Research Report on USA

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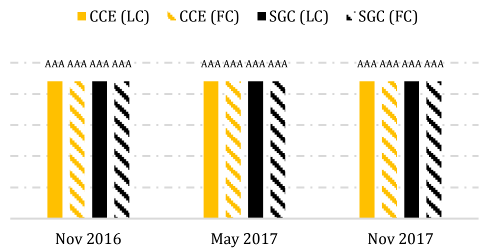
Ratings

Sovereign Government Credit (LC)	AAA
Sovereign Government Credit (FC)	AAA
Country Credit Environment (LC)	AAA
Country Credit Environment (FC)	AAA

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of USA

Macro indicators	2014	2015	2016
Gross gov. debt, USD bn	18308	19063	19948
Nominal GDP, USD bn	17428	18121	18624
Real GDP growth, %	2,6	2,9	1,5
Gross gov. debt/GDP, %	105,1	105,2	107,1
Deficit (surplus)/GDP, %	-4,0	-3,5	-4,4
Inflation rate, %	0,5	0,7	2,2
Current Account Balance/GDP, %	-	-	-2,4
External debt, USD bn	-	-	6,2

Development indicators	2016
Inequality adj. HDI	0,79
GDP per capita, USD th	57,6

Default indicator	17.11.2017
5-Year CDS spread, Bp	25,4
10Y Gov Bond Yield, %	2,35

Source: RAEX (Europe) calculations based on data from the IMF, WB, UN, Trading Economics

Summary

The ratings of the United States at ‘AAA’ remain underpinned by the country’s supportive economic conditions and significant resilience to external and domestic shocks.

Following the still declining unemployment rate, reduced output gap and inflation rates around the Fed’s target, the Federal Open Market Committee (FOCM) is moving towards monetary policy normalization.

Uncertainty over the tax cut plan of the government and the increase of the debt ceiling after December 2017, represent the major risks to the fiscal stance of the country.

The country’s trade deficit could narrow in the long run if some of the U.S. trade deals are renegotiated. However, we keep our view that such a move could potentially have a negative impact on prices and domestic supply.

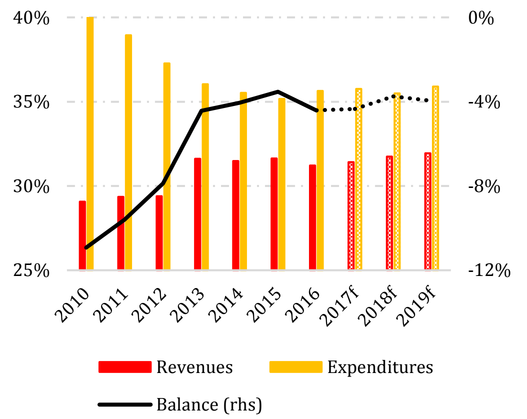
Fiscal pressures remain in place. The U.S. government managed to narrow its fiscal deficit until 2015 as a result of lower interest expenses and higher revenues linked to stronger economic activity. However, the fiscal balance dropped to -4,4% in 2016 driven by lower fiscal revenues and the fiscal deficit could remain flat going forward (see graph 1).

Trump’s administration is still dealing with the legislative branch on a bill which allows the government to reduce corporate tax and repeal state and local tax (SALT) deductions. The uncertainty on whether this bill will finally be passed, combined with the fact that the government debt ceiling is likely to be reintroduced in December 2017 contributes to the risk of financing for the government in the mid run.

In our view, the proposed tax cut could potentially have a negative impact on revenue. From a macro perspective, fueling demand through tax cuts at this point of the economic cycle is likely to derive in higher inflationary pressures over the long run. We expect the real GDP growth rate to be around 2% until 2018, but to slow down below that figure from 2019 onwards. In this sense, the country would enter the next economic downturn with an already large fiscal deficit and little room for further expansionary fiscal policy.

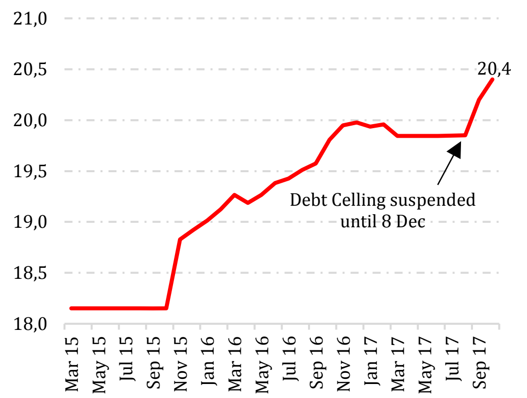
The cost of capital in the U.S. is already low, corporate profits are elevated and the effective tax rate paid by large corporations is well below the existing statutory rate. In this sense, we consider that lowering the

Graph 1: US fiscal balance, % of GDP



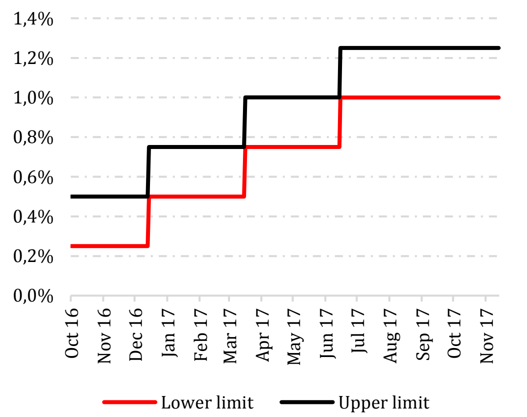
Source: RAEX (Europe) calculations based on data from IMF

Graph 2: US gross government debt, USD tn



Source: RAEX (Europe) calculations based on data from IMF

Graph 3: Lower and upper Federal funds rate, %



Source: RAEX (Europe) calculations based on data from FRED

corporate tax rate, without any further structural improvement which encourages investments, will ultimately only increase the risk of higher inflation.

In our view, the elimination of the SALT deduction could mitigate most of the aforementioned risks and propel fiscal revenues in the short run. Additionally, a new agreement between the executive and legislative branch to increase the debt ceiling in December 2017 is likely to reduce fiscal pressures along 2018 (see graph 2).

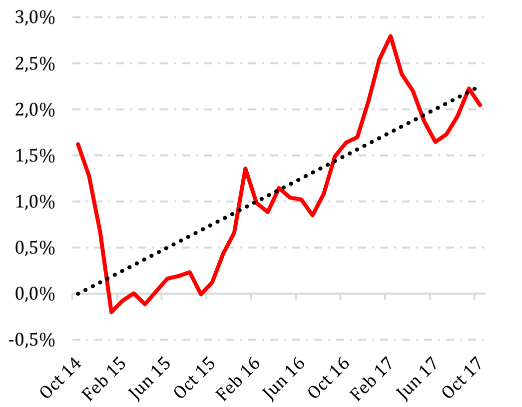
Monetary policy heading to normalization. The FOMC decided to raise the Fed Funds rate by 25b.p. at the June meeting this year, adding to a 25b.p. tightening in December 2016 (see graph 3). Such decisions came after inflation rates showed a sustained long-term positive trend since 2016 (see graph 4), real GDP growth rate kept its upward trend through 1Q 2017 and unemployment rate stood at a record low for almost a decade at 4,4% in April 2017.Given the downside risks to inflation and the steady reduction of the output gap towards zero, we expect the FOMC to consider further increases of the fed funds rate similar to those observed during 2017.

Alongside the ongoing normalization in the interest rate, we could potentially expect a reduction in treasuries and mortgage backed securities (MBS). Under the announced plan, if normalization is to begin by end-2017, the balance sheet would decline by USD 318 bn and USD 409 bn in 2018 and 2019 respectively.

Uncertainty over trade remains in place. So far, every U.S. trade negotiation points at the ultimate goal of narrowing the deficit with other countries and providing U.S. companies further access to other markets. However the U.S. proposals for the treaty changes are perceived as too radical. The most breaking points so far seem to be to end the Chapter 19 dispute mechanism which gives other partners a way to resolve trade conflicts outside U.S. courts, set minimum levels of U.S. content for autos (so called rules of origin) and suggestion that a trade agreement will be revised for a renewal every five years. These proposals became known as "poising pills", which could at the end doom the agreement.

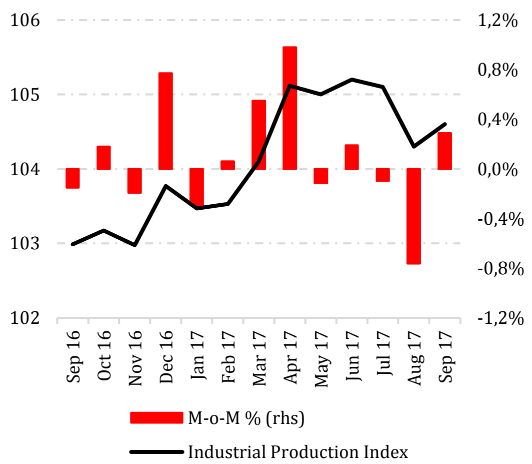
While a potential lower degree of foreign trade openness resulting from these actions could narrow the country's trade deficit, we are still of the view that this could ultimately shorten demand and increase domestic prices. Additionally, given the size and complexity of the U.S. economy, we estimate that the time span required to negotiate new trade agreements could potentially be large, eventually introducing risks to the creditworthiness of the country.

Graph 4: Monthly inflation rate, y-o-y %



Source: RAEX (Europe) calculations based on data from FRED

Graph 5: Industrial production index (seas. adj.)



Source: RAEX (Europe) calculations based on data from FRED

Encouraging macro conditions. The U.S. economy remains modern and diversified and the country is still underpinned by a broad economic policy flexibility and innovative technology. Additionally, the status of the USD as the world's key reserve currency gives the U.S. a strong tool to overcome any volatility in financial markets. GDP growth continued its upward trend through 2017 and we can expect it to stand at around 2% by end-2017. Job creation continues to be strong and the unemployment rate is expected to fall further, from 4,4% as of April 2017 to around 4,3% as of the end of 2017.

After two months of consecutive declines following the effects of hurricanes, industrial production rose by 0,3% (m-o-m) in September 2017 (see graph 5). However, the industrial production index increased in September 2017 by 1,6% (y-o-y) driven by sectors such as mining, construction and material.

The country also enjoys a high degree of development and competiveness, as it ranked 6th out of 190 countries in the Doing Business 2018 ranking prepared by the World Bank, which is a jump of two spots compared to the previous report.

Political risks could be mitigated. We keep our view that politicking between the executive and legislative branches is likely to lower as Republicans continue to hold a majority of votes in both the Senate and the House of Representatives. While this could mitigate the risk of technical debt defaults through a possible new suspension of the debt limit, it increases the risk of higher fiscal spending and government debt increase.

If the executive and legislative branches do not manage to agree on the increase of the debt limit until the 8th of December, or at least to continue with the suspension, the government's option is to use extraordinary measures to continue to finance the government on a temporary basis. This could buy the government a bit of time to meet its obligations through January 2018, however the final vote would have to take place soon. In order to have this bill passed, a major agreement of both parties is needed. However, even in the worst case scenario of a government shut-down, we do not expect a major market turmoil to happen.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://www.raexpert.eu/reports/Press_release_USA_17.11.2017.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the Agency.