

Why the United States is no longer AAA

Alvise Lennkh

Associate Director, Public Finance
a.lennkh@scoperatings.com

Giacomo Barisone

Managing Director, Public Finance
g.barisone@scoperatings.com



Analyst Conference Call, 11 October 2017, Frankfurt



Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

➤ On 29 September 2017, Scope affirmed US sovereign rating at AA Stable Outlook

Credit strengths

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

Credit weaknesses

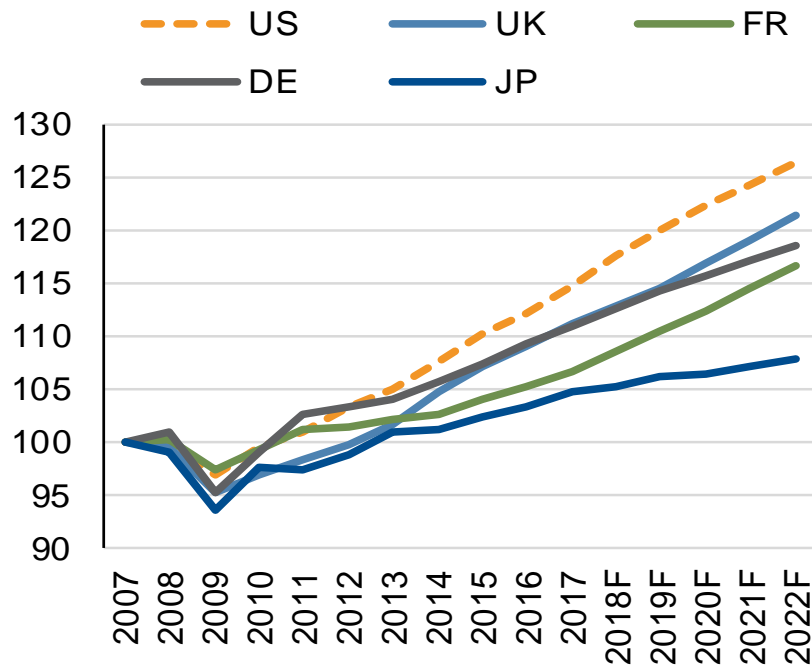
- Weakening potential growth outlook
- Large government debt burden
- High contingent liabilities
- Policy inaction and uncertainty

Why the United States is no longer AAA

Quick recovery with full employment; comprehensive crisis response

Real GDP growth

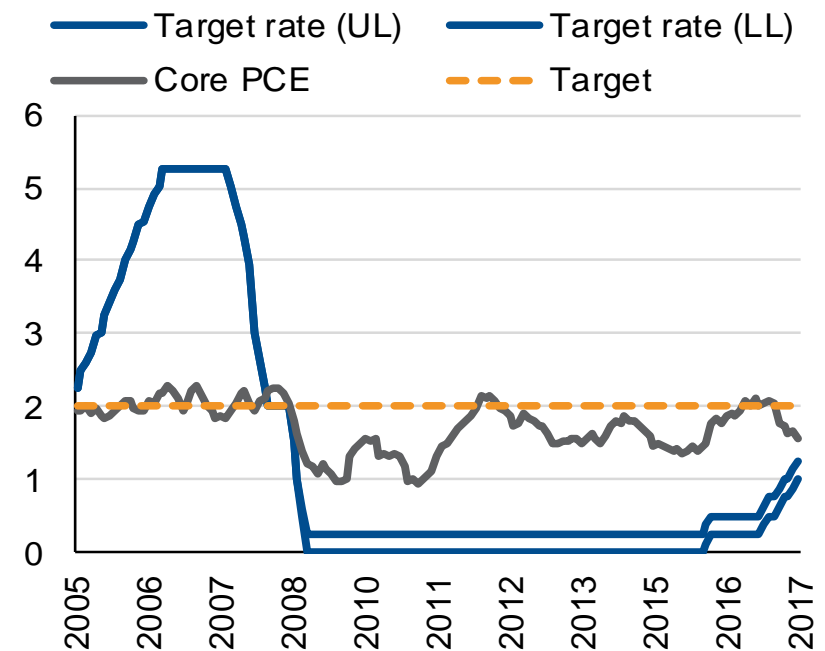
2007=100



Source: Bureau of Economic Analysis

Federal funds, target and core inflation

%



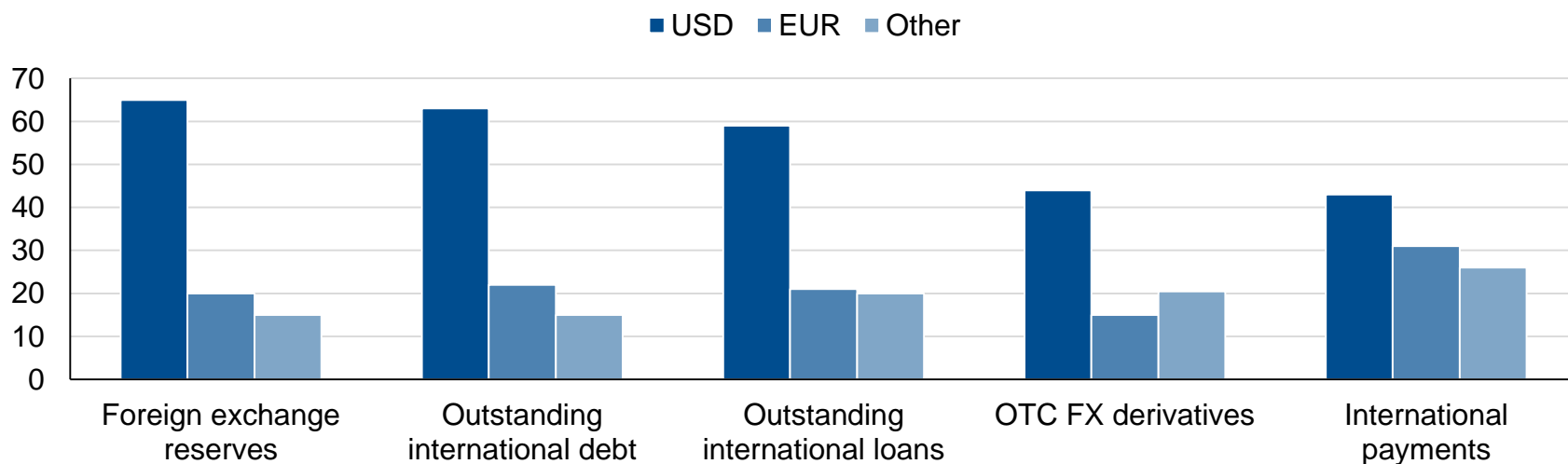
Source: IMF, Calculations Scope Ratings AG

Why the United States is no longer AAA

Unparalleled global reserve currency status

Currency composition

% of total



Source: BIS, ECB, IMF

➤ Qualitative Scorecard

- Excellent - Market access and funding sources
- Excellent - External debt sustainability
- Excellent - Resilience to short-term shocks



Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

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

Credit weaknesses

➤ Weakening potential growth outlook

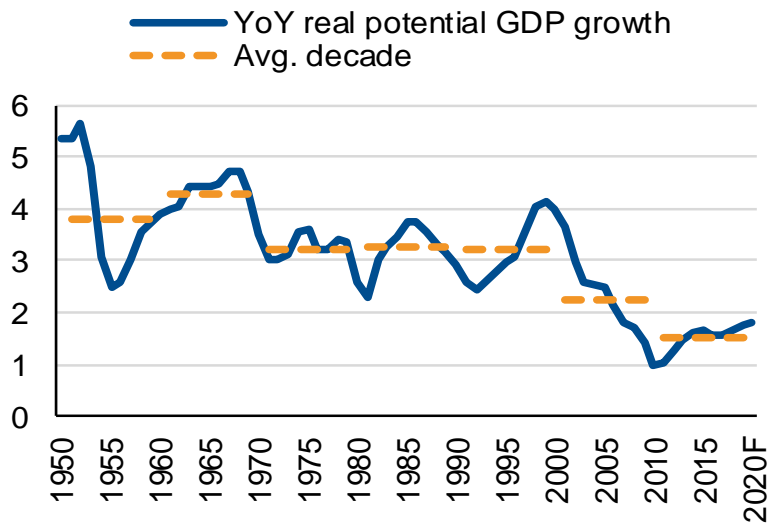
- Large government debt burden
- High contingent liabilities
- Policy inaction and uncertainty

Why the United States is no longer AAA

Weakening potential growth outlook due to lower productivity...

Real potential GDP growth

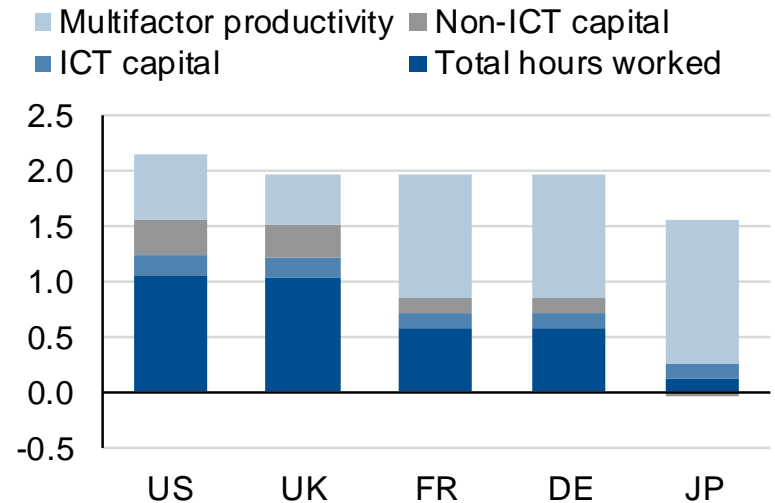
Y-o-Y % change



Source: CBO

Contribution real GDP growth

Avg. 2010-15, %



Source: OECD

➤ Causes

- Dwindling impact of IT revolution?
- Slower 'Schumpeterian' forces?
- Slowdown in global trade?

➤ Impact

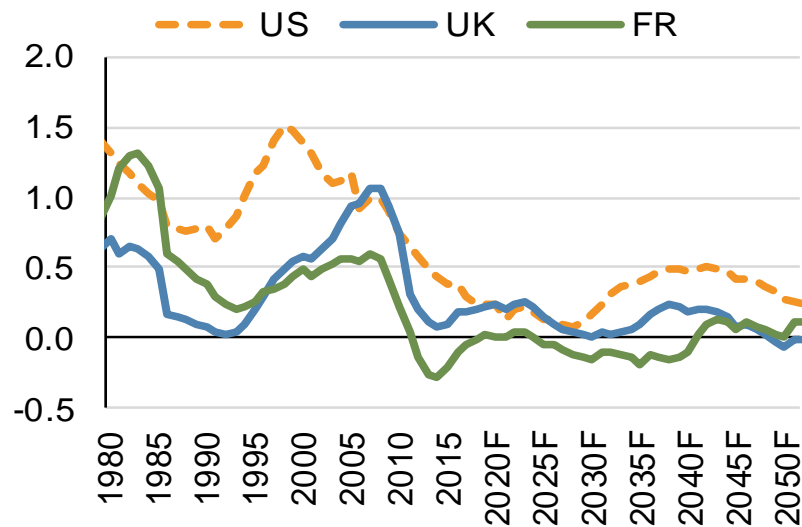
- Lower growth contribution from multi-factor productivity

Why the United States is no longer AAA

...and a lower growth contribution from labour going forward

Working-age population

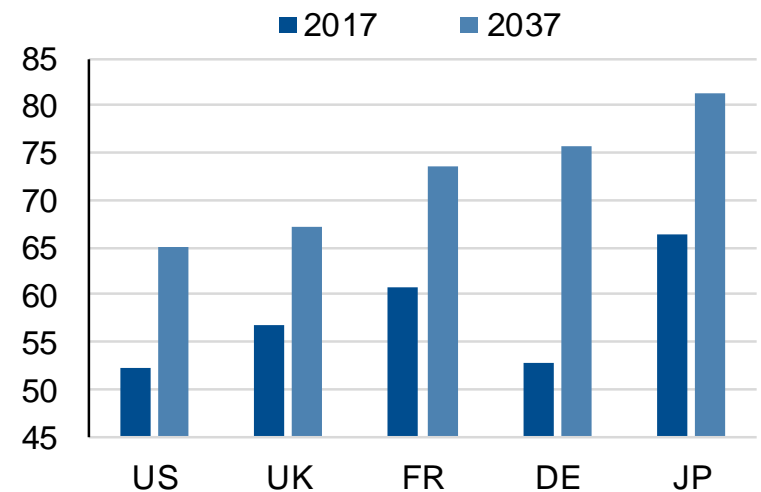
Y-o-Y % change



Source: UN

Dependency ratio

Per 100



Source: Census Bureau

➤ Causes

- Demographics
- Institutional factors
- Declining opportunities for low-skilled workers

➤ Impact

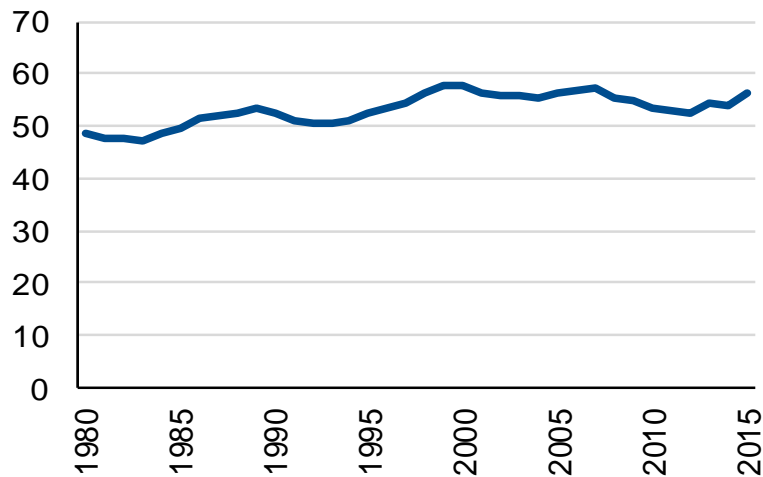
- Lower growth contribution from labour

Why the United States is no longer AAA

Income stagnation and inequality also dampen growth outlook

Income stagnation...

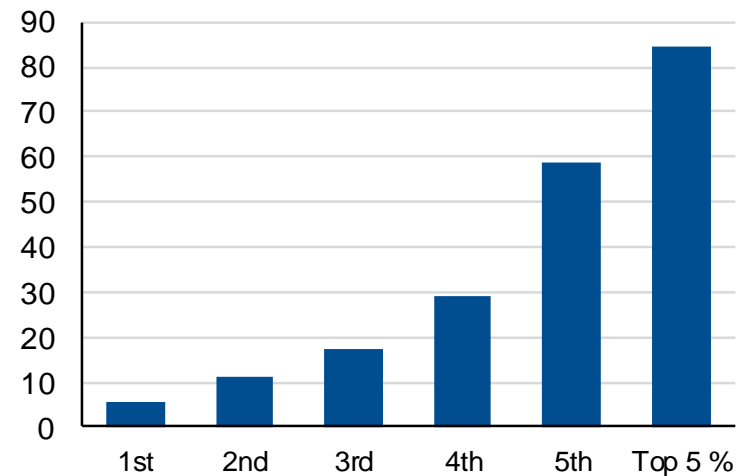
Real median household income, USD (1,000s)



Source: Census Bureau

...and rising income inequality

1980 to 2015, % change per quintile



Source: Census Bureau
NB: Real mean household income

➤ Causes

- Automation of tasks
- Exposure to trade
- Decline in union representation

➤ Impact

- Curbs consumption
- Weighs on labour supply
- Creates disparities in education system



Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

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

Credit weaknesses

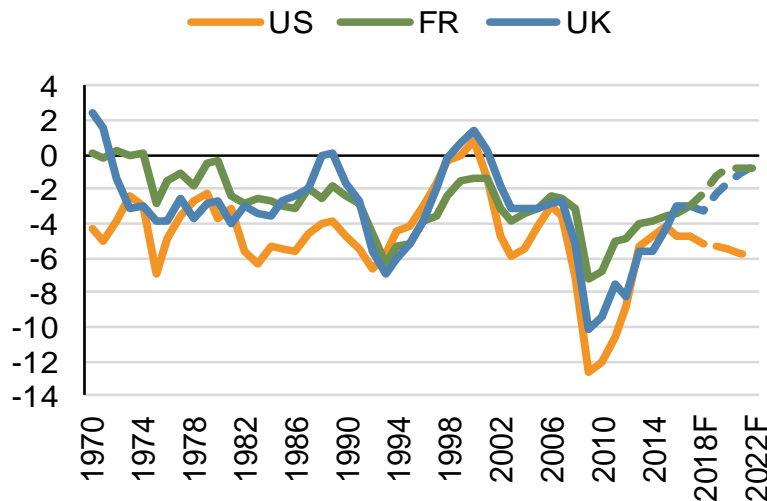
- ✓ Weakening potential growth outlook
- Large government debt burden
- High contingent liabilities
- Policy inaction and uncertainty

Why the United States is no longer AAA

Continuous fiscal deficits and rising debt level

Fiscal balances

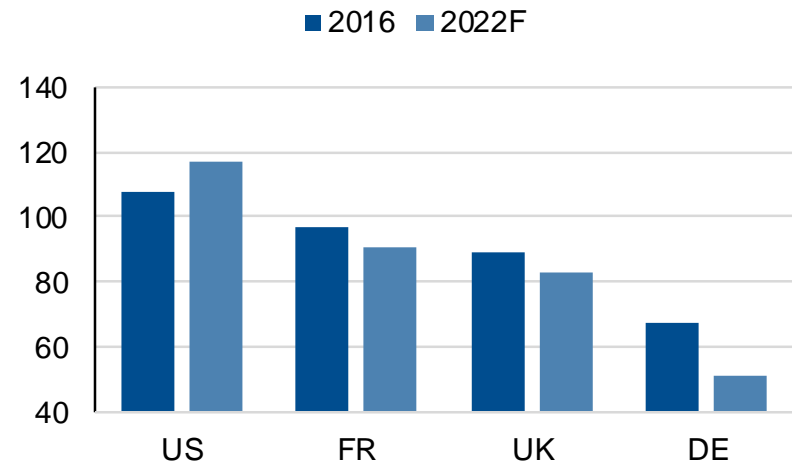
% of GDP



Source: IMF, EC, UK ONS

General government debt

% of GDP



Source: IMF

➤ Uncertainty related to fiscal legislation

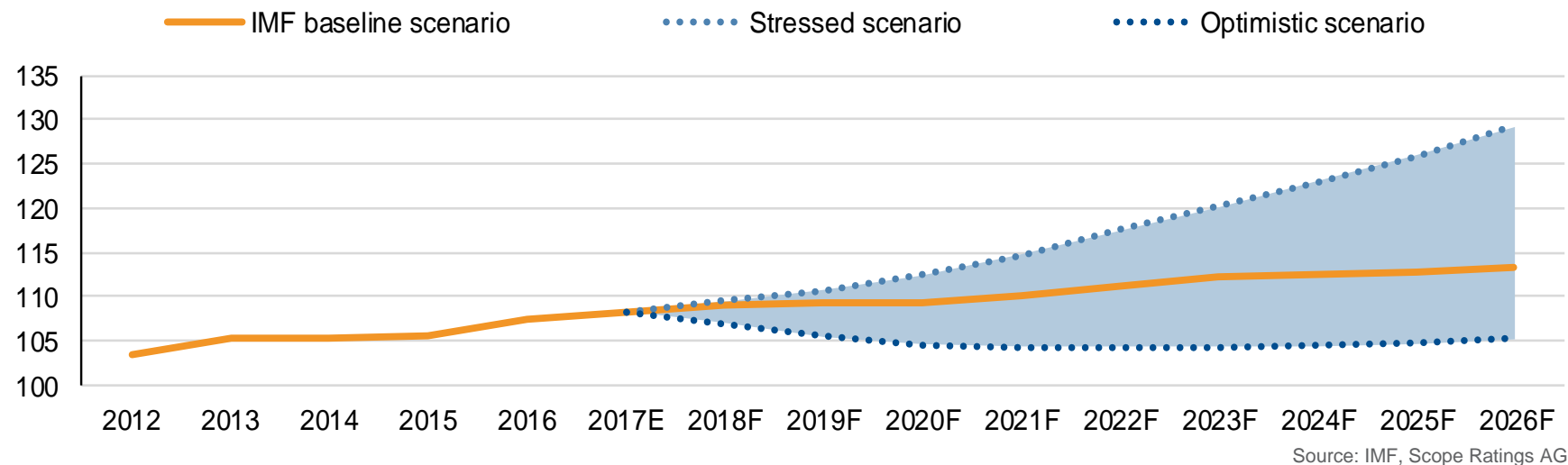
- Proposals include significant discretionary spending and tax cuts
- Scope's baseline: deficit enhancing budget by the end of the year

Why the United States is no longer AAA

Debt sustainability concerns

Debt sustainability analysis

% of GDP



2017-2026 average	Real GDP growth (%)	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



Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

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

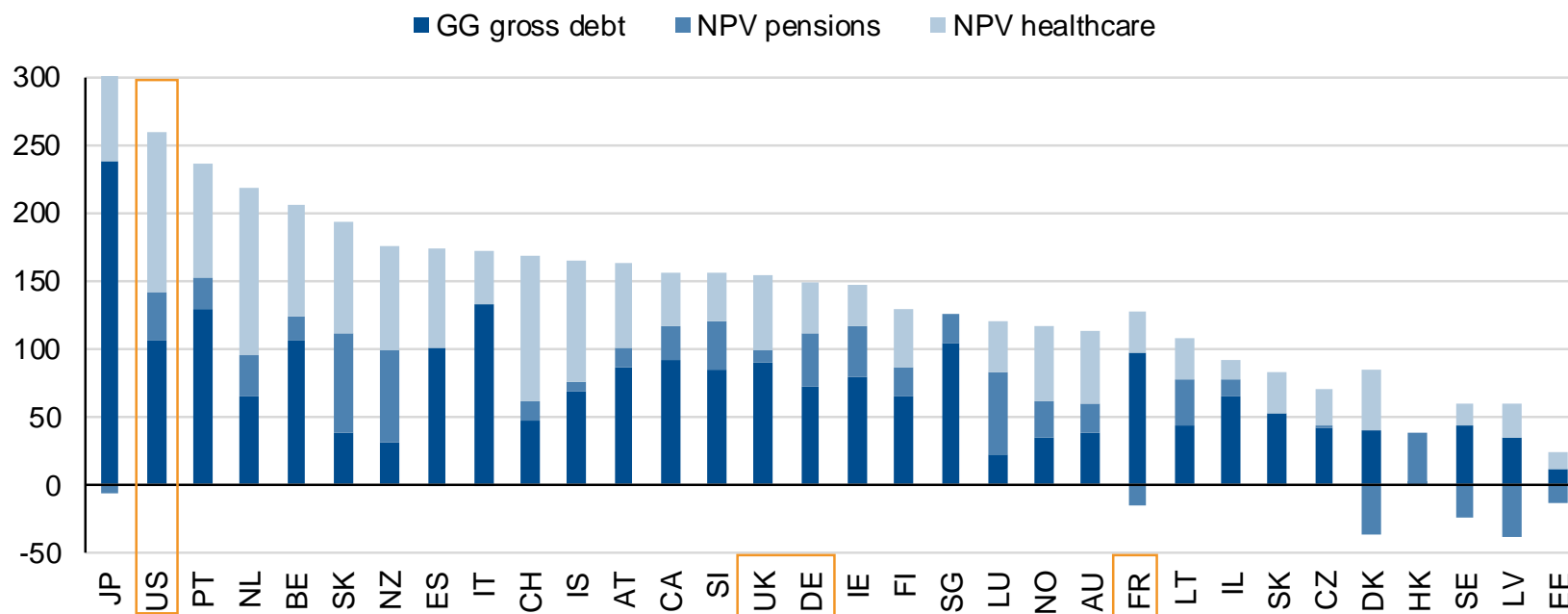
Credit weaknesses

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

Why the United States is no longer AAA

High contingent liabilities

General gov't obligations, including NPV of future pension and healthcare obligations % of GDP



Source: IMF Fiscal Monitor 2017

➤ Similar studies

- Cato Institute (2014): 360% of GDP (incl. FDIC and GSEs, excl. states, higher PV for pensions/health)
- Federal Reserve (2016): 316% of GDP (incl. state debt, pensions and health-care, excl. FDIC and GSEs)



Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

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

Credit weaknesses

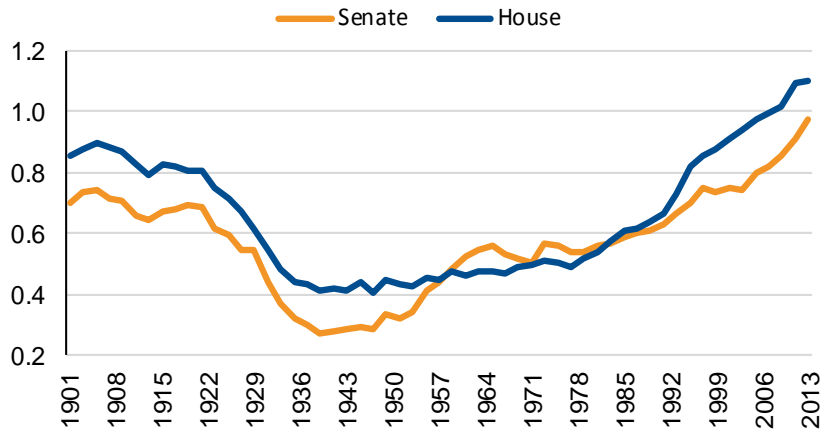
- ✓ Weakening potential growth outlook
- ✓ Large government debt burden
- ✓ High contingent liabilities
- Policy inaction and uncertainty

Why the United States is no longer AAA

Political polarisation at the expense of moderates

Distance between parties

Variance in DW-NOMINATE scores*



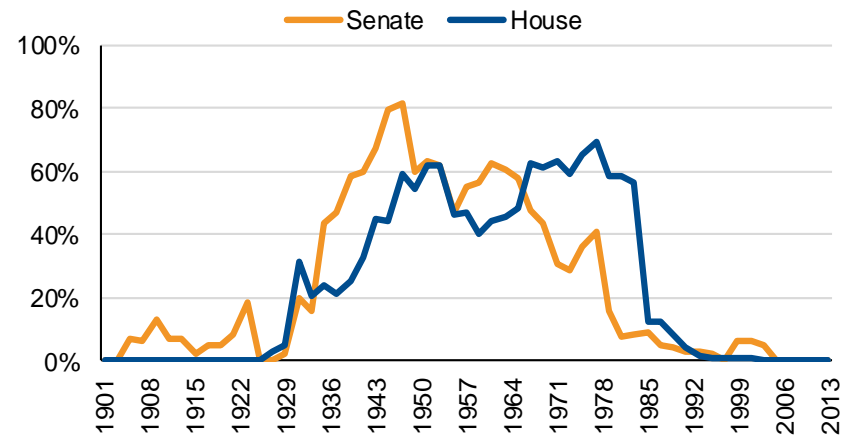
Source: https://legacy.voteview.com/Political_Polarization_2014.htm

NB: Distance between parties refers to ideological distance between moderates of each party

*Higher value indicates greater ideological distance between parties.

Overlapping members

% of total Congress members



Source: https://legacy.voteview.com/Political_Polarization_2014.htm

NB: Overlapping members refers to members of both parties that have overcome traditional party discipline by voting with the other party.

➤ Among the electorate

- Americans with a 'very unfavourable' view of the opposing party: 2016 (>50%); 1990s (20%)

➤ In Congress

- At the expense of moderates who bridge the parties to broker crucial compromises

Why the United States is no longer AAA

Policy inaction, swings and uncertainty

➤ Policy inaction

- Missed deadlines (appropriations process)
- Widespread use of the filibuster threat
- Delays in appointments

➤ Policy uncertainty

- Repeal and replace Affordable Care Act
- Budget reform / tax legislation
- Appointments to Federal Reserve Board

➤ Inability to address

- High debt level
- Significant pension and health-care liabilities

➤ Policy swings

- Inward-looking trade negotiations
 - Withdrawal from Trans-Pacific Partnership
 - Renegotiating NAFTA
- Withdrawal from Paris Climate Change Agreement

Why the United States is no longer AAA

Inherent credit strengths but important rating constraints

Credit strengths

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

Positive rating-change drivers

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

Credit weaknesses

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

Negative rating-change drivers

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



BERLIN

Lennéstraße 5
10785 Berlin
Germany

+49 30 27891-0
info@scoperatings.com
www.scoperatings.com



FRANKFURT – GERMANY

Eurotheum
Neue Mainzer Straße 66-68
60311 Frankfurt am Main



LONDON – UK

2 Angel Square
EC1V 1NY London



MADRID – SPAIN

Paseo de la Castellana 95
Edificio Torre Europa
28046 Madrid



MILAN – ITALY

Via Paleocapa 7
20121 Milan



OSLO – NORWAY

Haakon VII's gate 6
0161 Oslo



PARIS – FRANCE

33 rue La Fayette
75009 Paris



Disclaimer

© 2017 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings AG, Scope Analysis, Scope Investor Services GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope cannot, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided "as is" without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or otherwise damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party, as opinions on relative credit risk and not as a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings AG at Lennéstraße 5, D-10785 Berlin.