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ISSUER COMMENT

The Key Drivers Behind Moody's Confirmation of the US Aaa Rating

Extracted from "Moody's Weekly Credit Outlook", dated August 8, 2011

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On 2 August, Moody's Investors Service confirmed the Aaa government bond rating of the United States following a review for downgrade and assigned a negative outlook. The confirmation is based on our view that passage of last week's Budget Control Act was positive for the credit of the United States, even if not enough to cause us to maintain a stable rating outlook. We expect the economic recovery will continue and additional budget deficit reduction initiatives will be put in place by 2013. The political parties now appear to share similar deficit reduction objectives. However, the disagreement between the two parties over the means by which to achieve deficit reduction and the difficulties experienced in reaching a compromise on raising the debt ceiling highlight the risks of political polarization. This uncertainty is among the drivers of our negative outlook.

Characteristics that support the Aaa rating and that formed the basis of our decision to confirm the rating include the following:

1. The unparalleled diversity and size of the US economy and its long record of relatively solid economic growth, based on both demographics and productivity. Even if the short-term economic outlook exhibits some weakness, we believe that the long term remains favorable in relation to many other advanced economies. This provides a solid base for government finance.

2. The global role of the dollar, which underpins continued demand for US dollar assets, including US Treasury obligations. This feature, unique to the US, provides unmatched access to financing, meaning that the US government can support higher debt levels than other governments. Thus, while comparisons of government debt ratios form an important part of our rating analysis, the status of the dollar and the US government debt market need to be taken into account when making such comparisons. Over time, the dollar's role may be eroded, but we see no immediate threat.

3. Relative to other large Aaa-rated governments, the US debt position is somewhat high, but not out of line with the positions of these countries. While the projected trend of US government debt is less favorable without further deficit reduction measures, we believe that eventually such measures will be adopted. The less favorable debt ratio trend now in place is reflected in the negative outlook assigned to the rating.

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4. A step in the right direction toward deficit reduction was taken on 2 August with the passage of the Budget Control Act, even if by itself it will not produce all of the deficit reduction measures necessary to reverse the debt trajectory. Although the political process has been considerably more contentious than usual in the past few months, it finally did produce an agreement. We expect further fiscal measures over time, albeit with vigorous debate over the particulars.

Both political parties have indicated a goal of larger deficit reduction over time, but disagree about the method to accomplish this. For the Aaa rating to remain in place, we would look for further measures that would result in the ratio of federal government debt to GDP, for example, peaking not far above the projected 2012 level of near 75% by the middle of the decade and then declining over the longer term.

Last week's agreement suggests that coming to an agreement that would meet this criterion by early 2013 will be challenging, given the political polarization, but not necessarily impossible. We will closely monitor progress toward meeting these criteria in the meantime.

While we believe the US exhibits the characteristics necessary for a Aaa rating, a rating downgrade could be triggered before 2013 by (1) any weakening of fiscal discipline between now and then or (2) a significant deterioration in the economic outlook resulting in adverse fiscal implications that are not offset.

Aaa Credit Strengths Remain

These fundamental credit strengths supporting the Aaa rating are discussed in an updated analysis of the US published on 5 August, the main points of which are summarized here. The more detailed discussion can be found here.

Diversity, Size, and Growth Support Economic Strength

The economic strength of the US continues to be very high, based on the country's high per capita income, pre-eminence as the world's largest economy, economic diversity, and long track record of relatively high productivity growth. While Canada, France, Germany, Japan, and the UK are examples of other countries that share a similar assessment, one characteristic unique to the US is the global role of the dollar, which enables the economy and the government to easily access external savings.

The financial crisis and recession of 2008-10 resulted in a serious deterioration in government finances, but our assessment is that the factors underpinning the country's very high long-term economic strength, even if affected for a few years, remain in place. In the short term, economic and fiscal performance are being affected by the aftermath of the crisis. The correction of high debt levels in the household and government sectors, a still-troubled housing market, and lingering risks to the financial system continue to weigh on growth. The adjustment is also being delayed somewhat by decreased labor-force mobility because of weakness in housing prices. However, after a period, these influences should diminish, with a resultant re-emergence of the economy's long-term strength.

An important factor in the rating going forward will be the extent to which the US economy rebounds toward its long-term trend rate of growth. While this cannot be known with any certainty yet, we expect short-term growth to rise from recent low levels in the next couple of years. There are a number of longstanding characteristics that indicate the country's economy has a high potential for

rebounding. The US exhibits favorable demographics in relation to many other countries, has a diverse economy, a record of high productivity growth, and a high capacity for innovation. Additionally, US dollar assets still dominate international reserves globally, with over 60% of reserves still held in dollars, and the majority of international trade and investment continues to be denominated in dollars.

Based on all of the above characteristics, we evaluate the capacity of the US economy to return to a relatively good rate of economic growth over the medium term as high, despite the fairly low rate of growth recently. In 2012, real GDP is forecast to be in the 2%-3% range, higher than the euro area, Japan, or the UK. Economic growth, in the end, underpins the government's financial position by providing a source of increasing revenue. It therefore forms an important part of our rating analysis.

Institutional Strength Very High Even if Political Parties Disagree

The US retains a very high position on most indicators of governance, rule of law, and transparency. Political and institutional stability have characterized the country for a very long time, despite the different orientations of the two major parties on aspects of fiscal and other policies. In our view, the current wide political differences between the two parties, while complicating the formulation of sound economic and fiscal policies, represent a temporary conjuncture of forces but do not deflect from the overall long-term strength of governmental institutions. While the particular measures implemented during the recent financial crisis can be debated, the government and the central bank responded quickly and vigorously to the crisis. As a result, the institutional strength of the US is evaluated as very high, similar to other Aaa-rated sovereigns.

Government Finances in Line with Other Large Aaa Governments; Role of Dollar Adds Support

The ratios of general government (including all levels: federal, state, and local) debt to GDP and debt to revenue deteriorated sharply during the crisis and are now near the top end for Aaa-rated countries. By the end of 2012, we expect the US to record a debt to GDP ratio of over 90%, while the ratios for the other four large Aaa-rated governments will range from 74% in Canada to 89% for the UK, with Germany and France in between. The US federal government debt ratios rose steeply and will continue their upward trend, albeit more gradually, under current policies. The effect of the financial crisis, the recession, and the government response is seen in the ratio of federal debt to GDP, which nearly doubled from 40% at the end of 2008 to the administration's last forecast of 75% in 2012.

Despite high debt levels, the borrowing costs of the US federal government debt remain low, in part owing to the global role of the US dollar and the "safe haven" role of US Treasury debt obligations. Over the longer term, this role could be eroded, but we see no immediate threat to the US government's ability to continue to access financing at relatively low cost. This situation is somewhat analogous to that of Japan (Aa2 review for downgrade), which has more than double the debt levels of the US, but very low financing costs. The role of the dollar is an important factor supporting a Aaa rating.

On 2 August, a Budget Control Act was adopted that included $917 billion in spending cuts over the next decade. In addition, it established a credible mechanism for further deficit reduction of $1.2-$1.5 trillion. The act mandated a special Congressional committee composed of members of both parties to make recommendations for deficit reduction measures of $1.5 trillion by November, after which the measures would be voted on by the Congress. If the committee is unable to agree on measures,

automatic spending cuts totaling $1.2 trillion would come into place. Thus, total deficit reduction of $2.1-$2.4 trillion was mandated by this new law. While it could be changed by a future Congress and the projected debt reductions face some implementation risk, we believe that this act was a positive step toward deficit reduction, albeit not sufficient by itself to bring about a declining debt trajectory.

Debt Limit Process Adds a Low "Event Risk"

Because of the way the statutory debt limit is managed, periodically there is a small possibility of a default on Treasury interest payments if the limit is not raised on a timely basis. This introduces an element of "event risk" into Treasury debt securities that does not exist in other sovereign bonds. We expect that the debt limit will be raised as necessary, as recently demonstrated, but in the unlikely event that it is not raised on a timely basis, financial markets could begin to demand a risk premium on Treasury bonds. If an interest payment were actually missed as a result of failure to increase the Statutory Debt Limit, it is possible that this risk premium could become embedded in Treasury borrowing costs over the medium term, causing the interest burden to rise beyond what is now widely expected. With federal debt having an average maturity of about five years, interest payments would rise fairly quickly beyond the current baseline if such a premium lasted for a prolonged time. At this stage, we evaluate this event risk as low.

Summary

Despite the outlook for some further deterioration in the government's debt metrics over the coming few years, we believe that the US continues to exhibit the characteristics compatible with a Aaa rating. Over time, this status could be threatened if further measures to address the long-term fiscal situation are not adopted, but it is early to conclude that such measures will not be forthcoming. Thus, the rating was confirmed last week at Aaa with a negative outlook.

Report Number: 135136

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