UNITED STATES (GOVT OF)

Rating Analysis - 9/14/12
Debt: $15.2B

EJR Sen Rating(Curr/Prj) AA-/ N/A
EJR CP Rating: A1+
EJR's 1 yr. Default Probability: 1.2%

Up, up, and away - the FED's QE3 will stoke the stock market and commodity prices, but in our opinion will hurt the US economy and, by extension, credit quality. Issuing additional currency and depressing interest rates via the purchasing of MBS does little to raise the real GDP of the US, but does reduce the value of the dollar (because of the increase in money supply), and in turn increase the cost of commodities (see the recent rise in the prices of energy, gold, and other commodities). The increased cost of commodities will pressure profitability of businesses, and increase the costs of consumers thereby reducing consumer purchasing power. Hence, in our opinion QE3 will be detrimental to credit quality for the US. Some market observers contend that a country issuing debt in its own currency can never default since it can simply print additional currency. However, per Reinhart & Rogoff's "This Time Is Different: Eight Centuries of Financial Folly", p.111, 70 out of 320 defaults since 1800 have been on domestic (i.e., local currency) public debt. Note, US funding costs are likely to slowly rise as the global economy recovers or the FED scales back its Treas. purchases (75% recently).

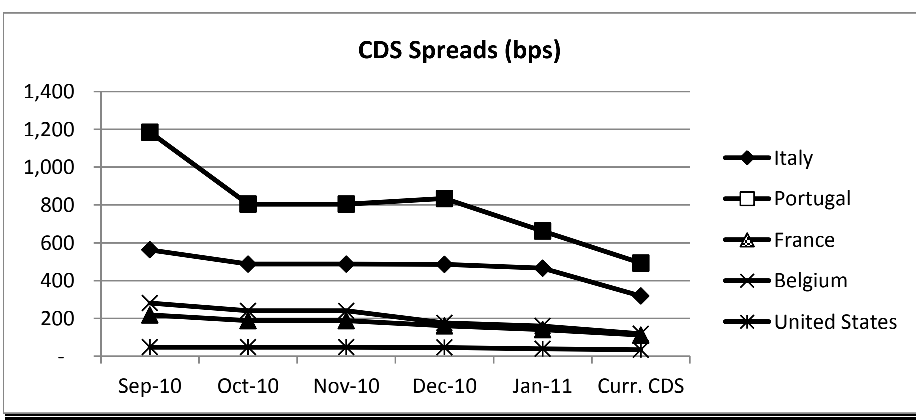
From 2006 to present, the US's debt to GDP rose from 66% to 104% and will probably rise to 110% a year from today under current circumstances; the annual budget deficit is 8%. In comparison, Spain has a debt to GDP of 68.5% and an annual budget deficit of 8.5%. We are therefore downgrading the US country rating from “AA” to “AA-“.

Annual Ratios (source for past results: IMF)

INDICATIVE CREDIT RATIOS	2009	2010	2011	P2012	P2013	P2014
Debt/ GDP (%)	88.8	97.1	100.9	110.2	119.2	128.2
Govt. Sur/Def to GDP (%)	-10.4	-8.7	-8.2	-8.1	-7.9	-7.8
Adjusted Debt/GDP (%)	88.8	98.7	102.4	111.7	120.7	129.6
Interest Expense/ Taxes (%)	14.6	14.6	14.7	12.7	13.8	14.1
GDP Growth (%)	-3.1	2.4	1.8	2.5	2.5	2.3
Foreign Reserves/Debt (%)	0.3	0.3	0.3	0.3	0.3	0.2
Implied Sen. Rating	BBB+	BBB+	BBB+	BBB+	BBB+	BB-

INDICATIVE CREDIT RATIOS	AA	A	BBB	BB	B	CCC
Debt/ GDP (%)	45.0	55.0	75.0	85.0	95.0	145.0
Govt. Sur/Def to GDP (%)	4.0	1.0	-2.0	-5.0	-8.0	-10.0
Adjusted Debt/GDP (%)	40.0	50.0	60.0	80.0	120.0	150.0
Interest Expense/ Taxes (%)	7.0	9.0	12.0	15.0	22.0	26.0
GDP Growth (%)	4.0	3.0	2.0	1.0	-1.0	-5.0
Foreign Reserves/Debt (%)	25.0	20.0	15.0	12.0	9.0	7.0

PEER RATIOS	S&P Sen.	Debt as a % GDP	Govt. Surp. Def to GDP (%)	Adjusted Debt/ GDP	Interest Expense/ Taxes %	GDP Growth (%)	Ratio-Implied Rating*
Government Of Canada	AAA	31.6	-4.5	31.6	14.1	1.9	A+
French Republic	AA+	88.9	-1.0	113.5	9.5	1.9	BB+
Kingdom Of Belgium	AA	102.1	-5.2	102.1	11.9	1.2	BB
Republic Of Italy	BBB+	120.0	-3.9	130.8	16.7	-0.5	B+
Portugal Republic	BB	106.8	-4.2	117.2	13.0	-3.0	BB-



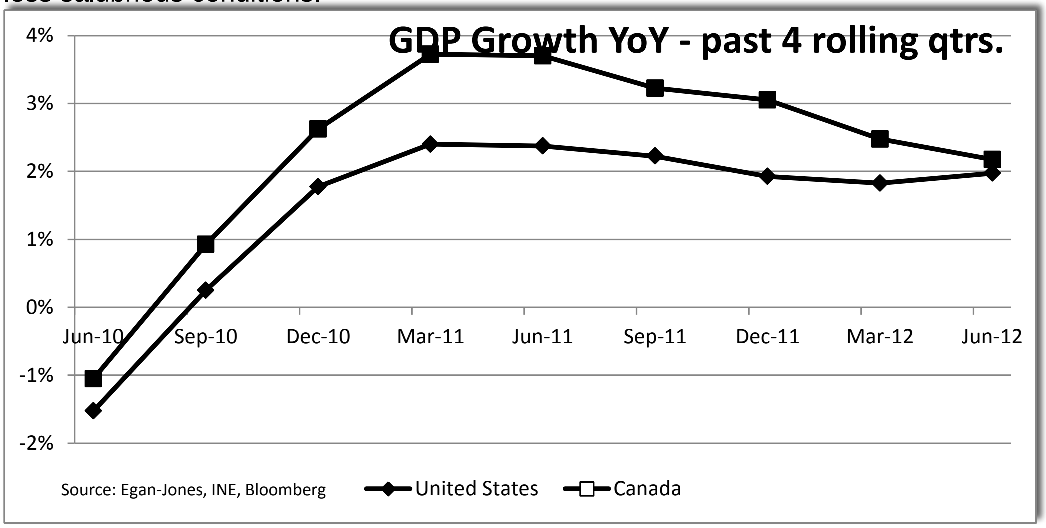
Country (EJR Rtg*)	Current CDS	Targeted CDS
Italy (C+)	319	4,300
Portugal (CCC+)	493	1,500
France (BBB-)	112	400
Belgium (BBB-)	119	400
United States (AA-)	35	70

* Projected Rating
* EJR's targeted CDS based on rating

Economic Growth

Economic growth has been anemic, averaging less than 2% on an annualized basis. The last annualized GDP growth showed that the US economy grew 1.75% YoY. Monetary stimulus has had no real effect on the general economy with the exception of greatly inflating individual cost structures. Wages in the US continue to be negative on an inflation-adjusted basis while costs on every-day items continue to rise. A major concern continues to be tepid economic growth and an overhang from the pending retirement of the baby boom generation.

As can be seen from the below chart, over the past couple of years GDP growth has been near Canada albeit at a slightly lower pace. although as of the end of 2009 and 2010 growth was negative and below Canada's. A major issue is that if the US is running hefty deficits with an economic recovery and depressed interest rates, the deficits might grow faster under less salubrious conditions.



Fiscal Policy

US fiscal policy is disconcerting with trillion dollar plus deficits for four years and a national debt over $16 trillion. Sequestration will result in only a minimal reduction in the rate in annual spending growth. Plans to reduce the budget deficit by both parties are inadequate and will contribute further to deteriorating financial flexibility. Entitlement spending which accounts for the majority of budgetary expenditures requires extensive reform and without it, the US cannot engage in any real meaningful deficit and debt reduction.

	Deficit-to-GDP (%)	Debt-to-GDP (%)	5 Yr. CDS Spreads
US	8.2	100.9	40
Canada	4.5	31.5	N/A
Germany	1.0	81.4	63
France	5.2	88.9	140
Italy	3.9	120.0	466
Portugal	4.2	106.8	662

Sources: Bloomberg and IFS

Unemployment

While BLS announced unemployment rate was reduced from 8.3% to 8.1%, nearly 400K was eliminated from the work force. The labor participation rate of 63.5% hasn't been this low since the Reagan admin. While the US added 96K jobs in Aug. nearly one third of them were in bars and restaurants. Also more discouraging are statistics on disability as at present according to BLS 6.25% are currently receiving disability vs. 2.8% workers in 1992.

Unemployment (%)	2010	2011
US	9.6	9.0
Canada	7.6	7.5
Germany	7.4	6.8
France	9.7	9.8
Italy	8.3	9.2
Portugal	11.1	14.0

Source: Intl. Finance Statistics

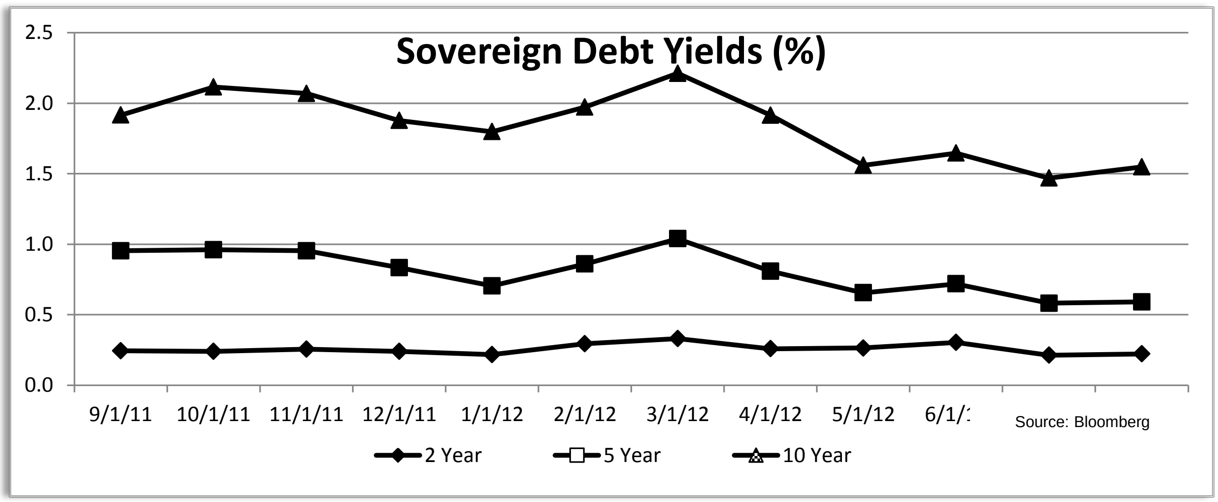
Banking Sector

The US Banking sector continues to be stagnant. Loan growth rates recorded by some banks have been the result of portfolio acquisitions rather than organic growth. The yield curve in the banking system continues to be on a downward trend with no abatement in sight. QE3 will further depress and already depressed yield curve in the banking industry. The US banking industry is heavily concentrated with the top six banks in the US accounting for 56% of GDP.

Bank Assets (billions of local currency)	Assets	Cap/ Assets %
BANK OF AMERICA	2,129	10.8
JPMORGAN CHASE	2,266	8.1
CITIGROUP INC	1,874	9.6
WELLS FARGO & CO	1,314	10.8
GOLDMAN SACHS	923	7.8
Total	8,506	
EJR's est. of cap shortfall at 10% of assets less market cap		282
United States's GDP		15,094

Funding Costs

Despite weakening credit metrics, the US has seen a significant decline in its funding costs over the past couple of years because of "monetary easing" (i.e., the FED's purchasing US Treasury debt) and a flight to quality stemming from the EU credit crisis. As can be seen in the below graph, the ten year debt yield has declined from 3.3% to 2.2% and the 2 year yield is below .5%. Our concern is that funding costs will rise over the next couple of years and further pressure federal budgets.



Ease of Doing Business

Major factors for growing the economy are the ease of doing business and the economic freedom; although not the sole factor for determining economic growth, a country which makes it easy for businesses to operate and provides a reasonably free environment to conduct business has a good chance for growth. The chart on the right indicates that with an overall rank of 4 (1 is best) is strong.

The World Bank's Doing Business Survey*	2012 Rank	2011 Rank	Change in Rank
Overall Country Rank:	**4**	**4**	**0**
Scores:			
Starting a Business	13	11	-2
Construction Permits	17	17	0
Getting Electricity	17	16	-1
Registering Property	16	11	-5
Getting Credit	4	4	0
Protecting Investors	5	5	0
Paying Taxes	72	70	-2
Trading Across Borders	20	20	0
Enforcing Contracts	7	7	0
Resolving Insolvency	15	14	-1

* Based on a scale of 1 to 183 with 1 being the highest ranking.

Economic Freedom

As can be seen below, United States is above average in its overall rank of 76.3 for Economic Freedom with 100 being best.

Heritage Foundation 2012 Index of Economic Freedom
World Rank 76*

	Rank**	2011 Rank	Change in Rank	World Avg.
Business Freedom	**91.1**	91.0	0.1	64.3
Trade Freedom	**86.4**	86.4	0.0	74.8
Fiscal Freedom	**69.8**	68.3	1.5	76.3
Government Spending	**46.7**	54.6	-7.9	63.9
Monetary Freedom	**77.2**	77.4	-0.2	73.4
Investment Freedom	**70.0**	75.0	-5.0	50.2
Financial Freedom	**70.0**	70.0	0.0	48.5
Property Rights	**85.0**	85.0	0.0	43.5
Freedom from Corruption	**71.0**	75.0	-4.0	40.5
Labor Freedom	**95.8**	95.7	0.1	61.5

*Based on a scale of 1-100 with 100 being the highest ranking.
**The ten economic freedoms are based on a scale of 0 (least free) to 100 (most free).
Source: The Heritage Foundation & Wall Street Journal

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Assumptions for Projections

	Peer	Issuer	Base Case	
Income Statement	**Median**	**Average**	**Yr 1&2**	**Yr 3,4,5**
Taxes Growth%	4.2	9.1	**3.0**	**3.0**
Social Contributions Growth %	1.4	(6.3)	**3.0**	**3.0**
Grant Revenue Growth %	0.0	0.0		
Other Revenue Growth %	6.8	1.2	**3.0**	**3.0**
Other Operating Income Growth%	0.0	0.0		
Total Revenue Growth%	3.1	4.6	**3**	**2.3**
Compensation of Employees Growth%	2.0	1.0	**1.0**	**1.0**
Use of Goods & Services Growth%	4.0	2.9	**3.0**	**3.0**
Social Benefits Growth%	2.4	2.4	**2.0**	**2.0**
Subsidies Growth%	2.9	9.6	**3.0**	**3.2**
Other Expenses Growth%	(7.0)	(7.0)	**2.0**	**2.0**
Interest Expense	0.0	2.8	**3**	
Balance Sheet				
Currency and Deposits (asset) Growth%	(20.7)	0.0	**2.0**	**2.0**
Securities other than Shares LT (asset) Growth%	5.0	(15.2)	**2.0**	**2.0**
Loans (asset) Growth%	14.4	11.4	**3.0**	**3.0**
Shares and Other Equity (asset) Growth%	(1.7)	21.2	**3.0**	**3.0**
Insurance Technical Reserves (asset) Growth%	3.0	7.9	**2.0**	**2.0**
Financial Derivatives (asset) Growth%	0.0	0.0		
Other Accounts Receivable LT Growth%	1.8	(3.3)	**3.0**	**3.0**
Monetary Gold and SDR's Growth %	0.0	(3.3)	**3.0**	**3.0**
Other Assets Growth%	0.0	0.0		
Other Accounts Payable Growth%	2.4	(3.3)	**1.0**	**1.0**
Currency & Deposits (liability) Growth%	(1.8)	0.0	**4.0**	**4.0**
Securities Other than Shares (liability) Growth%	5.3	8.7	**4.0**	**4.0**
Loans (liability) Growth%	5.7	11.4	**6.0**	**6.0**
Insurance Technical Reserves (liability) Growth%	0.0	7.9	**6.0**	**6.0**
Financial Derivatives (liability) Growth%	0.0	0.0		
Addl debt. (1st Year) billion USD	0.0	0.0		

Base Case
ANNUAL REVENUE AND EXPENSE STATEMENT (BILLIONS $)

	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Taxes	2,448	2,668	2,911	2,998	3,088	3,181
Social Contributions	969	992	929	957	985	1,015
Grant Revenue	0	0	0	0	0	0
Other Revenue	312	323	327	336	347	357
Other Operating Income	0	0	0	0	0	0
Total Revenue	3,729	3,983	4,166	4,291	4,420	4,553
Compensation of Employees	1,480	1,517	1,532	1,548	1,563	1,579
Use of Goods & Services	662	702	722	743	766	789
Social Benefits	2,116	2,259	2,314	2,360	2,407	2,455
Subsidies	60	57	63	65	67	69
Other Expenses	215	148	138	151	141	154
Grant Expense	0	0	0	0	0	0
Depreciation	270	279	293	302	311	321
Total Expenses excluding interest	4,803	4,963	5,061	5,169	5,254	5,367
Operating Surplus/Shortfall	-1,074	-980	-895	-877	-834	-814
Interest Expense	359	390	428	381	426	448
Net Operating Balance	-1,433	-1,370	-1,324	-1,258	-1,260	-1,262

Sources: Historical - IMF, Projections - EJR

Base Case
ANNUAL BALANCE SHEETS (BILLIONS $)

ASSETS	Dec-09	Dec-10	Dec-11	PDec-12	PDec-13	PDec-14
Currency and Deposits (asset)				46	47	48
Securities other than Shares LT (asset)	1,324	1,313	1,114	1,137	1,159	1,183
Loans (asset)	797	944	1,052	1,083	1,116	1,149
Shares and Other Equity (asset)	(407)	(590)	(716)	(737)	(759)	(782)
Insurance Technical Reserves (asset)	228	251	271	277	282	288
Other Accounts Receivable LT	723	805	778	802	826	851
Monetary Gold and SDR's	58	57	55	57	58	60
Additional Assets	366	499	265			
Total Financial Assets	3,088	3,279	2,820	2,929	2,994	3,061
LIABILITIES						
Other Accounts Payable	723	805	778	786	794	802
Currency & Deposits (liability)	26	26	26	26	26	26
Securities Other than Shares (liability)	11,374	13,076	14,214	14,783	15,374	15,989
Loans (liability)	797	944	1,052	2,310	3,570	4,832
Insurance Technical Reserves (liability)	228	251	271	287	305	323
Financial Derivatives (liability)						
Other Liabilities	(607)	(789)	(809)	(1,292)	(1,292)	(1,292)
Liabilities	12,542	14,313	15,533	16,900	18,225	19,554
Net Financial Worth	(9,453)	(11,034)	(12,713)	(13,971)	(15,231)	(16,493)
Total Liabilities & Equity	3,088	3,279	2,820	2,929	2,994	3,061

Sovereign Rating Methodology

Egan-Jones takes the perspective of the investor as its primary point of view when developing the ratings it issues for sovereigns. Therefore, in the case of sovereign ratings, we attempt to take a more holistic view of credit quality to include not only analytic comparisons of various sovereign issuers but also the impact on our quantitative and qualitative analyses by current global, sovereign, governmental and market events, including the effects of government investments in speculative, volatile or other high risk investment products. For example, many sovereign issuers have taken on significant exposures of major financial institutions over the past several years. Hence, we calculate the under-funding of financial institutions and include this amount in the total indebtedness of sovereigns. (We use a base assumption that no country can afford to allow its major banks to fail and therefore we believe that there will almost always be an intervention by either a host or allied nation should financial institutions or markets require support at some measurable level.)

Generally we devise modeling calculators and do an analysis that examines the debt load of a country with respect to its GDP and other economic indicators. The analysis is then adjusted to reflect the outlook on a myriad of factors that reflect the firm’s overall view of the sovereign debt and the quality of the country’s ability to meet and thrive under such load. Some of the qualitative factors that impact our ultimate assessment of credit quality such as the flexibility, stability and overall strength of the economy, ease of tax collection, acceptance of contract law, ease of doing business, and prospects for future growth and health. The non quant issues are generally subjective and a moving target, so each rating of a sovereign may differ because of the non-quantitative nuances being addressed. Note, debt levels for many sovereign issuers have increased over the past decade and has accelerated recently, effecting the implied ratings.

Nota Bene

History has proven that defaults on domestic public debt do occur. In fact, seventy out of three hundred twenty defaults since 1800 have been on domestic public debt (1). Egan-Jones does not view a country's ability to print its own currency as a guarantee against default. Additionally, Egan-Jones generally views cases of excessive currency devaluation as a de facto default.

1. "This Time Is Different: Eight Centuries of Financial Folly", Reinhart & Rogoff, p.111, 126