4-16: 1.3% annual q-o-q rates). Also, weak capacity utilization in manufacturing acts as a drag on business investment, as it has trended sideways since Mar-14, remaining in a range between 75.2 and 76.7% (avg. 1972-2016: 78.3%). At the same time, considerable gains in disposable income and favorable financing conditions have

resulted in solid consumer spending. Real disposable income displayed quarterly annual growth rates of at least 2% throughout the year, underpinned by the positive development of the labor market, which continued its improvement in 2016.

The US economy benefits extensively from its very flexible labor market. In the aftermath of the Great Recession, the US labor market exhibited a significantly faster recovery than other industrialized economies. In 2009-16, some 10.5m jobs were created in the US as compared to only 3.0m in the European Union. As measured by the number of newly created jobs, US employment growth remains strong. In February 2017, total nonfarm payrolls rose by 235,000, with the 12-month-moving average standing at 195,000, up from 187,000 in Dec-16. Meanwhile, the labor market is close to full employment as signaled by the FOMC's estimate of the longer-run normal rate of unemployment, ranging from 4.5 to 5.0%. In its latest reading of Feb-17, the unemployment rate stood at 4.7%, the tenth consecutive month below 5% and close to its nine-year low of 4.6% reached in Nov-16. However, the US labor force is shrinking. Although the labor force participation rate has been virtually flat since the beginning of 2014 and has moved up recently, increasing from 62.6% in Nov-16 to 63.0% in Feb-17, it has broadly followed its downward trend since the early 2000s (February 2000: 67.3%).

While the US economy is approaching full employment, inflation is gaining momentum and there are tentative signs that the Federals Reserve's inflation target of 2% may be within reach. To be sure, labor market conditions have not yet prompted significant compensation growth. Average hourly earnings have edged up only recently, posting monthly growth rates of 2.4 to 2.8% y-o-y in 2016 as compared to a monthly average of 2.0% in 2010-15 (2007-09: 3.0%). The Atlanta Fed's wage tracker has been trending upwards since 2014, indicating higher wage growth, though the 3-month moving average slipped from 3.9% in Nov-16 to 3.2% in Feb-17. Nevertheless, headline PCE inflation has been firming over the last year, mainly due to strengthening energy and food prices. Thus, the 12-month rate of the PCE deflator gradually rose to 1.9% in January 2017, up from 1.1% a year before, while core PCE inflation remained fairly flat at 1.7% y-o-y.

We expect real GDP to accelerate to 2.2% this year and to 2.1% in 2018. Hence, the US economy is likely to operate near, but somewhat above its potential. That said, real potential GDP growth has decreased from an average 3.1% in 1990-99, via 2.5% in 2000-09 to 1.4% in 2010-16 (Q4-16: 1.6%, CBO data). As in other advanced economies, potential output growth is facing headwinds on several fronts. A slow-growing labor force and falling share of working-age population (15-64y) are likely to curb potential growth in a no-policy-change scenario. The share of working-age population has declined to 65.9% (2016), down from 67.3% in 2007. Moreover, productivity growth has slowed significantly, as the average real output per hour in the nonfarm business sector dropped to only 0.5% in 2011-16, down from 2.6% in 2001-10 (BLS data). Anemic business dynamics may also be at work. According to the Census Bureau, the entry rate and the exit rate of establishments have come down to 10.0 and 8.6% in 2014, after standing at 12.7 and 11.9% in 2002, respectively.

Going forward, we expect inflation to increase gradually and the recent growth pattern to remain in place. On the back of a robust labor market and increasing disposable income,

PCEs are likely to display vivid growth and continue to be the main driver of growth, though rising energy prices should constrain PCE growth somewhat. While business sentiment signals a continuation of the modest recovery in nonresidential investment which began over the course of 2016, a strong USD as well as tighter financing conditions due to rising interest rates should curtail medium-term investment growth prospects. In the same vein, net exports are likely to drag on growth, due to strong import growth underpinned by favorable terms of trade.

Against the backdrop of solid economic growth and the divergent monetary policy stance, we expect the USD to stay strong; after exhibiting significant gains against the major foreign currencies since mid-14, the real trade-weighted USD Index for major currencies appreciated by 25.9% between Jul-14 and Dec-16. However, the external dependence of the US economy is fairly low, as trade makes up only 25% of its GDP.

Meanwhile, we believe that private household debt will not constrain PCE growth. In nominal terms, total household debt had climbed to a new peak at USD 14.6tr in 2015, the highest reading since 2007 (USD 14.4tr), and increased further to USD 15.1tr in 2016. As measured by GDP, household debt rose slightly from 81.1 to 81.4% of GDP, but stood well below its peak at 99.6% of GDP in 2007. Housing debt, accounting for two thirds of household indebtedness, increased from USD 9.8tr in 2015 to USD 10.0tr in 2016. At the same time, the mortgage delinquency rate 90+ days is on a declining trend, posting at 1.57% in Q4-16, coming down from 8.89% in Q1-10.

In general, it should be stressed that uncertainty for the perspectives of economic growth and the path of inflation has increased substantially over recent months due to the ambiguity regarding the timeline, size and composition of prospective government policies. As the Trump administration has envisaged a number of changes with regard to increased spending on infrastructure, individual income, corporate tax reforms, and regulatory policies, these may boost output growth in the near term, carrying some upside risk.

However, we believe that these policies tend to have a rather limited impact on growth, on several grounds; while individual income tax cuts may increase the households' disposable income, the relief should mainly benefit the upper income brackets which have a higher propensity to save. Furthermore, the direct impact of an infrastructure program worth USD 1tr over ten years would only amount to a mere 0.5% of 2016 GDP per year. More importantly, such a rough calculation assumes that the private sector has the capacities and is willing to participate in these infrastructure spending programs and, importantly, that a corresponding number of profitable projects exist. Greater impact may be expected from deregulation initiatives and an overhaul of the corporate income tax system which are likely to enhance business investment, though such gains should be set against potentially adverse effects emanating from changes in foreign trade policies. However, benefits arising from changes in government policies should be balanced by higher refinancing costs stemming from rising interest rates and a stronger USD, which may weigh on consumer spending and investment.

As regards fiscal sustainability, the United States made significant progress in fiscal consolidation in the aftermath of the financial crisis, as the federal budget deficit significantly

narrowed from 9.8 (2009) to 2.4% of GDP in 2015. However, after six consecutive years of declining deficits, budget consolidation came to a halt in 2016, as revenue growth substantially lagged that of expenditures. Due to the extension of tax breaks for both businesses and individuals, revenues experienced only a marginal increase of 0.5%. At the same time, federal outlays expanded by 4.5%, reflecting, in particular, higher mandatory spending on social security programs, Medicaid and Medicare. As a result, the federal budget saw an increase in net borrowing to -3.2% of GDP in the fiscal year 2016, which added to the government's already elevated debt levels. Thus, the ratio of federal debt held by the public rose from 73.3% in 2015 to 77.0% of GDP (2016), the highest reading since 1950 and well above its long-term average of 39.8% (1967-2016) – mirroring the legacies of the financial crisis.

In its 2018 budget blueprint, the new administration announced it would increase spending on military and homeland security, fully counter-financed by budgetary cuts affecting most federal agencies and cabinet departments. Accordingly, total discretionary spending in FY2018 would be 1.2% lower than the figure for 2017. However, changes on mandatory spending, which accounts for the bulk of federal expenditures, are expected to be specified later this spring.

Looking forward, medium-term fiscal risks may arise due to the Trump administration's proposed economic and fiscal programs. Under current law, the Congressional Budget Office (CBO) projects the government's budget deficit to widen in the years beyond 2018 – with costs related to an ageing society and a higher interest burden contributing the bulk to increasing deficits. While social security and health expenditures are estimated to rise to 12.9% of GDP in 2027 (2017e: 10.4% of GDP), net interest payments as measured by GDP are projected to almost double from 1.4 to 2.7%. As sustained deficits accumulate, growth of the debt stock is set to increase in a no-policy-change scenario, reaching almost 90% of GDP in 2027.

It has to be noted that budget forecasts are characterized by a substantial degree of uncertainty as the Trump administration currently elaborates on numerous legislative changes with regard to healthcare, public investment, and taxation. With respect to healthcare legislation, the new administration intended to revamp the Affordable Care Act (ACA) passed in 2010, which extended health insurance coverage by expanding both private and public insurance. Recent CBO estimates point to some budgetary relief (USD 336.5bn) in the 2017-2026 period, should the current legislation be replaced by the American Healthcare Act proposed by the Republican Party. Yet, the draft law was withdrawn due to uncertain support by House Republicans. The USD 1 trillion infrastructure stimulus package, as well as the envisaged individual and corporate income tax reforms, are likely to increase budget deficits going forward. The reform aims to lower statutory rates for all personal income tax brackets and to cut corporate taxes from 35 to 15%. Estimates considering the revenue loss of these policies over a ten-year period range from USD 9.5 to 12.0tr. In addition to easing the tax burden, the new corporate tax framework could include a destination-based cash flow tax that would subject all imports to a tax while exempting US exports.

Although shape and timeline of the implementation of the respective reforms have hitherto not been specified, there are indications that the new administration may follow a more expansive fiscal policy stance – which could put additional strain on public finances. We expect that an infrastructure program is likely to be implemented next year or later, as the government continues to attach high importance to a tax reform – which could start to take effect in late 2017 – pointing to some prioritization. To be sure, the administration's large-scale reform proposals would have to be approved by Congress. Hence, it is not unlikely that we may see some back-tracking on elements of the proposals or that proposals may be considerably modified in the legislative process.

In our baseline scenario, we expect the federal debt as well as the budget deficit to stabilize at current levels in 2017 before increasing somewhat next year. The debt ceiling, which was suspended by the Bipartisan Budget Act 2015, was reinstated on 16 March 2017. Given the Republican majority in both chambers of congress, we believe that a further increase of the debt limit will eventually be approved and that the Department of Treasury can fund government activities using extraordinary measures during the time of negotiations. In any case, the Full Faith and Credit Act (H.R.807) was approved by the House of Representatives in May 2013, requiring the government to prioritize debt service before spending funds on domestic items.

Despite uncertainties related to the increase of federal debt and comparatively large refinancing needs (end of fiscal year 2017 and 2018: 25.5 and 26.3% of federal debt outstanding, OMB data), we believe that near-term refinancing risks are mitigated by the unique role of US Treasuries in global debt markets. Both in terms of size and liquidity, the US sovereign bond market is unmatched. US Treasury securities alone account for more than a third of global sovereign debt outstanding (Q3-16: 36.7%), while daily trading volumes averaged at USD 548.7bn (Feb-17). These characteristics support the immediate absorption of large funds and thus make the US the world's principal safe haven in times of global financial market distress.

Should the US unilaterally decide to introduce a border tax adjustment, this may entail retaliatory actions by US trading partners, with negative repercussions on trade and capital flows and thus on the US current account, which has recorded persistent deficits for almost 25 consecutive years (1991-2015 avg.: -3.0% GDP). After the US current account deficit had peaked at 5.8% of GDP in 2006, it gradually declined to 2.6% of GDP by 2015, mainly driven by an improving balance of trade in goods. The current account rebalancing can be partly attributed to the ramp-up of domestic shale oil production in the recent past. As a result, import demand for fuel decreased significantly (2011-15: -56.5%) and oil imports dropped from 3.0 to 1.1% of GDP in 2011-15. Last year, the US-current account balance should have stabilized on its 2015 level as indicated by data of Q3-16 (-2.4% of GDP). The reduction of its current account deficit over the last years has also contributed to the stabilization of the country's net international investment position (NIIP). Despite reporting still sizeable external liabilities (in particular with regard to portfolio investment), the NIIP has hovered at around -40% of GDP since 2014.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of AAA is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the near term.

We could consider a downgrade of our ratings if US medium-term growth falls substantially short of our expectations. In particular, such a scenario could materialize if a faster-than-projected rise in interest rates significantly dampened US growth via the exchange rate channel. A sharp and rapid appreciation of the US-Dollar against the currencies of the country's most important export markets (export share Canada: 18.6%; EU-28: 18.2%) could weaken the external competitiveness of US corporates, with knock-on effects on growth. In the same vein, a prolonged period of sluggish growth and/or renewed financial turbulences in the European Union could lead to upward pressure on the USD and in turn weaken the country's export performance. Domestic risks to the growth outlook largely pertain to political uncertainty. What is more, legislative changes which intend to restrict the free movement of goods and persons may jeopardize the United States' medium-term growth potential.

Also, if the implementation of government policies turns out to have a significant negative impact on budget deficit and debt burden, this could exert downward pressure on the rating. Furthermore, we believe that surfacing financial stability risks could seriously impact the federal budget and debt trajectory, given the large domestic financial sector (assets-to-GDP ratio in Q4-16: 462.9%). In particular, the non-banking sector, which accounts for 79.0% of total financial system assets, harbors significant risks. Mutual funds' and ETFs' volume of assets under management increased by 79.5% in 2011-16. However, data limitations are hampering the assessment of liquidity and counterparty risks within the asset management sector. While we regard the US banking sector to be sound in terms of capitalization and asset quality (Q3-16: CET Tier I to risk-weighted-assets: 13.1%; NPL-ratio: 1.3%), excessive financial deregulation and rolling back the Dodd-Frank Act may contribute to the build-up of future imbalances in the banking sector thus putting public finances at risk.

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Ratings*

Long-term sovereign rating	AAA /stable
Foreign currency senior unsecured long-term debt	AAA /stable
Local currency senior unsecured long-term debt	AAA /stable

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	1.6	2.2	1.7	2.4	2.6	1.6	2.2
GDP per capita (PPP, USD)	49,726	51,385	52,705	54,502	56,084	57,294	59,407
PCE inflation, (q4/q4) change	2.7	1.8	1.2	1.2	0.4	1.4	1.9
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	78.6	78.7	78.8	78.9	n.a.	n.a.	n.a.
Federal budget balance/GDP	-8.5	-6.8	-4.1	-2.8	-2.4	-3.2	-3.3
Current account balance/GDP	-3.0	-2.8	-2.2	-2.3	-2.6	-2.5(e)	n.a.
External debt/GDP	99.9	97.1	98.8	99.2	98.2	98.6(e)	n.a.

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of Creditreform Rating´s “Sovereign Ratings” methodology. Creditreform Rating AG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of Creditreform Rating´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in Creditreform Rating´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

Disclaimer

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