Research Report on USA

11 May 2018

Responsible Expert:

Gustavo Angel
Rating Associate

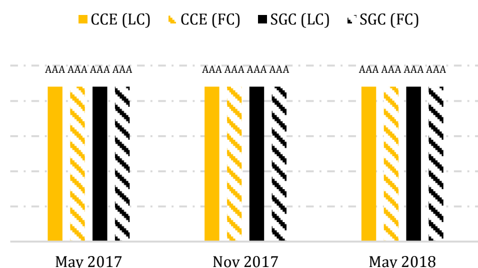
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

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	2015	2016	2017
Gross gov. debt, USD bn	19 080	19 959	20 900
Nominal GDP, USD bn	18 121	18 624	19 391
Real GDP growth, %	2,9	1,5	2,3
Gross gov. debt/GDP, %	105,3	107,2	107,8
Deficit (surplus)/GDP, %	-3,5	-4,2	-4,6
Inflation rate, %	0,7	2,2	2,1
Current Account Balance/GDP, %	-2,4	-2,4	-2,4f
External debt, USD bn	-	-	6,5

Development indicators	2017
Inequality adj. HDI	0,80*
GDP per capita, USD th	59,3

Default indicator	09.05.2018
5-Year CDS spread, Bp	20,12
10Y Gov Bond Yield, %	2,99

Source: RAEX (Europe) calculations based on data from the IMF, WB. *2016.

Summary

The ratings of the United States are confirmed at 'AAA' and remain underpinned by the country's supportive economic conditions and resilience to external and domestic shocks. However, the deterioration and negative forecast of key macroeconomic metrics challenges the long-term sustainability of these ratings.

Gross government debt increased between February and April 2018 following the recently passed tax reform and suspension of the debt limit until March 2019. If this scenario remains in place, we can anticipate debt metrics to increase and fiscal deficit to widen further through 2018.

Monetary policy normalization is set to continue on the back of higher inflation expectations and stable economic growth, which is likely to propel further interest rate hikes throughout the current year. Inflows of foreign direct investments (FDI) recorded its largest drop since the 2009 financial crisis, showing a slowdown of investments in the country. Nonetheless, this might be partially offset by a potential windfall of investments motivated by the recently passed tax reform.

In our view, a potential renegotiation of NAFTA and the recent announcement of the federal government to impose import tariffs on aluminum and steel is more likely to derive in a trade war with other countries or a reduction in the volume of trade rather than in a reduction of the trade deficit of the country.

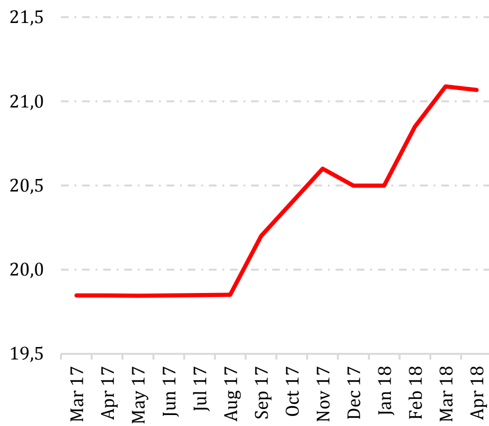
Fiscal stance set to deteriorate. The U.S. fiscal balance deteriorated slightly in 2017 to -4,6% of GDP (from -4,2% a year before) as a result of lower than expected revenues and a steady increase of expenditures. Going forward we anticipate revenues to increase at a slower pace than expenditures, which is likely to derive in a wider fiscal deficit, which we forecast at around 5,3% of GDP by the end of 2018. Our expectation is based on the negative impact that the recently approved tax reform will potentially have on the government finances.

The new tax law includes a number of provisions which, in our view, will have a permanently negative effect on the fiscal budget. While corporate tax rates were cut permanently, individual tax rates were lowered for most of the seven income brackets temporarily (going into effect in 2018 and expiring in 2025).

Disclaimer

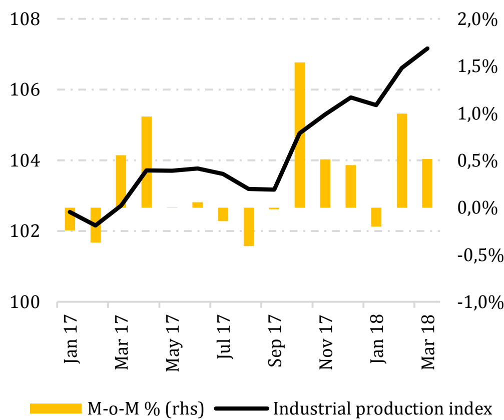
The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.
This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Graph 1: U.S. Gross government debt, USD tn



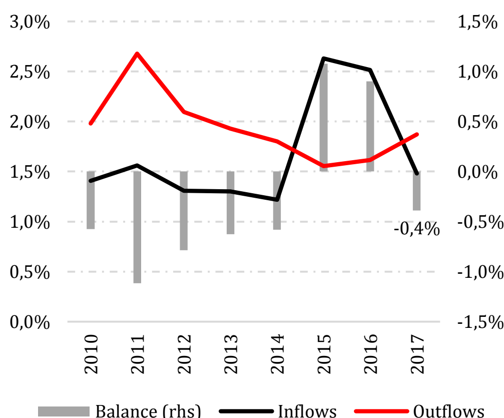
Source: RAEX (Europe) calculations based on data from the U.S. Treasury

Graph 2: Industrial production index, (2012 = 100)



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

Graph 3: U.S. FDI, % GDP



Source: RAEX (Europe) calculations based on data from the WB and OECD

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

The only positive effect that this fiscal stimulus may have is reflected in a temporary expansion of the economy as shown by the GDP growth rate, which we forecast at around 3% by the end of 2018. However, the GDP growth rate is expected to slow down significantly in the long run driven by lower investments and uncertainty over trade. If this materializes, the country would enter the next economic downturn with an already large fiscal deficit and little room for further expansionary fiscal policies.

In 8 February 2018, about two months after the tax law was passed, Senate leaders from both parties reached a deal to raise government spending and suspend the government's debt ceiling once again until March 2019. As a result, the U.S. gross government debt increased by around USD 500 bn between February and April 2018 (see graph 1). Under such scenario, we expect government debt to increase further and reach 108% of GDP and 351% of budget revenues by the end of 2018.

Mixed performance of macroeconomic indicators. The U.S. economy remains resilient to external and domestic shocks and the country is still underpinned by a broad economic policy flexibility and innovative technology. However, the deterioration of some key macroeconomic metrics presents a risk for the long-term sustainability of the country's creditworthiness.

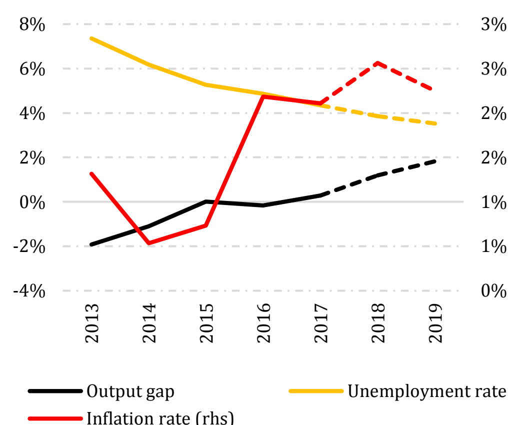
Real GDP grew by 2,3% in 2017 and we forecast it at around 3% in 2018 mainly fueled by the one-time effect of the recently introduced fiscal stimulus. In our view, the growth pace is likely to slow down to around 2% by 2020. Following these figures, the industrial production index grew steadily since October 2017 (except for January 2018), reaching a historically record of 107 in March 2018 as a result of a rebound in utilities (see graph 2). However, the percentage of the industrial capacity in use rose by 0,3% in March to the highest level in three years (78%), which suggests that it has lower room to accelerate before sparking higher inflation.

A recent source of weakness to the credit rating is evidenced by the sharp decline of the inflow of foreign investments which, coupled with an increase in outflows, pushed the net FDI to post a negative figure in 2017 for the first time since 2014 (see graph 3). Even though this might be

Disclaimer

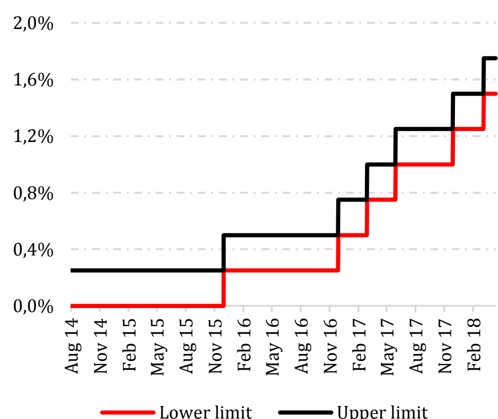
The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.
This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

Graph 4: Output gap vs. inflation & unemployment



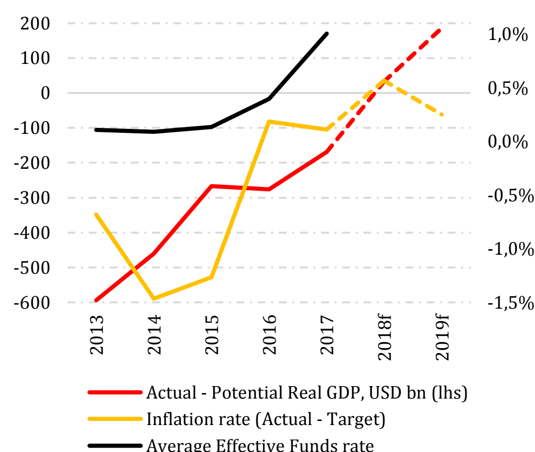
Source: RAEX (Europe) calculations based on data from the IMF

Graph 5: Federal funds rate corridor, %



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

Graph 6: Taylor rule components



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

partially offset by a potential windfall of investments motivated by the recently passed tax reform, there is a high risk of companies sharing the extra profits among shareholders through share buybacks or dividends.

Unemployment rate is still declining and stood at 4,4% in 2017. Going forward, we expect the unemployment rate to reduce the pace of its decline and to stabilize around 3,6% following the move of the output gap from negative to positive ground (see graph 4).

Interest rates set to increase further. Following the increase in inflation rates and stronger economic growth, the Federal Open Market Committee (FOMC) intensified the monetary policy normalization, as the FED funds rate corridor increased four times along 2017 and the beginning of 2018 (see graph 5). Going forward, we expect the appointment of Jerome Powell as Chairman of the Federal Reserve to intensify the hikes of interest rates along 2018 and 2019 as a result of increasing inflation and further widening of the positive output gap (see graph 6).

In our view, however, the FED currently faces different challenges, including unwinding its tremendous balance sheet without disturbing markets and increasing short-term interest rates without harming recently improved economic growth.

Alongside the ongoing normalization in the interest rate, we observed a reduction in treasuries and mortgage backed securities (MBS) in the balance sheet of the FED. Total assets recorded a steady decline since April 2017, reaching USD 4 356 bn by beginning of May 2018. We keep our expectation that if the pace of the ongoing normalization remains in place the balance sheet would decline by USD 318 bn and USD 409 bn in 2018 and 2019 respectively.

Uncertainty over trade remains in place. The long term trade policy of the U.S. remains unclear despite the government having taken a number of measures aiming at limiting imports and narrowing the trade balance deficit.

The renegotiation of the NAFTA agreement is moving slower than it was initially expected. However, the results of the Mexican presidential election to be held on 1 July 2018 will define the future tone of discussions on this topic. Andres Manuel Lopez Obrador (AMLO), a candidate from the coalition called *Juntos Haremos Historia* led by the left-wing party National Regeneration Movement which opposes much of Trump's foreign policies, has emerged as the contender with the highest chances of becoming the next president of Mexico. In our view, this could introduce further uncertainty over NAFTA as agreements between partner-countries may become more cumbersome.

Disclaimer

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.
This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

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_11.05.2018.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.

Disclaimer

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.
This Report represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.