United States of America Rating Report

SCOPE AA STABLE OUTLOOK

Credit strengths

- Wealthy, diversified economy
- Institutional checks and balances
- Global reserve currency status
- Deep, liquid capital markets

Credit weaknesses

- Weakening potential growth outlook
- Large government debt burden
- High contingent liabilities
- Policy inaction and uncertainty

Rating rationale and Outlook:

Scope's affirmation of the United States AA rating reflects the country's wealthy, competitive and diversified economy, its transparent and accountable institutional framework, as well as the US dollar's unparalleled global reserve currency status which enables the country to run fiscal and current-account deficits with limited debt sustainability concerns. The rating is constrained by the weakening potential growth outlook, combined with the high level of government debt and significant contingent liabilities from pension and healthcare related obligations. Given the divisions between the political parties, and the lack of bipartisan collaboration, solutions to these underlying structural challenges are unlikely to be implemented in the foreseeable future.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	U.S.A.	Peer Comparison		
		Average	U.K.	France
Domestic Economic Risk				
Public Finance Risk				
External Economic Risk				
Financial Risk				
Political and Institutional Risk				
Qualitative adjustment (notches)	-		-	-
Final rating	AA		AA	AA

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Improved potential growth outlook
- Debt trajectory on downward path
- Reduction in contingent liabilities

Negative rating-change drivers

- Reduced global role of the US dollar
- Deterioration in public finances
- Weakening fiscal framework

Ratings and outlook

Foreign currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AA/Stable
Senior unsecured debt	AA/Stable
Short-term issuer rating	S-1+/Stable

Lead analyst

Rudolf Alvise Lennkh, CFA
+49 69 6677389-85
a.lennkh@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings AG

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

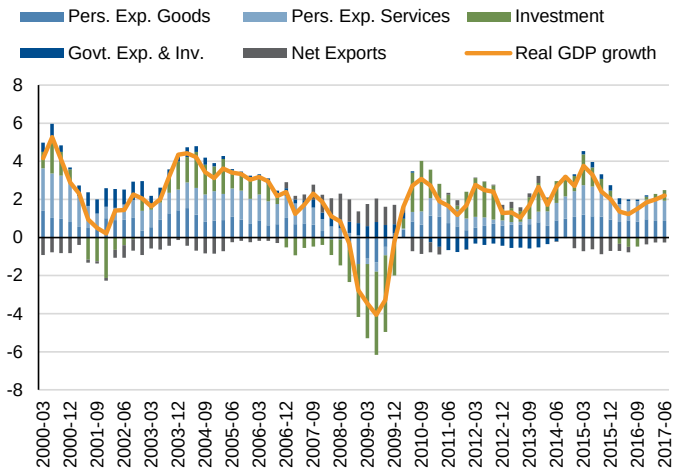
Bloomberg: SCOP

Domestic economic risk

Moderate growth prospects

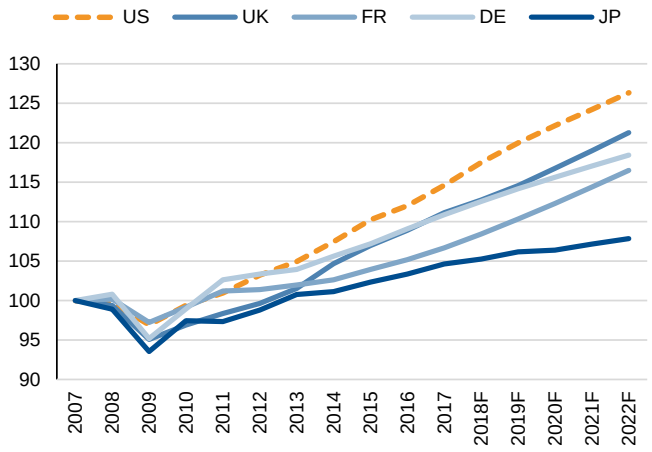
The economic recovery in the United States has proven resilient, with the economy growing for 30 consecutive quarters, averaging a real GDP growth rate of about 2.1% since 2010. The economy is close to full employment, with an unemployment rate below 5% since January 2016, and core inflation near, albeit slightly below, the Federal Reserve's price stability mandate of 2%. The US economy recovered faster from the Great Financial Crisis (GFC) than its peers and, in terms of real GDP, is now a solid 14% above its pre-crisis level. This reflects the country's flexible and competitive economy, which has led to one of the highest GDP per capita levels in the world, of around USD 59,000 (the seventh highest level, based on IMF figures). Going forward, Scope expects real GDP growth to hover around 2%, driven by solid private consumption, helped by a strong labour market and rising household wealth, as well as a rebound in investment as indicated by strong purchasing manager indices and industrial orders. In Scope's assessment, the contribution from government expenditure, in the form of a fiscal stimulus, is expected to be moderate given the relatively high uncertainty associated with the budget plans of the current administration.

Figure 2: Real GDP growth (YoY, %)



Source: Bureau of Economic Analysis

Figure 3: Real GDP growth (2007=100)

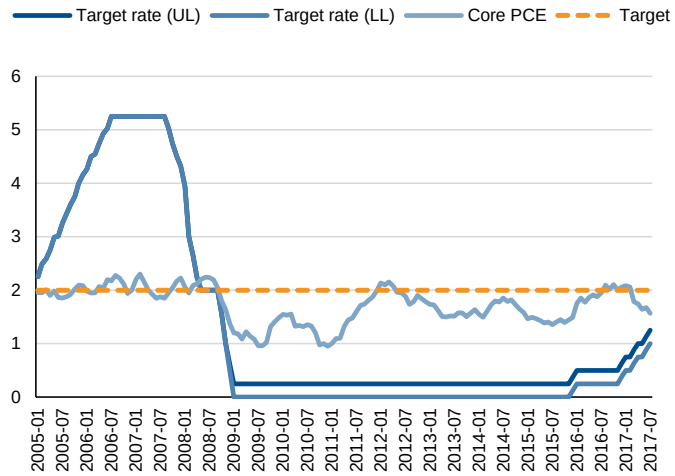


Source: IMF, Calculations Scope Ratings AG

Table of Contents

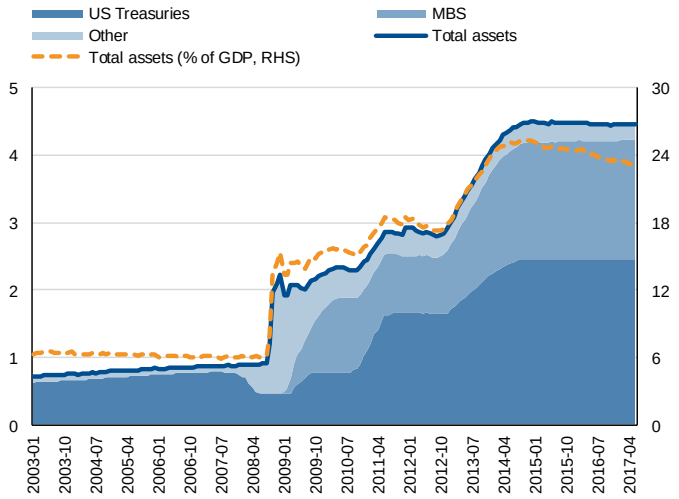
The economic recovery has also been driven by the effective policy implementation of the Federal Reserve since the onset of the crisis. Following decisive policy action over the past few years, resulting in historically low interest rates and a marked increase in the size of the Federal Reserve's balance sheet to approx. USD 4.5trn (or 25% of GDP), the Fed is on track to achieving its dual mandate of price stability and maximum employment. Core personal consumption expenditure (PCE) inflation is broadly in line with, albeit slightly below, the medium-term target of 2%. The Federal Open Market Committee (FOMC) raised the target range for the federal funds rate for the first time in December 2015; it has raised the target range again in December 2016, in March and in June 2017, bringing it to 1-1.25%. While the FOMC stresses the fact that future changes in the federal funds rate will be data-dependent (taking inflation pressures and expectations, labour market conditions as well as financial and international developments into account), Scope expects monetary tightening to continue in 2018, with the federal funds rate expected to converge around the 2.75% neutral policy rate by 2019.

Figure 4: Federal funds, target and core inflation rate (%)



Source: Federal Reserve, BEA

Figure 5: Federal Reserve balance sheet (USD trn)



Source: Federal Reserve

Federal Reserve gradually reducing its balance sheet

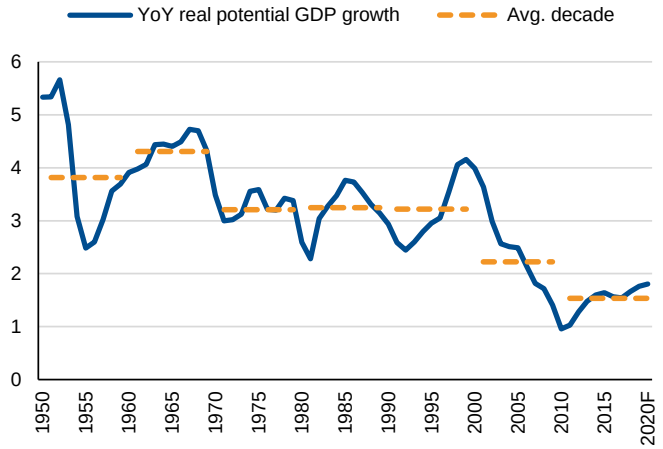
In addition, the Federal Open Market Committee expects to start implementation of its balance sheet normalisation programme this year, by gradually reducing its reinvestment of the principal payments it receives from its US Treasury (USD 2.5trn) and mortgage-backed securities (USD 1.8trn) holdings. Specifically, principal payments received will be reinvested only to the extent that they exceed gradually rising caps to limit the volume of securities that private investors will have to absorb[1]. The IMF expects the Fed balance sheet to decline by USD 318bn in 2018 and by USD 409bn in 2019, estimating that the monetary policy impact would be equivalent to a 22 bp increase in the federal funds rate over two years[2].

Considerable medium-term growth challenges

While the short-term economic outlook is robust, the United States faces considerable medium-term challenges owing to its difficulty in adapting to structural shifts arising from technological changes that are reshaping the labour market, low productivity growth, rising skills premia and an ageing population[3]. In fact, potential GDP growth has slowed significantly because of falling total-factor and labour productivity, and is now estimated at around 1.5% for the 2011-2020 decade – an all-time low since the 1950s, according to data from the Congressional Budget Office (CBO). The IMF has stated that weak productivity growth and the slower growth of the labour force account for three-quarters of the decline in potential growth since 2000.

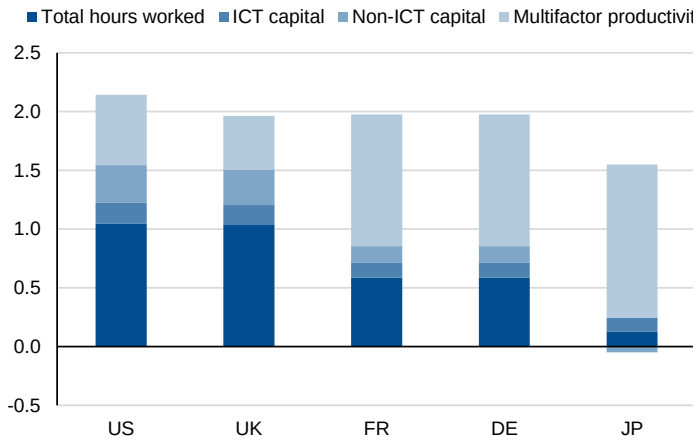
[1] For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that the cap will be an initial USD 6bn per month initially, increasing in steps of USD 6bn at three-month intervals over 12 months until it reaches USD 30bn per month. For payments of principal that the Federal Reserve receives from its holdings of agency debt and mortgage-backed securities, the Committee anticipates that the cap will be USD 4bn per month initially, increasing in steps of USD 4bn at three-month intervals over 12 months until it reaches USD 20bn per month. Federal Reserve System, Monetary Policy Report, July 2017.
[2] IMF, 2017 Article IV Consultation United States, IMF Country Report No. 17/239.
[3] Ibid.

Figure 6: Real potential GDP growth (YoY, %)



Source: CBO

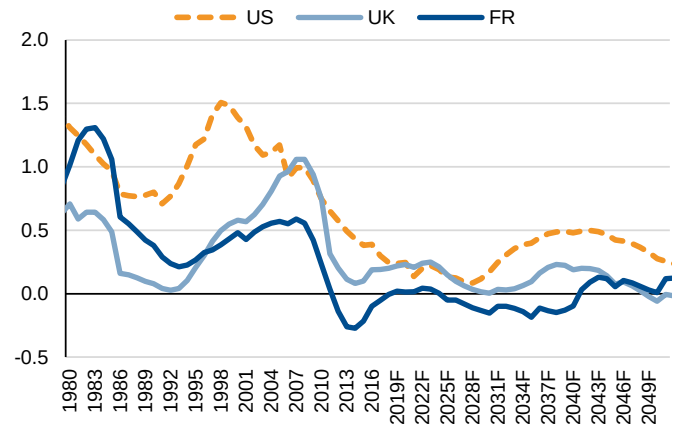
Figure 7: Contribution to real GDP growth (avg. 2010-15,%)



Source: OECD

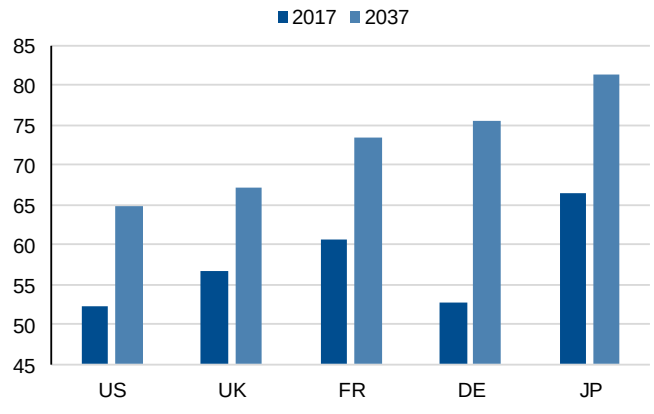
While the US labour market has made significant gains, with the unemployment rate falling to below 5% in 2016 from 10% in 2009, and non-farm employment increasing by about 17m people since 2010, labour force participation peaked in 2000 at 67% and has since fallen to below 63%. According to the IMF, this comparatively low labour force participation rate is due to demographics, institutional factors such as limited subsidies for childcare and lack of paid family leave, as well as declining work opportunities for the low-skilled. Based on UN data, demographic changes alone will further slow labour force growth from an annual average of about 1% over the last 25 years to about 0.2% in the coming decade. Consequently, the dependency ratio, i.e. the share of the old and young (dependents) to the working-age-population will increase from about 52% in 2017 to around 65% by 2037. The United States will therefore, despite positive net migration, not be immune to the consequences of an ageing population.

Figure 8: Working-age population (YoY, %)



Source: UN, Calculations Scope Ratings AG

Figure 9: Dependency ratio (per 100)



Source: UN, Calculations Scope Ratings AG

Income inequality risks reducing consumption and future productivity

In addition, low productivity has been associated with a stagnation in household incomes for a large share of the population. While median household income in inflation-adjusted terms has improved over the past few years, standing at USD 56,516 in 2015, it remains lower than in 1999. Moreover, there has been a widely documented acceleration in income inequality over the past few decades. Based on Census Bureau data, while the

real mean household income of the lowest quintile actually fell by about 3% compared to its 1995 level, over the same time period, the second, third, fourth and fifth quintiles increased their real incomes by 3.5%, 8%, 14% and 20% respectively.

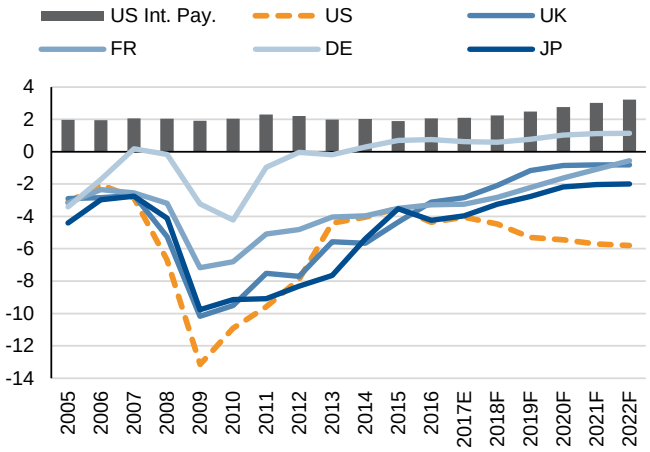
Along with an uneven income distribution, the labour share of income has fallen by about 5% over the past 15 years. Since 2000, most of this decline can be explained by changes in technology linked to the automation of tasks, but also exposure to trade, and the significant decline in union representation of workers. These developments affect US growth prospects as, according to the IMF, income inequality is curbing consumption (which has been the main growth driver), weighing on the labour supply and reducing the ability of households to adapt to shocks. Moreover, with one in seven Americans with incomes currently under the poverty line, high levels of financial need are creating disparities in the education system, hampering human capital formation and reducing future productivity[4].

Public finance risk

Expansionary fiscal policy in response to the Great Financial Crisis

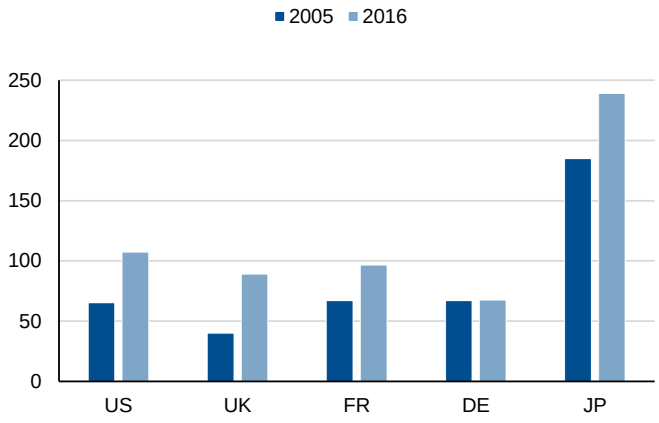
According to IMF World Economic Outlook figures, the budget deficit hit a record high of 13.2% in 2009 (as a result of successive accommodative fiscal policies implemented in response to the GFC) and has fallen gradually to around 4% in 2016, still about 2 pp higher than that of its peers, despite rock-bottom interest expenses of around 2% of GDP. The accumulation of fiscal deficits has also led to a sharp increase in general government gross debt from 65% of GDP in 2005 to around 107% in 2016, currently the second-highest in its highly-rated peer group after Japan.

Figure 10: Fiscal bal. and US interest expenses (% of GDP)



Source: IMF

Figure 11: General govt. gross debt (% of GDP)



Source: IMF, Calculations Scope Ratings AG

According to the Congressional Budget Office, the budget proposals of the Trump administration would reduce the federal deficit from 3.6% of GDP in 2017 to 2.6% by 2027 and keep the federal debt level held by the public at around 80% of GDP, compared to the CBO baseline of 91%[5]. However, the government's macro-economic assumptions include a relatively optimistic real GDP growth rate of 3% from 2021 onwards. Compared to the CBO baseline, the deficit reduction over the 2018-2027 time period would stem from decreased mandatory and discretionary spending as well as lower interest costs.

[4] IMF, 2017 Article IV Consultation United States, IMF Country Report No. 17/239.
[5] The difference between the IMF's general government gross debt and the CBO's gross federal government debt held by the public has been about 30% of GDP over the past few years and represents mostly intra-governmental debt of about USD 5.5trn.

Uncertainty regarding implementation of budget

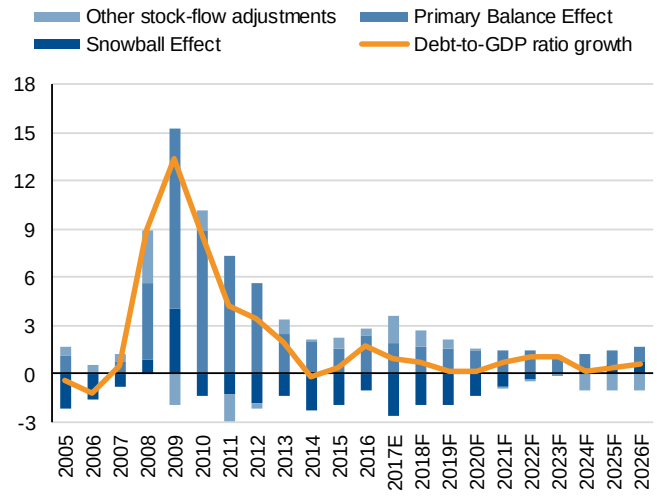
In addition, the Trump administration's budget proposals include about two dozen changes to laws which, if enacted, would reduce revenues by USD 0.9trn over the 2018-2027 horizon. These reductions would mainly be attained by the proposal to repeal and replace provisions of the Affordable Care Act ('Obamacare') leading to lower health insurance coverage[6]. The planned reform of the tax system, which is set to be deficit-neutral, lacks sufficient detail for the CBO to estimate its effects on the budget[7]. In addition, the timing and volume of fiscal stimulus, bringing a reduction in corporate tax rates and infrastructure spending, are, in Scope's assessment, likely to be later and more moderate than originally expected. Taken together, given the great uncertainty regarding the implementation of the proposed budget plans, and because it remains unclear which modifications or alternatives Congress will propose, Scope does not believe it is currently possible to assess how the Trump administration's plans will affect the growth outlook and debt trajectory of the United States.

Debt sustainability concerns

The results of Scope's debt sustainability analysis raise some concerns regarding the debt trajectory. The IMF's baseline scenario expects the debt-to-GDP ratio to increase modestly from about 105% in 2017 to around 113% by 2026. While this is a manageable increase, the interest-rate growth differential is expected to become a debt-creating flow in the future.

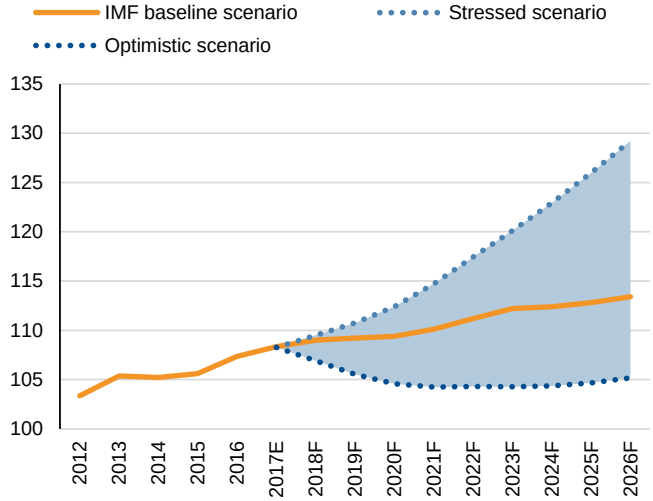
In fact, in Scope's view, the lower potential growth outlook combined with the expected increase in interest rates in line with the ongoing normalisation of the Federal Reserve's monetary policy, and an almost 47-year track record of fiscal deficits (with four years of exception), raises debt sustainability concerns. Thus, in Scope's stressed scenario, which, over the 2018-2026 time period assumes a consistent 0.5 pp reduction (increase) in growth (interest rates and the primary deficit) compared to the IMF's baseline scenario, the debt-to-GDP level rises to around 130% by 2026. Conversely, under a more optimistic scenario, assuming a real GDP growth rate of around 2.7% while keeping the primary deficit and interest rates in line with the IMF's baseline, the debt level remains basically unchanged at around 105% of GDP.

Figure 12: Contribution to gov't debt changes (% of GDP)



Source: IMF, Calculations Scope Ratings AG

Figure 13: General government debt (% of GDP)



Source: IMF, Calculations Scope Ratings AG

[6] At the time of writing this report, it appeared as if Senate Republicans abandoned their latest plan to repeal the Affordable Care Act.
[7] CBO, 'An Analysis of the President's 2018 Budget', July 2017.

2017-2026 average	Real GDP growth (% change)	Primary balance (% of GDP)	Real eff. interest rate (%)	Debt End Period (% of GDP)
Historic values (2012-2016)	2.1	-2.8	0.4	107.4
IMF baseline	1.8	-1.4	1.1	113.4
Optimistic scenario	2.7	-1.4	1.1	104.7
Stressed scenario	1.4	-1.8	1.6	129.2

Source: IMF, Calculations Scope Ratings AG

Unparalleled market access

Purchases of US government bonds benefit from the safe-haven status of the US. Concerns about the sustainability of US debt are partially offset by the US government's low financing costs and unparalleled market access and capital market depth, based on the US dollar's reserve currency status. Specifically, as of Q2 2017, the share of short-term debt (Treasury bills) was around 12% of the total debt stock, with the average maturity of marketable debt ranging between five and six years. The bid-to-cover ratio of the 10-year Treasury note has averaged 2.7 since 2005 (currently around 2.5) and the average interest rate on interest-bearing debt stands at around 2.6%. While the share of international US Treasury holders has doubled from about 15% in 1990 to around 30% in 2017, constituting the second-largest share of Treasuries held after that held by the Federal Reserve, which has about 40%, refinancing risks are limited due to the US dollar's global reserve currency status. Underscoring the ability to finance almost exclusively using the US dollar, only once, during the 1980s, did the US finance itself in foreign currency, when it borrowed in Japanese yen[8].

Unparalleled role of the US dollar as reserve currency

Scope does not believe that the US dollar's reserve currency status will be questioned by investors over the coming years. This status is also because credible alternatives to the US dollar have yet to emerge. In fact, according to the IMF's COFER database, about 65% of the world's total foreign exchange reserves are allocated in US dollars, followed by the euro (20%), yen (5%) and pound sterling (4%) while currently only 1% of allocated reserves are denominated in yuan. Similarly, the share of the US dollar remains the highest among several indicators, including outstanding international debt securities (63%, followed by the euro with 22%), outstanding international loans (59%, followed by the euro with 21%), over-the-counter foreign-currency derivative contracts (44%, followed by the euro with 16%) and international payments (42%, followed by the euro with 31%)[9]. In addition, the US dollar has maintained its position as the dominant exchange rate anchor, with eight countries having adopted the dollar as legal tender and another 31 using the dollar as the officially-announced monetary anchor. However, the share of countries using the dollar as an exchange rate anchor has been steadily decreasing from 33% in 2008 to 20% in 2016[10].

Weakening indispensability of US leadership but no credible alternative in sight

In Scope's view, given the overwhelming dominance of the US dollar, any shift towards another global reserve currency – or a weighted basket of currencies such as the IMF's special drawing rights – is likely to take place either abruptly, via a major geopolitical shock akin to the one that led to the substitution of the British pound by the dollar, or very gradually, over a long period of time, owing to either US domestic- and foreign-policy or market-driven structural changes.

[8] http://voxeu.org/article/external-debt-us-no-cause-concern-yet
[9] https://www.ecb.europa.eu/pub/pdf/other/ecb.euro-international-role-201707.pdf?b4347db86b0303160e518b60e7ddb5fe
[10] https://www.imf.org/~/media/Files/Publications/AREAER/AREAER_2016_Overview.ashx

Within this context, the four upcoming appointments by the Trump administration for the seven-person Federal Reserve Board, even before Chair Janet Yellen's term ends next year, as well as the evolving discussion on the debt ceiling, will represent important sign-posts for Scope's assessment of the independence of the Federal Reserve and fiscal discipline of the federal government.

Significant commitments and contingent liabilities

In addition to the government's gross debt figures, Scope notes the significant burden arising from implicit and explicit federal government commitments as well as from contingent liabilities, due to: i) federal employee and veterans' benefits payable (USD 7.2trn, or 38% of GDP); ii) accrued trust fund deficits related to Social Security and Medicare (USD 46.6trn, or 247% of GDP)[11]; iii) state and local government debts (USD 3.0trn, or 16% of GDP) and unfunded pension obligations (USD 3.8trn, or 20% of GDP); and iv) liabilities of housing-related government-sponsored enterprises (USD 8.7trn, or 45% of GDP)[12].

In Scope's assessment, the first category is a direct liability, while Social Security and Medicare (category two) refer to obligations which the federal government can alter unilaterally. Categories three and four are contingent liabilities which, although not explicitly related to the federal government, could, under specific circumstances, require federal intervention. Adding the first two categories to the officially reported federal government debt, which includes debt held by the public as well as intra-governmental debt, results in a debt-to-GDP ratio of approximately 400%; while adding contingent liabilities raises the potential burden to 478% of GDP[13].

These figures are in line with those from related studies. A Cato Institute study (2014)[14] estimated the total dollar value of the off-balance-sheet commitments of the federal government at around USD 70trn (or 360% of GDP) as of 2012. The study added deposits insured by the Federal Deposit Insurance Corporation but excluded possible contingent liabilities from state and local government commitments. In addition, the study also excluded intra-governmental debt from the federal government liabilities.

Similarly, a 2016 Federal Reserve study estimated that gross general government liabilities, including pensions and health care as well as state and local government debts, amounted to 316% of GDP in 2014, while net liabilities, excluding central and state government assets, amounted to 288% of GDP[15]. Finally, the latest IMF Fiscal Monitor found that among 32 advanced economies, the United States ranks second in terms of total government liabilities, including the net present value of future pension and health care obligations, with a ratio of 260% of GDP, just after Japan (294%), but significantly above the UK (153%), Germany (149%) and France (110%)[16]. As the trustees note, these figures point to the urgent need to implement reforms to numerous benefit programmes.

[11] Editor's note: This section was updated following the special comment 'US Government Obligations & Contingent liabilities: A High and Rising Fiscal Risk' published on October 18 to present the federal budget, not the trust fund perspective. The present value of future government transfers to the Supplementary Medical Insurance trust fund (Medicare Parts B and D) is included as an obligation of the federal government. The original wording was: 'accrued trust fund deficits related to federal employee and veterans' benefits, Social Security and Medicare (USD 21.5trn, or 110% of GDP).'

[12] Scope has excluded guarantees from the Federal Deposit Insurance Corporation from this assessment, given the fact that even the recent global financial crisis was not enough to cause these guarantees to be called and result in a direct cash outflow from the US Treasury. However, the FDIC is a government corporation that was created as part of the Banking Act of 1933 to insure depositors against losses should their banks become insolvent, and, on 3 October 2008, Congress raised the limit on deposit insurance from USD 100,000 to USD 250,000. As of Q1 2017, total FDIC insured deposits amounted to about USD 7trn. https://www.fdic.gov/bank/analytical/quarterly/2017_vol11_2/fdic_v11n2_1q17.pdf
Accrued trust fund deficits refer to the present value of future expenditures in excess of future revenue as reported in the Financial Report 2016 of the US government for the 75-year horizon. The reported unfunded pension liabilities of states are based on market discount rates as calculated by a 2017 study of the Hoover Institution. Unfunded liabilities based on expected returns are about USD 1.4trn.

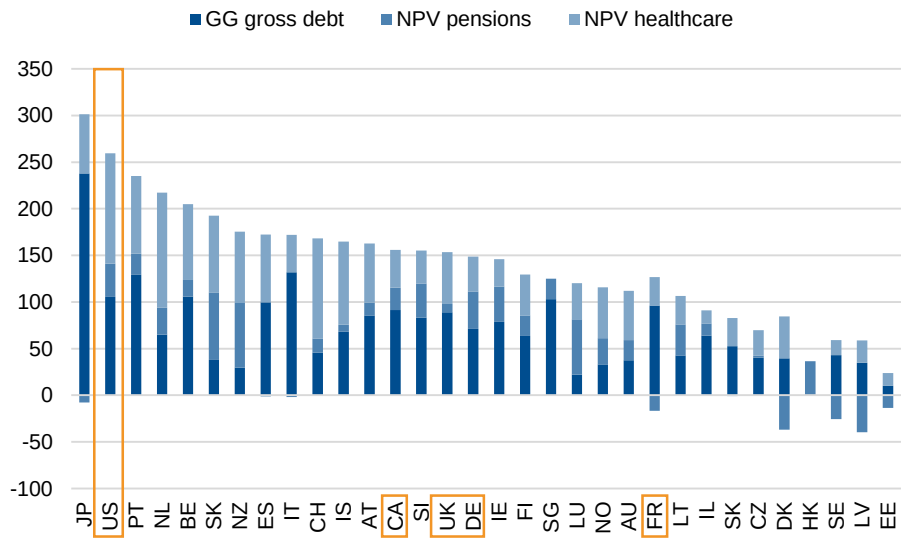
[13] Editor's note: This section was updated following the special comment 'US Government Obligations & Contingent liabilities: A High and Rising Fiscal Risk' published on October 18 to present the federal budget, not the trust fund perspective. The present value of future government transfers to the Supplementary Medical Insurance trust fund (Medicare Parts B and D) is included as an obligation of the federal government. The original wording was: 'Adding the first two categories to the federal government debt level, which includes debt held by the public as well as intragovernmental debt, results in a debt-to-GDP ratio of approx. 250%.'

[14] https://object.cato.org/sites/cato.org/files/serials/files/cato-papers-public-policy/2014/6/cppp-3-1.pdf

[15] https://www.chicagofed.org/~/media/publications/chicago-fed-letter/2016/cfl353-pdf.pdf

[16] www.imf.org/en/Publications/FM/Issues/2017/04/06/fiscal-monitor-april-2017

Figure 14: General gov't obligations, including NPV of future pension and healthcare obligations (% of GDP)



Source: IMF Fiscal Monitor, April 2017

Misuse of debt ceiling

The Public Debt Act of 1941 set an overall limit of USD 65bn on Treasury debt obligations[17] that could be outstanding at any one time. Since 1960, Congress has acted 78 times to permanently raise, temporarily extend, or revise the definition of the debt limit. Increasing or suspending the debt limit was not done to increase spending or authorise new spending; rather, it was done to permit the United States to continue to honour pre-existing commitments to citizens, businesses, and investors domestically and around the world[18].

Scope believes that the US' debt ceiling rule has led to a rating-relevant inconsistency. At present, lawmakers first approve spending but then debate whether to allow the US Treasury to borrow the funds needed to honour its obligations. In fact, over the past few years, this situation has led to several instances in which the US Treasury was weeks or even days away from defaulting on its obligations. In Scope's view, this represents a unique situation among Scope's highly rated sovereigns. As of Q2 2017, debt subject to the statutory limit stood at USD 19.8trn, a mere USD 25m below the limit[19]. On 8 September, Congress again passed a bill to temporarily suspend the statutory debt limit until 8 December 2017. While this removes the immediate pressure to conform to the limit – the debt outstanding increased by USD 317bn in the week after the agreement to just above USD 20trn[20] – it has only extended the problem for three months.

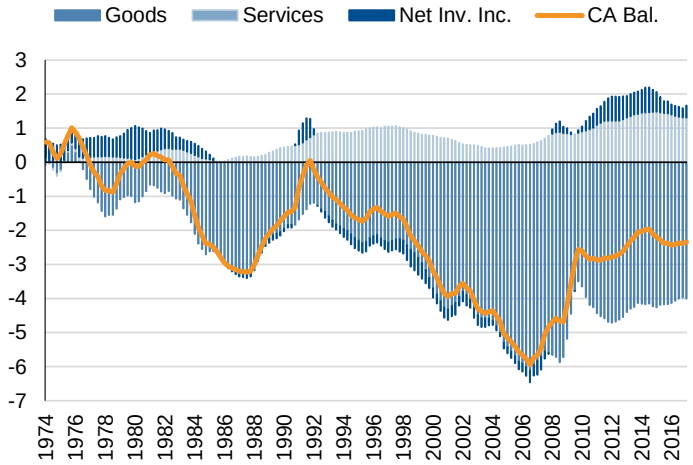
External economic risk

Sustained current-account deficits and negative international investment position

The US generates a persistent current-account deficit that represents a risk to the US external position. The net international investment position (NIIP) deteriorated from -12% of GDP in 2006 to -43% of GDP in Q1 2017. While the current-account deficit has narrowed slightly due to higher private savings, lower investment in the aftermath of the GFC and a significantly improved energy trade balance, Scope expects the current-account deficit to increase somewhat going forward due to moderate fiscal expansion and continued economic growth.

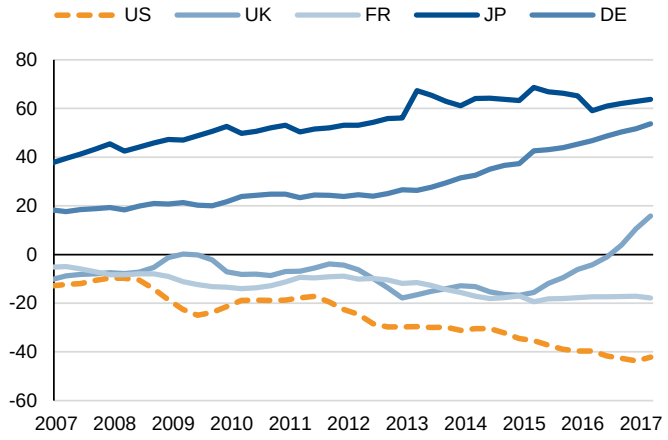
[17] The sum of debt held by the public and intra-governmental debt.
[18] https://www.treasury.gov/initiatives/Pages/debtlimit.aspx
[19] Ibid.
[20] https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=w&fname=17090800.pdf

Figure 15: Current-account balance (% of GDP)



Source: IMF

Figure 16: Net international inv. position (% of GDP)



Source: IMF, Calculations Scope Ratings AG

A negative NIIP usually implies a negative balance of primary income. However, the international assets held by the United States have a strong direct investment (32% of total external assets) and portfolio equity investment (about 30% of total assets) component while external liabilities are overwhelmingly in debt securities (33% of total external liabilities) and loans and deposits (15% of total liabilities). The large share of relatively high-yielding investments in US international assets on the one hand and the large share of low-yielding liabilities on the other result in the US receiving more in dividends and profits on its investments abroad than it has to pay on its lower-yielding external liabilities. For this reason, the net investment income of the United States has been positive over past years.

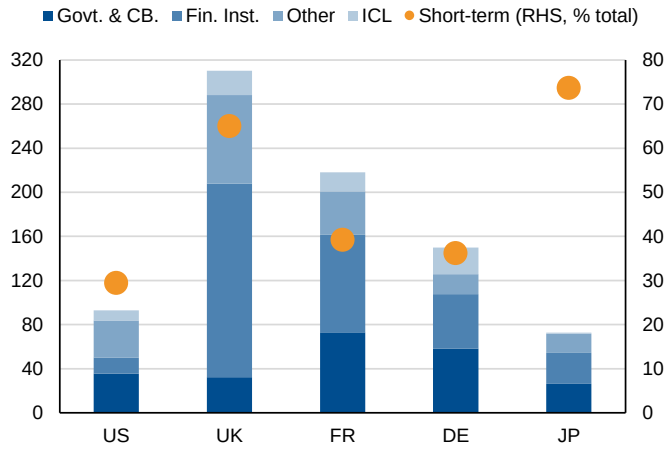
US assets in foreign currency but liabilities in domestic currency

Further, most US foreign assets are in foreign currency, while liabilities are in US dollars. Hence, any appreciation of the US dollar reduces the value of US foreign assets and increases the valuation of its liabilities, negatively impacting the NIIP. This has been the case over the previous two years as the dollar increased by 14% in 2015-2016. Conversely, a depreciation of the US dollar would improve the US NIIP. A 10% depreciation of the US dollar is estimated to improve the US NIIP by USD 1trn, or about 5% of GDP[21]. The recent depreciation of the dollar, down 5% since the beginning of this year on a real trade-weighted basis, should contribute positively to valuation effects on the NIIP going forward.

However, as a large share of US foreign liabilities are in the form of debt securities, Scope believes that rating-relevant financial stability risks may emerge due to an unexpected decline in foreign demand for US debt securities. Such a scenario, although not Scope's baseline, could emerge from a failure to reestablish long-run fiscal sustainability. Within this context, both fiscal and external debt sustainability are crucially intertwined and ultimately are dependent on the global reserve currency status of the US dollar. However, the external debt position of the US compares favourably with that of peers, both in terms of total amount outstanding, at around 90% of GDP, and structure, with the share of short-term debt in total external debt falling from around 40% in 2008 to 30% in Q1 2017.

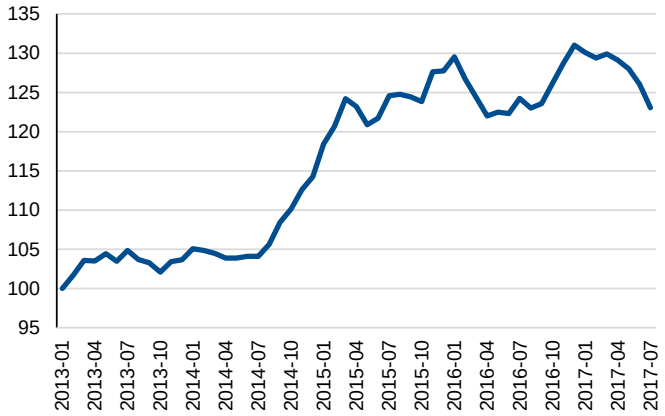
[21] http://voxeu.org/article/external-debt-us-no-cause-concern-yet

Figure 17: External debt (% of GDP)



Source: IMF, World Bank

Figure 18: USD real trade-weighted exchange rate (Jan 2013=100)



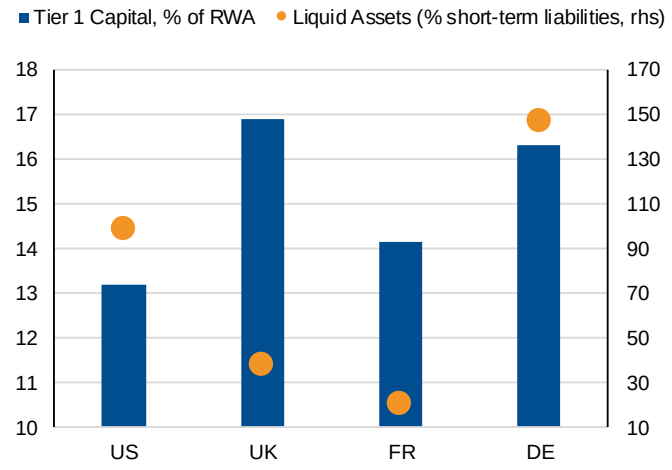
Source: FRB, Calculations Scope Ratings AG

Financial stability risk

Adequate capital and liquidity position of banking system

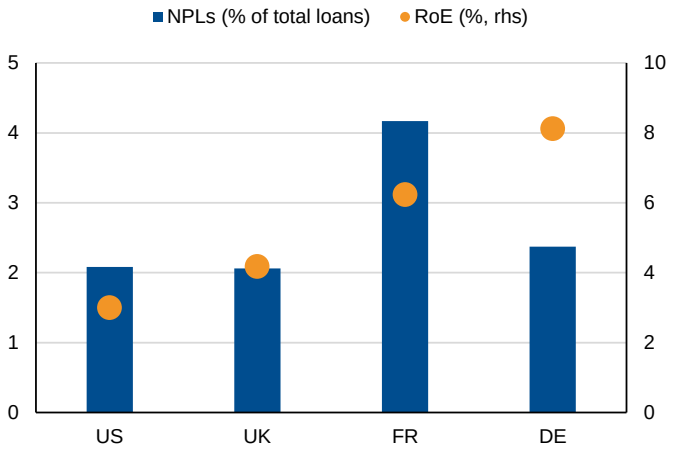
In line with peers, US banks have increased their regulatory Tier 1 capital to risk-weighted assets ratio from about 11% in 2009 to around 13% at the end of 2016, reflecting an increase of about USD 350bn, according to IMF data. The UK and Germany stand out with CET ratios of around 17% and 16% respectively. Scope sees the liquidity of the US banking sector to be adequate, with coverage of short-term liabilities of around 98%, below Germany (147%) but significantly above the UK (38%) and France (20%). With a falling non-performing loan ratio, currently around 1.3%, asset quality is in line with that of peers and in Scope's view, does not constitute an area of concern. However, profitability, measured as return on equity, remains somewhat lower compared to peers at around 3%, despite having improved slightly over the past few years.

Figure 19: Capitalisation and liquidity (2016)



Source: IMF

Figure 20: Asset quality and profitability (avg. 2012-16)



Source: IMF, Calculations Scope Ratings AG

Comprehensive regulatory reforms following the Great Financial Crisis

From a regulatory perspective, substantial progress has been made since the GFC in several areas, including enhanced capital and liquidity requirements, better underwriting standards in the housing sector, greater transparency to mitigate counterparty risks, and limits on proprietary trading. The current law covering financial oversight, the Dodd-Frank Act, requires heightened supervisory intensity, with increased emphasis on bank capital planning, stress testing, and corporate governance, including the Federal Reserve's Comprehensive Capital Analysis and Review. In fact, the Federal Reserve did not object to the capital plans of any of the 34 bank holding companies participating in its latest review. There was, however, one case in which the Board required a financial institution to submit a new capital plan within six months addressing weaknesses identified in its capital planning process[22]. Additional regulatory measures in Dodd-Frank include liquidity risk requirements for money market and mutual funds, the standardisation of derivative products and markets, measures that reduce banks' medium-term asset liability mismatch and a framework for bank recovery and resolution[23].

Recent reform proposals could risk eroding the effectiveness of the regulatory regime

In addition, over the past few months, US authorities have started a formal process of reviewing financial regulations. In March 2017, the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the National Credit Union Administration detailed their review of regulations affecting smaller financial institutions, such as community banks, and described burden-reducing actions. These include: i) simplifying regulatory capital rules for community banks and savings associations; ii) streamlining reports of condition and income; iii) increasing the appraisal threshold for commercial real estate loans; and iv) expanding the number of institutions eligible for less frequent examination cycles[24]. Similarly, the Treasury published its policy proposals in June, which aim to substantially simplify and reduce regulatory costs and burdens as well as tailoring regulations to the size and complexity of a financial organisation's business model.

While some proposed reforms would reduce regulatory overlaps and unnecessary compliance costs, Scope notes that some of the proposals risk an erosion in the effectiveness of the regulatory regime. These include: i) increasing the asset threshold above which banks are subject to Fed stress testing, reducing the number of banks subject to enhanced supervision; ii) excluding Treasury securities from the calculation of the supplemental leverage ratio; and iii) allowing institutions with a 10% leverage ratio to be exempt from risk-based capital, liquidity, stress testing and the Volcker rule[25].

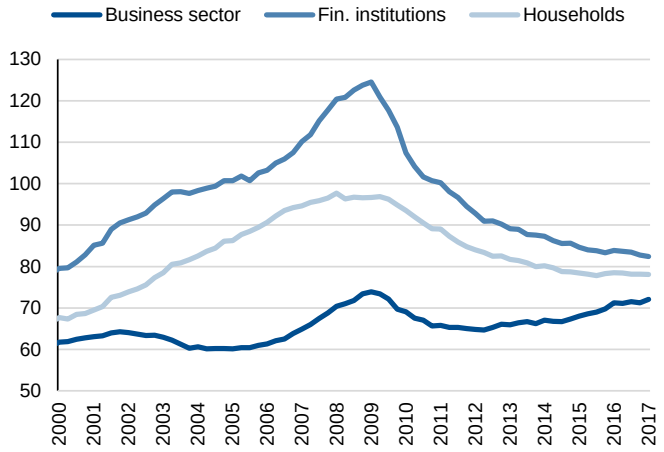
Private debt levels do not pose a concern but a rise in student loans could have negative long-term consequences

Following the GFC, financial institutions reduced their outstanding debt relative to GDP significantly, from 125% in Q1 2009 to around 82% in Q1 2017. Households also cut debt levels from about 97% of GDP to 78% over the same period. While corporate debt increased starting in 2012, the moderate debt ratio of around 72% of GDP remained unchanged. This is further cushioned by the extension of the average maturity of corporate debt from around five years in 2005 to longer than six years in 2016[26]. Scope notes, however, that the composition of household debt has changed meaningfully since Q3 2008, with a decrease in mortgage debt of around USD 600bn, more than offset by significantly higher auto loans (up USD 400bn) and student debt (up USD 700bn). Student debt has consistently increased over the past 15 years to around USD 1.3trn in Q2 2017, with possible long-term consequences for the mortgage market and consumption[27]. Despite these emerging risks, total debt servicing of households remains below financial-

[22] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170628a.htm
[23] IMF, 2017 Article IV Consultation United States, IMF Country Report No. 17/239.
[24] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170321a.htm
[25] https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf
[26] IMF, 2017 Article IV Consultation United States, IMF Country Report No. 17/239.
[27] https://www.nar.realtor/sites/default/files/reports/2017/2017-student-loan-debt-and-housing-09-18-2017.pdf

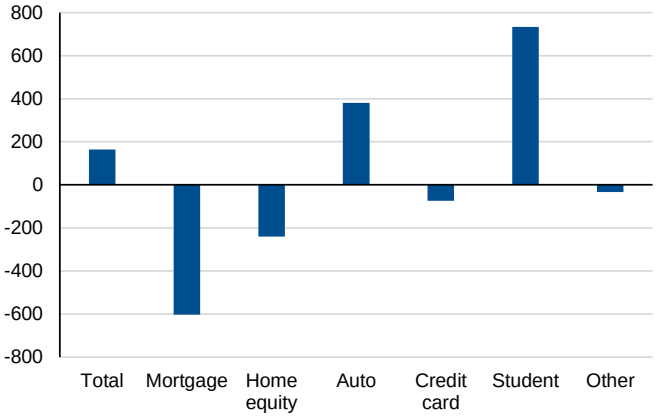
crisis levels, at around 10% of disposable personal income. In addition, new household borrowing has been driven primarily by households with relatively strong credit scores.

Figure 21: Outstanding private sector debt (% of GDP)



Source: FRB

Figure 22: Household debt (Q3 2008 vs Q1 2017, USD bn)

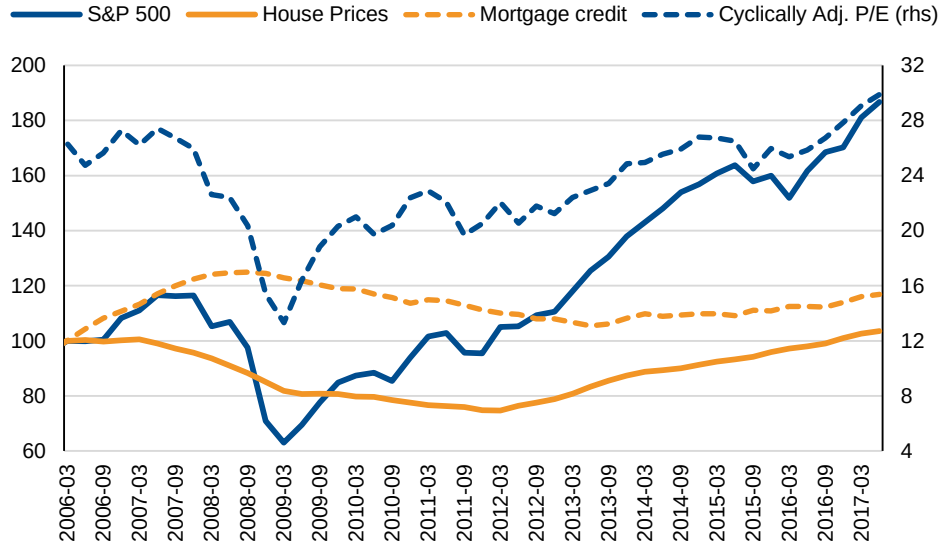


Source: FRBNY, Calculations Scope Ratings AG

Elevated equity markets

Scope believes elevated US asset prices constitute a growing source of financial risk. Equity market valuations are at all-time highs and price-earnings ratios are well above long-term averages. While nominal house price indices are again near or above pre-crisis peaks, mortgage growth has remained subdued and the house-price-to-rents ratio is staying well below the previous peak. However, as interest rates rise, debt servicing will increase, albeit gradually as most household debt is in the form of fixed-interest products[28].

Figure 23: Equity and housing prices (2006 Q1=100)



Source: Standard's & Poor's, Case Shiller Index, FRBNY, Calculations Scope Ratings AG

[28] Federal Reserve System, Monetary Policy Report, July 2017.

Institutional and political risk

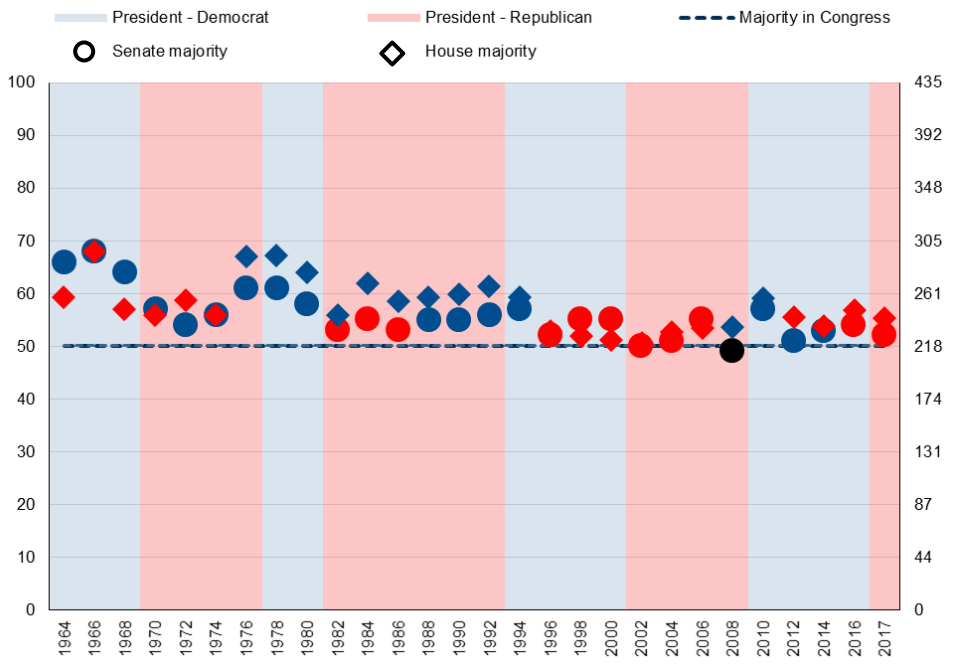
Strong institutional checks and balances

The US benefits from a strong institutional framework with multiple checks and balances between the executive branch, headed by the President, the Congress (Senate and House of Representatives) and the judiciary (the Supreme Court and lower federal courts) at both the federal and state level. This institutional arrangement has allowed the US to effectively address domestic issues and defend its foreign interests in a timely manner, irrespective of which political party was in the Oval Office or commanded a majority in either the Senate or House.

Heightened policy fluctuation

The Trump administration assumed office in January 2017. Despite enjoying a Republican majority in both the House and Senate, President Trump has faced difficulties in implementing his policy agenda. Scope notes the emergence of significant fluctuations in policy outcomes in the US, shifting away from the ideological centre, whenever party control of Congress or the presidency changes. Most recently, this trend has been demonstrated by the ongoing discussion around the repeal and replacement of the Affordable Care Act ('Obamacare'), and the administration's nationalistic, inward-looking approach to trade and investment, including the withdrawal from the Trans-Pacific Partnership and the planned renegotiation of NAFTA, all of which stands in stark contrast to the trade negotiation strategy of the previous administration.

Figure 24: President, Senate (LHS) and House (RHS), party affiliation and seats



Source: http://history.house.gov/Institution/Party-Divisions/Party-Divisions/ and https://www.senate.gov/history/partydiv.htm

Bipartisan collaboration needed to address structural challenges

Scope believes today's political polarisation adversely affects the institutional framework of the United States. This is despite the system of checks and balances enshrined in the US constitution. Nonetheless, in Scope's assessment, the country's long-term structural challenges, including: i) low productivity levels and labour force participation; ii) a high and rising debt level; and iii) elevated contingent liabilities due to Social Security and health care programmes, can only be met via bipartisan cooperation. Scope believes the polarisation of US politics results in costly policy inaction and uncertainty, especially in relation to tackling elevated US government debt and needed structural reforms.

Geopolitical risks likely to drain government resources

From a geo-political point of view, the US is exposed to several ongoing conflicts that could continue to drain the federal government's resources, including the North Korea crisis, wars against the Taliban in Afghanistan and the Islamic State in Iraq, the civil wars in Syria and Libya as well as territorial disputes in the South and East China Seas between China and its neighbours, including Japan[29].

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/governance-and-policies/regulatory/esma-registration.
Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

[29] https://www.cfr.org/interactives/global-conflict-tracker#!/global-conflict-tracker

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative 'AA' ('aa') rating range for the United States of America. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on the analysts' qualitative findings.

The following relative credit strengths have been identified for the United States of America: i) market access and funding sources; ii) external debt sustainability; and iii) resilience to short-term shocks. Relative credit weaknesses include: i) fiscal performance; ii) debt sustainability; iii) recent events and policy decisions; iv) geopolitical risk; and v) macro-financial vulnerabilities and fragility. The combined relative credit strengths and weaknesses generate no adjustment and signal a sovereign rating of AA for the United States of America. A rating committee has discussed and confirmed these results.

Rating overview	
CVS category rating range	aa
QS adjustment	AA
Final rating	AA

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower-case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

The United States of America had foreign-currency-denominated debt for a brief period during the 1980s only. Scope sees no evidence that the United States of America would differentiate among any of its contractual debt obligations based on currency denomination should foreign-currency denominated debt be issued again. This is further corroborated by the recent history of sovereign defaults, which does not provide a strong justification for a rating bias in favour of either local- or foreign-currency debt.

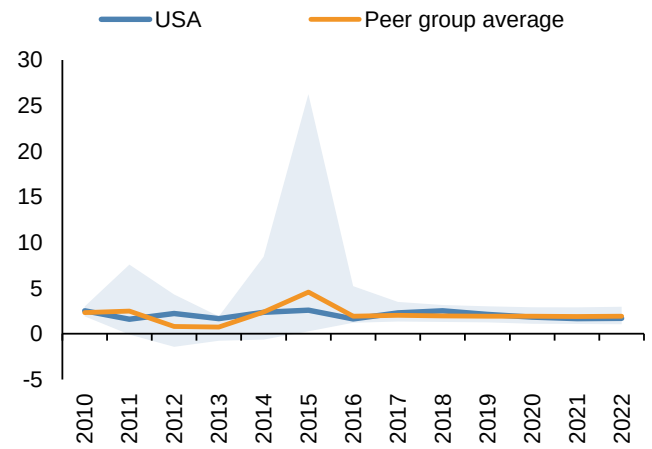
II. Appendix: CVS and QS results

CVS		QS					
			Maximum adjustment = 3 notches				
Rating indicator	Category weight		+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Domestic economic risk	**35%**	Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	◉ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential wel under trend or negative
Economic growth Real GDP growth Real GDP volatility GDP per capita Inflation rate Labour & population Unemployment rate Population growth		Economic policy framework	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
		Macroeconomic stability and imbalances	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Public finance risk	**30%**	Fiscal performance	○ Exceptionally strong performance	○ Strong performance	○ Neutral	◉ Weak performance	○ Problematic performance
Fiscal balance GG public balance GG primary balance GG gross financing needs Public debt GG net debt Interest payments		Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	○ Neutral	◉ Weak sustainability	○ Not sustainable
		Market access and funding sources	◉ Excellent access	○ Very good access	○ Neutral	○ Poor access	○ Very weak access
External economic risk International position International investment position Importance of currency Current-account financing Current-account balance T-W effective exchange rate Total external debt	**15%**	Current-account vulnerabilities	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
		External debt sustainability	◉ Excellent	○ Good	○ Neutral	○ Poor	○ Inadequate
		Vulnerability to short-term shocks	◉ Excellent resilience	○ Good resilience	○ Neutral	○ Vulnerable to shock	○ Strongly vulnerable to shocks
Institutional and political risk	**10%**	Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Control of corruption Voice & accountability Rule of law		Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
		Geo-political risk	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Financial risk	**10%**	Financial sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Non-performing loans Liquid assets Credit-to-GDP gap		Financial sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
		Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Indicative rating range	**aa**	*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**					
QS adjustment	**AA**						
Final rating	**AA**						

Source: Scope Ratings AG

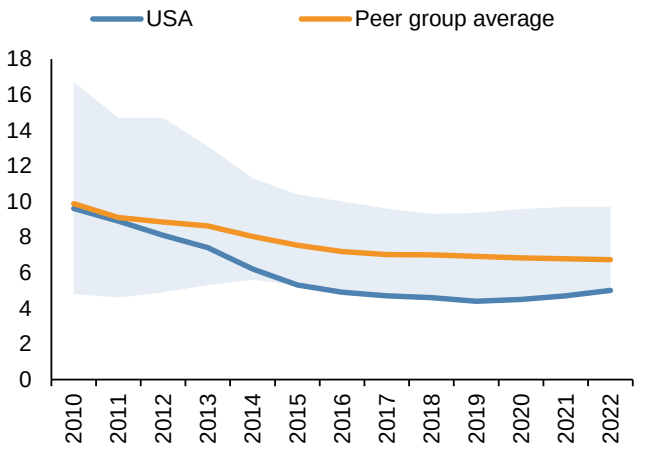
III. Appendix: Peer comparison

Figure 25: Real GDP growth



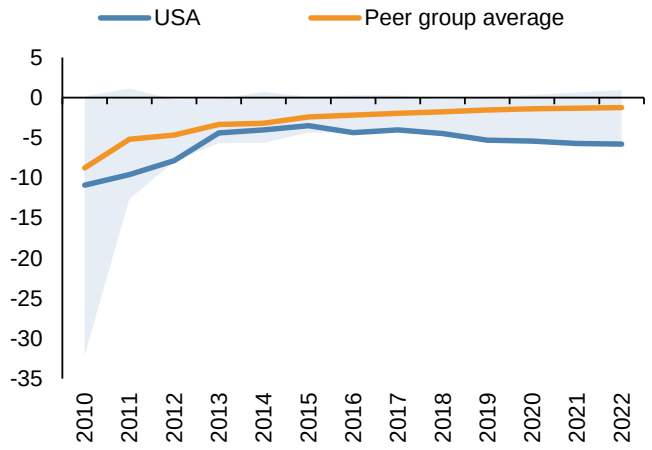
Source: IMF, Calculations Scope Ratings AG

Figure 26: Unemployment rate, % of total labour force



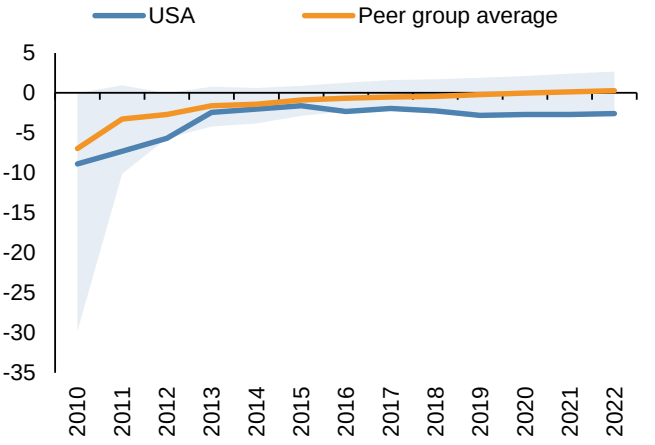
Source: IMF, Calculations Scope Ratings AG

Figure 27: General government balance, % of GDP



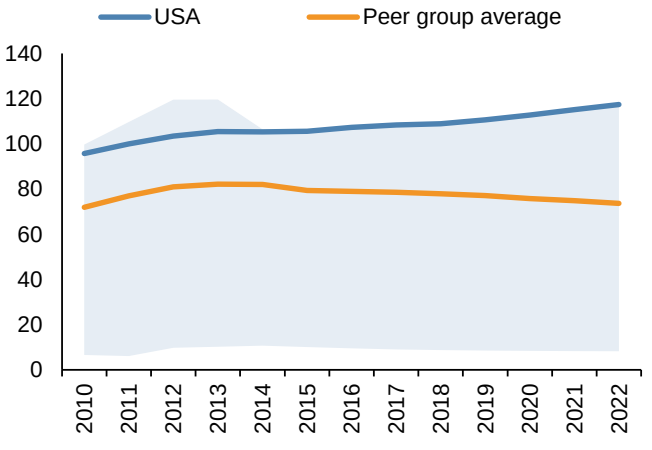
Source: IMF, Calculations Scope Ratings AG

Figure 28: General government primary balance, % of GDP



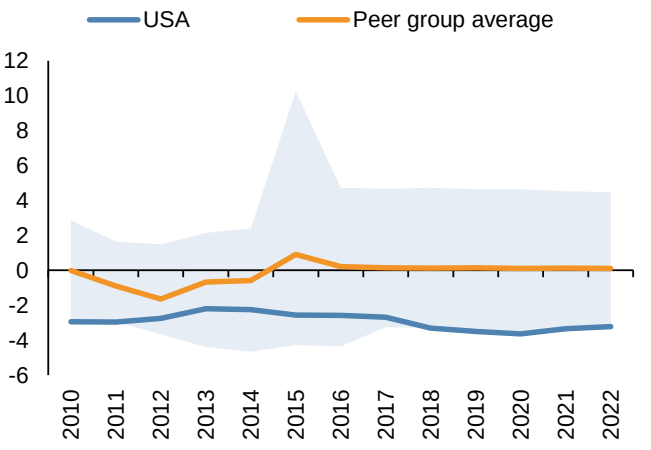
Source: IMF, Calculations Scope Ratings AG

Figure 29: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 30: Current-account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (Bil.USD)	16,155.3	16,691.5	17,393.1	18,036.7	18,569.1	19,417.1	20,351.8
Population (millions)	313.3	315.5	317.7	319.9	322.2	324.5	326.8
GDP-per-capita PPP (USD)	51,450.1	52,787.0	54,598.6	56,207.0	57,466.8	-	-
GDP per capita (USD)	51,403.4	52,741.7	54,559.9	56,174.9	57,436.4	59,609.1	62,002.0
Real GDP grow th, % change	2.2	1.7	2.4	2.6	1.6	2.1	2.1
GDP grow th volatility (10-year rolling SD)	1.9	1.9	1.8	1.7	1.7	1.7	1.6
CPI, % change	2.1	1.5	1.6	0.1	1.3	2.7	2.38
Unemployment rate (%)	8.1	7.4	6.2	5.3	4.9	4.7	4.6
Investment (% of GDP)	19.4	19.8	20.0	20.3	19.7	20.0	20.6
Gross national savings (% of GDP)	17.7	18.3	19.2	19.1	18.6	17.3	17.3
Public finances							
Net lending/borrow ing (% of GDP)	-7.9	-4.4	-4.0	-3.5	-4.4	-4.0	-4.5
Primary net lending/borrow ing (% of GDP)	-5.7	-2.4	-2.0	-1.6	-2.3	-1.9	-2.2
Revenue (% of GDP)	29.4	31.6	31.5	31.8	30.9	31.0	30.4
Expenditure (% of GDP)	37.3	36.0	35.6	35.3	35.2	35.1	34.9
Net interest payments (% of GDP)	2.2	2.0	2.0	1.9	2.0	2.1	2.23
Net interest payments (% of revenue)	7.5	6.3	6.4	5.9	6.6	6.8	7.3
Gross debt (% of GDP)	103.4	105.4	105.2	105.6	107.4	108.3	108.91
Net debt (% of GDP)	80.2	81.5	81.0	80.5	81.5	82.4	83.1
Gross debt (% of revenue)	351.7	333.3	333.6	332.3	347.8	349.4	358.0
External vulnerability							
Gross external debt (% of GDP)	97.1	98.9	99.0	96.9	98.4	-	-
Net external debt (% of GDP)	-	-	-	-	-	-	-
Current-account balance (% of GDP)	-2.8	-2.2	-2.3	-2.6	-2.6	-2.7	-3.3
Trade balance [FOB] (% of GDP)	-4.6	-4.2	-4.3	-4.2	-4.0	-	-
Net direct investment (% of GDP)	0.8	0.6	0.6	-1.1	-0.9	-	-
Official forex reserves (EOP, Mil. USD)	50,459.6	42,663.8	42,226.0	39,572.0	39,160.0	-	-
REER, % change	3.0	0.6	2.6	13.4	4.0	-	-
Nominal exchange rate (EOP, USD/EUR)	1.32	1.38	1.21	1.09	1.05	-	-
Financial stability							
Non-performing loans (% of total loans)	3.3	2.5	1.9	1.5	1.3	-	-
Tier 1 ratio (%)	12.7	12.8	13.1	13.1	13.2	-	-
Private debt (% of GDP)	149.9	148.9	148.6	149.4	151.6	-	-
Domestic Credit-to-GDP gap (%)	-15.1	-14.7	-13.1	-10.7	-7.7	-	-

Source: US Treasury, Federal Reserve, IMF, World Bank, BIS, OECD, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by Rudolf Alvise Lennkh, Lead Analyst

Person responsible for approval of the rating: Dr Stefan Bund, Chief Analytical Officer

The ratings/outlook were first assigned by Scope as a subscription rating in January 2002. The subscription ratings/outlooks were last updated on 05.05.2017. The senior unsecured debt ratings as well as the short term issuer ratings were assigned by Scope for the first time. As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on the United States of America are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

Rating Committee: the main points discussed were: i) economic growth potential and outlook; ii) public finance performance and debt sustainability analysis, including contingent liabilities; iii) external debt sustainability; iv) the role of the US dollar; v) financial and banking sector performance; vi) political polarisation and policy uncertainty; and vii) consideration of peers.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: US Treasury, Federal Reserve, BIS, IMF, ECB, OECD, WB, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

Conditions of use / exclusion of liability