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US CREDIT TAKEN DOWN A NOTCH

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Fitch Downgrades Treasury and Agency Debt to AA+

On the evening of August 1st, Fitch downgraded the US Treasury credit rating from AAA to AA+, and lowered federal agency debt, including Fannie Mae and Freddie Mac, in line to AA+ one day later. This follows S&P's downgrade in August of 2011, and leaves Moody's as the last of the three major ratings agencies to rate the US Treasury at Aaa, their highest credit rating. Despite the downgrade, we do not expect to see a material change in trading activity or liquidity, either relative to Treasury debt or for debt obligations directly or indirectly backed by the US Treasury.

We Do Not Foresee a Major Market Impact

There are two major reasons for our view. First, the US Treasury bond is the largest, most transparent, and most liquid debt offering in the world. The US Dollar is the world's reserve currency and the functional currency for most global trade. Much of modern financial theory functions on the assumption that a Treasury bond of a given tenor represents the risk-free rate for that period of time, and between this and their widespread availability, Treasuries are the most common form of collateral in global finance. From a purely functional standpoint, there is no other financial instrument that can replace Treasury bonds. A ratings downgrade from AAA to AA+, which we note is still an exceptionally strong rating, will not change this dynamic because the market lacks an alternative to Treasury debt. The very fact it took Fitch as long as it did to lower their rating, when in their rating action they note the US Treasury had exceeded their debt-to-GDP downgrade trigger by 2.5x and interest-to-revenue by 10x their AAA rating median, speaks strongly to the exceptional nature of US Treasury debt, where the Treasury both issues debt and manages the US monetary supply. We believe that barring a much more dramatic future downgrade or technical default, Treasuries will continue to function in the global markets as instruments that introduce no credit risk.

Second, speaking philosophically, the purpose of a credit rating is to fill an informational gap. Even the most sophisticated investors may not know the intimate workings or financial health of a corporate or municipal issuer, so a third-party ratings agency credit opinion offers a very useful summary of the risk profile of a bond. By contrast, the US Treasury and US Government are extremely transparent entities and are very well understood by even casual market participants. The financial health of the US Government is largely an open book, and the long-term budgetary challenges and lack of political will that have led to Fitch's ratings action are well understood. We believe this downgrade represents grudging recognition of longstanding political gridlock, rather than new information Fitch is providing to the market.

Secondary Market Affect Has Been Limited

We see limited potential for this action to lead to additional downgrades of US-domiciled AAA rated debt. Importantly, Fitch did not revise their country ceiling rating for the US from AAA. Had they done so, this would have resulted in a wave of corresponding downgrades for the large number of AAA-rated municipal obligors and the handful of AAA-rated corporate issuers. We do not expect Fitch to take this step and note that S&P has continued to rate US issuers at their highest AAA rating, where appropriate, in the 12 years since they downgraded the Treasury to AA+. Additionally, while the Tax Cuts and Jobs Act has made the pre-refunded municipal market smaller than it once was, we expect no change in Treasury and Agency debt being held as collateral to pre-refund bonds. Treasuries and Agencies are still rated Aaa at Moody's, which we feel is primarily because the market will continue to treat Treasury debt as riskless by convention and use debt guaranteed by the US Treasury as the preferred defeasement collateral.

We also do not foresee an impact to banks holding Treasuries as part of their capital requirements. The Basel regulatory framework merely requires debt must be at least AA- to meet High Quality Liquid Asset definitions, so a downgrade from AAA to AA+ should not change banks' willingness to hold Treasuries or impact the quality of bank issuers' balance sheets.

While Treasury yields rose after the announcement, they did so after a series of strong economic reports, and we note that yields were flat overnight following the announcement. Yields moved higher only after an above-consensus ADP jobs report, and a larger-than-expected increase in the Treasury's quarterly refunding issuance.

Proprietary Credit Research Remains Critical

Appleton subscribes to the major rating agencies for both municipal and corporate credit research. The ratings are broadly disseminated measures of the agencies' views on credit health and therefore important tools in making relative value decisions. The agencies also conduct their own due diligence on issuers, including the US Treasury, which can provide insightful information for our research analysts. That said, Appleton has a longstanding history of relying on internal research capabilities to determine appropriate creditworthiness and that approach has served our clients well through many volatile market environments. We have invested in our research staff and technology and will continue to do so. Proactive, diligent, and consistent investment research remain a hallmark of our investment process. As we have noted in this commentary, Fitch's downgrade of the US debt may unnerve some market participants, but it won't change our approach to credit analysis. We will continue to incorporate new external information while staying committed to fundamental research.

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