APPLETON PARTNERS, INC.

LIMITED BOND MARKET IMPACT EXPECTED FROM US DEBT DOWNGRADE

Moody's Investor Services downgraded the US Government's credit rating from Aaa/negative to Aa1/stable on May 16th, reflecting accelerating deficit growth and associated borrowing requirements, a fiscal situation exacerbated by recently elevated borrowing costs. Despite considerable attention being paid to federal spending cuts, Moody's noted a lack of faith in the willingness of Congress to actually reduce the deficit, and US debt levels have now reached thresholds that are materially weaker than other Aaa-rated peers.

Municipal Credit Dynamics Differ by Sector and Issuer

Moody's action means that the US Government no longer enjoys a top credit rating from any of the major three agencies. **The effect of this development on the Treasury and housing markets is difficult to predict, although we expect only modest impacts on the tax-exempt bond market.** Below, we offer thoughts on likely issuer implications.

While newsworthy, the US Government downgrade was not unexpected as Moody's had changed their credit outlook to "negative" from "stable" in November 2023. At the time, only a handful of public finance issuers were also placed on "negative," and Moody's tempered their analysis by stating that *"few public finance issuers are directly affected (by its then revision of the US outlook change to "negative"). The relatively minor credit impact would also be the case if US credit strength continues to decline and results in a one-notch downgrade."*

S&P was the first to downgrade US credit to AA+ way back in 2011, citing brinkmanship surrounding the debt ceiling. Importantly, S&P made clear distinctions that allow the agency to provide other US-based entities, including municipalities, with a higher rating than the sovereign debt (i.e., AAA). We expect this practice to continue and do not see Moody's current rating action affecting S&P's view of these credits. An example of language that S&P includes in its research reports is excerpted below:

"We rate Greenwich higher than the sovereign because we believe the town can maintain better credit characteristics than the US in a stress scenario, due to its predominantly locally derived revenue base and our view that pledged revenue supporting debt service on the bonds is a limited risk of negative sovereign intervention." S&P Global Ratings, January 17, 2025.

We expect Moody's to afford itself similar leeway as S&P, thereby allowing public finance issuers to have a rating higher than the sovereign. Therefore, those public finance issuers that currently possess an Aaa rating from Moody's are not necessarily at risk of being downgraded. However, there are entities that are directly linked to the US Government's rating, and others that are linked to its underlying federal fiscal standing. Issuers of this nature could see negative rating actions from Moody's.

Direct linking: Entities that are directly linked with Federal funding programs

Housing	Bonds where there is either a high degree of reliance on FNMA and FRMC insurance on loans, or the Housing Agency owns a large percentage of FNMA or FRMC mortgage-backed securities. Housing bonds that are rated AA+ may still be at risk of a downgrade if Moody's had previously applied a notching mechanism.
Standalone GARVEEs	Based on Moody's current methodology and Appleton's proprietary research, an immediate downgrade of stand-alone GARVEEs (i.e., those not supported by state-derived revenues) in the wake of the US credit downgrade is unlikely. Any change in our opinion would likely be precipitated by a change in Moody's methodology. We also note that stand-alone GARVEEs are already rated multiple notches below the US Government, avoiding potential Moody's "rating cap" implications.

Indirect linking: Entities that rely on Federal funding or employment to support their credit profile, although Federal funding does not directly back the bonds.

District of Columbia and Metro D.C.	These issuers were very likely already being closely watched by Moody's and other rating agencies, given proposed cuts to Federal spending. We feel one-notch downgrades are quite possible, but do not expect more significant changes.

Pre-refunded: Bonds issued to refinance existing debt ahead of the call or maturity date

Pre-refunded ("Pre-re") bonds	Issuers are not required to have their Pre-re bonds "re-rated," but historically, when they did, they received a AAA rating if escrowed proceeds were invested in U.S. Government securities or securities tightly linked to the Federal Government. That will no longer be the case, although we feel municipal market participants will continue to view Pre-re bonds as extremely strong securities. Some issuers may not choose to get their Pre-re bonds re-rated given the US Government's AA+ rating, but we do not expect to see material changes in this corner of the market.

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Moody's credit action shines a light on US fiscal conditions but should have a very modest and manageable impact on municipal issuers, and any rating changes will likely be limited to one or two-level downgrades. Most potentially impacted entities have maintained very strong credit profiles for an extended time, and we do not expect that to change. However, we continue to closely monitor municipal bond market trading and, while not expected, any meaningful impact could flow through to borrowers.

Modest Pressure On the US Dollar and Treasury Curve Is Anticipated

The Treasury and IG Credit markets are also expected to see limited direct impact, in our opinion. US fiscal challenges were already understood by financial market participants, and the Moody's move was well telegraphed, coming more than a year after the US rating was put on negative outlook. A Treasury default is not a realistic risk in our view, regardless of rating. For better or for worse, a sovereign nation that issues debt in its own currency can simply monetize that debt to avoid default, although we remain a very long way from needing to seriously consider this scenario. We expect any direct effects on the high-grade taxable bond markets to be price-related, most likely manifesting itself in a weaker dollar and higher Treasury yield curve, due largely to a rise in inflation expectations created by slightly higher risk of debt monetization impact. On this front, initial market reaction has been encouraging; the dollar weakened only modestly after the move, dropping roughly 0.6%, and while Treasury yields moved higher by close to 10bps over the weekend, they have since retraced that move and more across the curve.

Indirect effects of the credit downgrade are likely to continue in the near term. As expected, Moody's cut US Agency debt ratings to Aa1 in response to the sovereign's downgrade on Friday**.** Market function impacts – for example, forced selling of Treasuries held as collateral in agreements that require collateral to be rated Aaa, where the language has not yet been updated to reflect the possibility of an Aa1/AA+ rated Treasury – are possible but unlikely. Last Friday's news was the final step in a process that has now stretched over more than a decade since S&P first cut its US Treasury rating.

Corporate downgrades of US-domiciled Aaa-rated issuers are also possible, but not likely. While Moody's treats a sovereign rating as a cap for domestic issuers, the universe of Aaa-rated corporations is both very small and very global, and the agency allows corporations to exceed their home sovereign rating in situations where they operate on a global scale.

There will, of course, be political effects, as the US downgrade comes after years of neither political party treating persistent deficit levels as a serious concern. Moody's downgrade may have been tactical in the sense that it follows extension of the 2017 Tax Cuts and Jobs Act, which Moody's expects to add $4 trillion in debt and raise the deficit to nearly 9% of GDP over the next ten years, failing to advance out of committee over opposition from budget hawks. We also emphasize that, although not a likely outcome, a Treasury downgrade increases the risk of the US dollar losing world reserve currency status at the margin at a time when a trade war is also incrementally increasing dollar risk. Additionally, a reasonably likely near-term, but secondary impact is that President Trump's path for trade renegotiation may have gotten slightly narrower.