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## Default Not the Only Trigger for Downgrade of U.S. Treasuries Credit Agencies May Initiate Modest Rating Cut If Debt Ceiling Agreement Fails to Address Their Concerns about Federal Debt

Throughout Washington's long struggle to break the debt ceiling deadlock, the news media and the public have focused on the prospect of the U.S. defaulting on its debt, but there is a growing consensus that the U.S.'s long-term sovereign debt rating could be cut whether or not policy makers avoid a default.

Standard & Poor's and Moody's Investors Service have placed the U.S.'s sovereign debt rating on watch or review for a downgrade, while reiterating the need for policy makers to address the country's deteriorating fiscal position. Importantly, the ratings agencies could downgrade U.S. sovereign debt if a debt ceiling agreement fails to achieve the significant debt reduction the ratings agencies are advocating. BofA Global Capital Management believes there are three potential outcomes with regard to a downgrade of U.S. debt:

- The U.S. government misses a payment and defaults on its debt, causing at least Standard & Poor's – the most vocal of the credit agencies on the government's fiscal morass – to slash the U.S. sovereign debt rating from AAA to D
- The debt ceiling agreement significantly reduces federal deficits, placating the ratings agencies and avoiding a default
- Policy makers reach a debt ceiling agreement that does not meet the standards established by the ratings agencies, which drop the U.S.'s debt rating one notch from AAA/Aaa to AA+/Aa1.

Given the political dynamics and the tone of the rhetoric in Washington, the likeliest of these three scenarios, in our view, is the one in which the ratings agencies initiate a one-notch drop in the country's sovereign debt rating. Needless to say, even a small drop would impact both issuers and purchasers of debt instruments, but we believe money market funds are positioned to contain the fallout from a downgrade.

### Impact on Money Market Funds

In our view, a drop in the U.S.'s sovereign debt rating would not necessarily have an immediate impact on money market funds because a drop in the U.S.'s debt rating does not automatically impact the rating on the short-term credits purchased by money funds. As the ratings matrix on the following page reveals, the credit rating on the U.S.'s debt would need to drop by roughly eight notches to BBB/Baa before the short-term debt rating dipped below A-2/P-2, the minimum credit rating for money market fund securities.

One of the major concerns generated by the debt ceiling stalemate is that a default and subsequent debt rating downgrade would force money market funds to sell securities into a distressed market. We do not foresee such selling activity because the U.S.'s debt rating would need to drop a full eight notches (from AAA/Aaa to BBB+/Baa2) before the short-term debt rating fell below the Tier II level. And even if the short-term ratings of a fund's holdings were to fall below the rating required for eligible securities, the fund would not be required to dispose of them if the fund manager and the fund's board of trustees determine that continuing to hold the security is in the best interest of shareholders.

NOT FDIC INSURED	May Lose Value
NOT BANK ISSUED	No Bank Guarantee

## Short-Term Debt Credit Ratings

Money market fund category		Moody's		Standard & Poor's		Fitch		
Eligible securities	First Tier	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
		Aaa	P-1	AAA	A-1+	AAA	F-1+	
		Aa1		AA+		AA+		
		Aa2		AA		AA		
		Aa3		AA-		AA-		
		A1				A+*		
		A2*						
		A3*						
				A+	A-1	A+*	F-1	
		A*	A					
				A-*				
Second Tier	A2*	P-2	A*	A-2	A-*	F-2		
	A3*		A-		BBB+			
	Baa1		BBB+		BBB			
	Baa2*		BBB*					
Third Tier	Baa2*	P-3	BBB*	A-3	BBB*	F-3		
	Baa3		BBB-		BBB-			
			BB+*					
	Ineligible securities	Non-investment grade	Ba1 to B3	Not Prime	BB+* to CCC*	B	BB+ to B-	B
			Caa1 to Ca		B* to CC	C	CCC to C	C
In default		C	Not Prime	SD, D	SD, D	RD, D	RD, D	

### Impact of U.S. Debt Downgrade on Funds' Ratings

The possibility that a U.S. debt downgrade could pressure the debt ratings of money fund holdings has raised concerns about the impact of a downgrade on money market funds' AAAm/Aaa-mf ratings. Until recently the ratings agencies had provided little guidance on this issue, but on July 26, Moody's stated that it "considers MMFs rated Aaa-mf to be largely resilient to the direct impacts of a downgrade of the US rating to Aa1, given the ability of fund advisors to actively manage their portfolios, although a downgrade to Aa2 or lower could negatively impact the ratings of a large number of funds." While this statement clearly leaves open the possibility of fund ratings downgrades in the event of a sizeable drop in the U.S.'s sovereign debt rating, it reinforces our view that money market funds are positioned to absorb the impact of a modest downgrade.

Because we are in uncharted territory, it is difficult to assess the impact of a downgrade on U.S. sovereign debt, let alone to gauge the downstream impacts of such a momentous development. Having said that, we believe the money market funds industry is well positioned to manage the impact of the modest debt downgrade many market observers anticipate. At BofA Global Capital Management, we continue to manage the risk of a default/ downgrade by significantly reducing our exposure to direct U.S. Treasuries and by increasing our funds' liquidity levels.

# BofA™ Global Capital Management

BofA Global Capital Management will continue to provide you with information on market developments that impact your investments with us. Please contact your client service officer or BofA Global Capital Management sales representative if you have questions about the actions BofA Global Capital Management is taking to manage the risk of a U.S. debt default/downgrade.

<b>Institutional Investors</b> 800.353.0828	<b>Retail Investors</b> 888.331.0904
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Please read and consider the investment objectives, risks, charges and expenses for any fund carefully before investing. For a prospectus, which contains this and other important information about the fund, contact your BofA Global Capital Management representative or financial advisor or go to [www.bofacapital.com](http://www.bofacapital.com).

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Investing in fixed-income securities may involve certain risks, including the credit quality of individual issuers, possible prepayments, market or economic developments and yields and share price fluctuations due to changes in interest rates. When interest rates go up, bond prices typically drop, and vice versa.

Any guarantee by the U.S. Government, its agencies or instrumentalities applies only to the payment of principal and interest on the guaranteed security and does not guarantee the yield or value of that security.

The credit quality ratings represent those of Moody's Investors Service, Inc. (Moody's), Standard & Poor's Corporation (S&P) or Fitch Ratings (Fitch) credit ratings. The ratings represent their opinions as to the quality of the securities they rate. Ratings are relative and subjective and are not absolute standards of quality. The security's credit quality does not eliminate risk. For information regarding the methodology used to calculate the ratings, please visit Moody's at [www.moody's.com](http://www.moody's.com) or S&P at [www.standardandpoors.com](http://www.standardandpoors.com) or Fitch at [www.fitchratings.com](http://www.fitchratings.com).

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