



Potential Impact of U.S. Credit Downgrade on Fixed Income Markets

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Executive Summary

Investment professionals from Standish Mellon Asset Management Company LLC share their initial thoughts in response to Standard & Poor's (S&P) downgrade of the U.S. government's debt to AA+ from AAA. They point out that while Moody's confirmed, as did Fitch, the AAA rating for the U.S., though on negative outlook, S&P's action might potentially have a far-reaching impact on fixed income markets. S&P has also maintained a negative outlook on U.S. government debt, even with the downgrade. The group looks at what was in S&P's report from August 5, 2011, and discusses potential effects on different segments of the fixed income markets.

Credit Rating Impact

S&P noted that while banks and broker dealers wouldn't likely suffer any immediate ratings downgrades, it would downgrade the debt of Fannie Mae, Freddie Mac, the AAA-rated Federal Home Loan Banks, and the AAA-rated Federal Farm Credit System Banks to correspond with the U.S. sovereign rating downgrade. S&P said it would also lower the ratings on AAA-rated U.S. insurance groups, as per its criteria that correlates insurers' and sovereigns' ratings.

For structured financing transactions, S&P said it would assess the degree of each deal's exposure to U.S. government obligations or guarantees as part of its analysis. S&P said it believes that any potential modest rise in interest rates would not generally affect the ratings of structured finance transactions. For tax-exempt securities, pre-refunded municipal bonds, FHA, GNMA and FNMA-backed housing bonds as well as federally funded project finance bonds (Garvee) will be directly affected, according to the S&P report. We believe the combined market share of these credits is minimal. Moody's did not downgrade the five AAA state general obligation credits or the local general obligation (GO) bonds that it had considered in the event of a federal government downgrade.

After the S&P announcement, the Federal Reserve immediately reported that, for risk-based capital purposes, the risk weights would not change for U.S. Treasury securities and other securities issued or guaranteed by the U.S. government, government

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agencies, and government-sponsored entities. The treatment of Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities under other federal banking agency regulations, including, for example, the Federal Reserve Board's Regulation W, would also be unaffected, according to the Fed statement.

Potential Market Reaction

According to S&P's internal analysis, it believes that the downgrade could result in a moderate rise in long-term interest rates (25-50 basis points), despite an accommodative Fed, due to an ebbing of market confidence, as well as some slowing of economic growth (25-50 basis points on GDP growth) amid an increase in consumer and business caution.

We anticipate heightened financial market volatility and a further correction in risk assets in the near term. Ironically, despite S&P's ratings action, U.S. Treasuries are benefiting from a flight to safety bid as a result of the sell-off in global equity markets. However, once financial markets stabilize, Treasuries could come under pressure as investors price in the new rating. We would view this as a buying opportunity, given the deterioration in the economic outlook.

In the municipal bond market, we believe certain categories of munis might sell off. We would also view this as a potential buying opportunity. The likeliest candidate for this scenario, in our view, is the A-rated revenue category. We believe many of these are stable credits even in a weak economy, but less efficiently traded and followed. We are positioned with additional liquidity to exploit this opportunity. The past two weeks have shown great strength in the muni market across all rating categories, so in our view it is hard to predict if munis will be seen as a safe haven or some sectors will experience flight.

In our view, the financial markets will be the primary transmission mechanism for the shock as well as a window into unforeseen consequences. Already we have seen concerted action by global policy makers in response to the S&P decision. We will only be able to fully judge the economic impact of this event once we see the financial market impact in coming weeks.

The final market impact of the present situation is uncertain, but we are standing ready to adjust portfolios as the situation warrants and to take advantage of any temporary market dislocations.

Debt Reduction Impact on the U.S. Municipal Market

As with the downgrade, we believe actions aimed at U.S. deficit reduction are expected to have uneven, but limited, impact on municipal bonds. We expect no material impact on the ability of municipalities to pay debt service. States will likely experience reduced subsidies for infrastructure projects, likely leading to termination or delay. Local governments are more removed from the impact of federal subsidies than states. Reductions to Medicaid payments will likely affect hospital reimbursements, as states' responsibilities are limited to half of total reimbursements. We believe essential purpose revenue bonds are expected to continue to demonstrate stable revenues and cost structures as they operate separately from federal, state and local government.

In our view, potential negative economic fallout from deficit reduction will likely impact tax revenues and could force continued austerity. Still, we believe most state and local GO bonds are strengthened by strong security provisions.

S&P indicated its muni ratings (aside from those cited above) will not be affected by the U.S. downgrade, but the ratings might be in the future, depending on the specific details of a federal deficit reduction program. Moody's said it will review the potential economic and fiscal impact to these credits.

With a base case expectation of possible increased volatility and potentially other more negative effects, we have recently positioned portfolios with less risk relative to their benchmarks. The final market impact of the present situation is uncertain, but we are standing ready to adjust portfolios as the situation warrants and to take advantage of any temporary market dislocations.

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