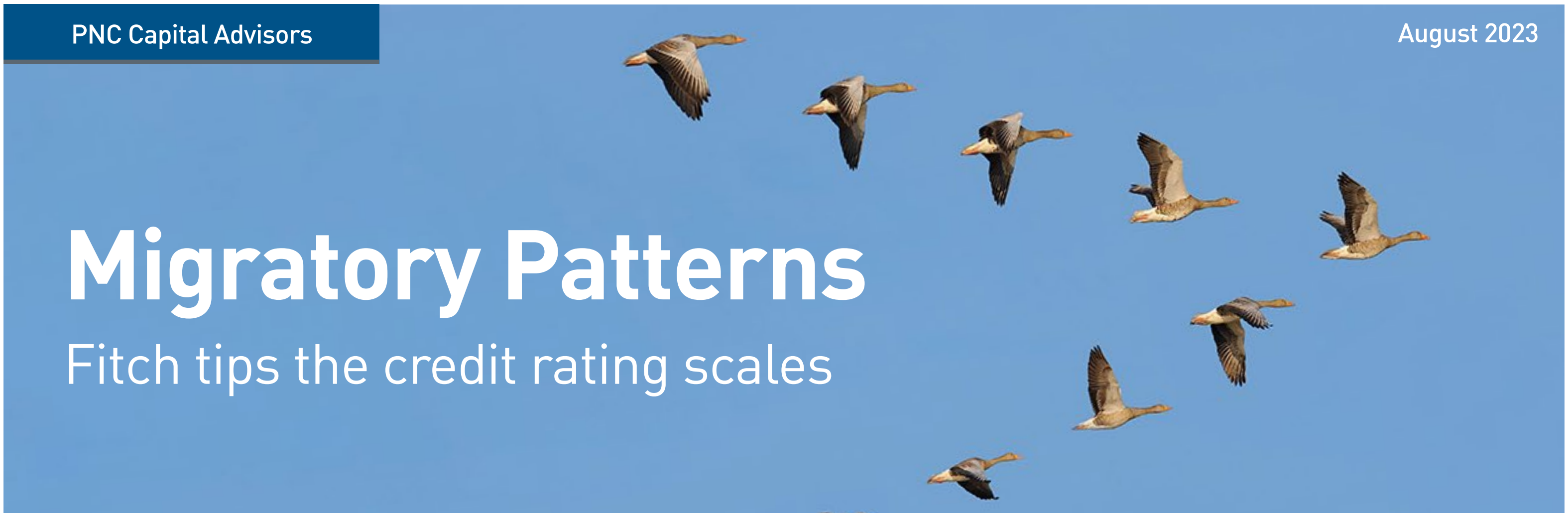

# Migratory Patterns

## Fitch tips the credit rating scales

### Where my AAAs at?

While Fitch Ratings had the United States on watch for a credit rating downgrade since late May, when debt ceiling negotiations were reaching an apex, they caught markets by surprise on August 1 with a cut in the U.S. sovereign rating to "AA+." This echoed the downgrade by S&P Global Ratings during a similar period of brinksmanship in August 2011. As justification, Fitch noted the United States' persistent fiscal deficit will push its ratio of debt-to-GDP above 118%, from a current 112.9%, more than two-and-a-half times the "AA" median of 44.7%. Additionally, higher U.S. Treasury yields will drive the interest-to-revenue ratio to 10% by 2025, versus the "AA" median of 2.8%. Fitch did not attempt to veil its disdain for the current political environment, noting "a steady deterioration in standards of governance over the last 20 years" — solons take heed!

Although a U.S. credit rating downgrade has precedent, thanks to S&P, there are new market implications to consider as Fitch's move tips the scales. The Bloomberg bond index family applies a blended approach to calculate the index-equivalent rating using the three primary ratings agencies, Moody's Investors Service, S&P and Fitch. We also use this approach to evaluate the credit quality of individual securities, issuers and benchmarks. With Fitch's downgrade, U.S. Treasury securities will now fall from "AAA" to "AA+," per Bloomberg. Subsequently, as expected, Fitch extended the downgrade across government-related entities that benefit from both explicit and implicit guarantees, including agency debentures and mortgage-backed securities. As a result of Fitch's downgrades, on a pro-forma basis, the estimated "AAA" concentration in the Bloomberg Aggregate Index will fall from approximately 73% to less than 4%! Within the Credit sector, most AAA-rated issuers will be concentrated in the higher education industry, non-U.S. domiciled supra/sovereigns and just two U.S.-based corporations, Microsoft Corp and Johnson & Johnson.

> WITH FITCH'S DOWNGRADE, U.S. TREASURY SECURITIES WILL NOW FALL FROM "AAA" TO "AA+"

Investors should also consider the impact on average portfolio quality. While moving much closer to "AA-," we estimate the Bloomberg Aggregate index's current average quality of "AA" will not change following the Fitch downgrade. In contrast, given the higher allocation to lower-rated securities, the Bloomberg Government/Credit Index is expected to fall to "AA-," as "A" and lower-rated securities account for 33% of the index, compared to less than 25% for the Aggregate. Consider a hypothetical portfolio composed of 60% Credit and 40% U.S. Treasuries; its average rating would fall from "AA-" to "A+."

> ON A PRO-FORMA BASIS, THE ESTIMATED "AAA" CONCENTRATION IN THE BLOOMBERG AGGREGATE INDEX WILL FALL FROM APPROXIMATELY 73% TO LESS THAN 4%!

With a shallower pool of AAA-rated investment alternatives, we believe investors will have additional incentives to consider AAA-rated asset-backed securities. We emphasize the Structured Products sector — particularly in short- to intermediate-duration portfolios — given the generally high credit quality and strong risk-adjusted return profile. While less liquid than Credit broadly, we see consistent supply from the issuers and collateral types we emphasize. Overall, the asset-backed sector has produced average issuance of $250 billion over the last five years.

### Those who fail to learn from the past...

Heading into fall, we expect the cumulative impact of Federal Reserve policy changes to further tighten financial conditions. Disappointingly, rhetoric from Capitol Hill suggests we are set up for a redux of the budget negotiations that led to Fitch's recent downgrade. Our awareness of the potential for elevated volatility informs our more defensive portfolio positioning and supports allocations to sectors with strong historical risk-adjusted return profiles. As high-quality assets become scarcer, we believe our clients will continue to benefit from exposure to asset-backed securities — one of the last remaining AAAs.

**For more insights visit pnccapitaladvisors.com**

**Indices**

**Bloomberg U.S. Aggregate Bond Index** measures the performance of investment grade, U.S. dollar-denominated, fixed rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS. It rolls up into other flagship indices, such as the multi-currency Global Aggregate Index and the U.S. Universal Index, which includes high yield and emerging markets debt.

**Bloomberg U.S. Government/Credit Index** measures the performance of U.S. dollar denominated U.S. Treasury bonds, government-related bonds (i.e., U.S. and foreign agencies, sovereign, supranational and local authority debt) and investment-grade U.S. corporate bonds that have a remaining maturity of greater than or equal to one year.