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We wanted to share our initial thoughts in response to Standard & Poor's downgrade of the U.S. government's debt to AA+ from AAA. While Moody's confirmed, as did Fitch, the AAA rating for the U.S., though on negative outlook, this change does have potentially a far reaching impact. S&P also has maintained a negative outlook, even with the downgrade.

Credit Rating Impact

S&P noted that while banks and broker dealers wouldn't likely suffer any immediate ratings downgrades, they 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. They said they would also lower the ratings on AAA rated U.S. insurance groups, as per their criteria that correlates insurers' and sovereigns' ratings. We expect that this will occur early this week.

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 their analysis. They said they believe that any potential modest rise in interest rates would not generally affect the ratings of structured finance transactions.

For tax-exempt securities, prerefunded municipal bonds, FHA, GNMA and FNMA backed housing bonds as well as federally funded project finance bonds (Garvee) will be directly affected. The combined market share of these credits is minimal. Moody's did not downgrade the five AAA state general obligation credits or the local GOs that it had considered in the event of a federal government downgrade.

After the S&P announcement, the Federal Reserve immediately released a statement that, for risk-based capital purposes, the risk weights for Treasury securities and other securities issued or guaranteed by the U.S. government, government agencies, and government-sponsored entities will not change. 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, will also be unaffected.

Market reaction

According to S&P's internal analysis, they believe 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.

From our perspective, any sell-off in Treasuries will likely be temporary given the deterioration in the economic outlook. Therefore, it should be viewed as a buying opportunity. Some market analysts have speculated that the downgrade may be already priced into financial markets, but we are not convinced. We anticipate heightened market volatility and further correction in risk assets this week.





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

It is likely that the dollar suffers and gold performs well next week. We are carefully monitoring Asian market reaction to provide additional data to judge the impact. The financial markets will be the primary transmission mechanism for the shock, as well as providing insight to unforeseen consequences. There is talk of some 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.

Debt Reduction Impact on the Municipal Market

As with the downgrade, deficit reduction is 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, which will likely experience termination or delay. Local governments are more removed from the impact of federal subsidies than states. Reductions to Medicaid payments will likely effect hospital reimbursements, as states' responsibility is limited to half of total reimbursements. 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.

Potential negative economic fallout from deficit reduction will likely impact tax revenues and could force continued austerity. Most state and local GO bonds are strengthened by strong security provisions.

S&P's indicated its muni ratings (aside from those cited above) will not be affected by the U.S. downgrade but may be by the results of a federal deficit reduction program once the specifics are detailed. Moody's will review the potential economic and fiscal impact to these credits.

Standish Tax-Sensitive Portfolios Direct Impact

Prior to the official S&P action, Standish performed Guideline Compliance on all portfolios assuming AA+ US Treasury rating and its direct impact on munis. Small adjustments were made to very few portfolios to preemptively prevent forced selling in the case of a downgrade. We also included the five state GOs losing their AAA Moody's rating, though that did not occur.

Standish Active Fixed Income Portfolios Direct Impact

We have previously analyzed how a ratings downgrade would impact portfolio quality relative to active fixed income client guidelines. Under a scenario where the U.S. sovereign credit rating is downgraded, we have communicated how your portfolio as it is constituted today may fare. While most portfolios would still be in compliance with the minimum quality currently specified by their guidelines, some may require adjustment.





Moreover, as we noted also, your portfolio is likely to be impacted in other ways. 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.

Please feel free to reach out to any of us at Standish with further questions or comments. We will continue to keep you posted as to developments.

Sincerely,

Standish Mellon Asset Management Company LLC

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