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from Montage Investments

The Sequester and Potential Municipal Market Impacts

With Congress unable to agree on alternative spending measures, the federal budget sequestration was triggered on March 1. Sequestration is the term for the mandatory federal spending caps that were put in place by the Budget Control Act of 2011 (BCA), the law that resolved the July 2011 debt ceiling showdown. The across-the-board nature of the cuts were intended to be a motivation for both parties in Congress to seek a longer-term solution to federal spending fights, but that effort has not materialized. Instead, the federal government will now be forced to make across-the-board cuts to discretionary spending of $85 billion in the current fiscal year, with little discretion as to how those cuts are allocated.

While sequestration was technically triggered on March 1, nothing notable will happen immediately. The current fiscal year cuts will be phased in over the remainder of the federal fiscal year (ending Sept. 30, 2013) and there is no reason that Congress can't take action during the current year to address the federal budget and satisfy the provisions of the BCA. Congress may even take steps to address the sequestration cuts in the upcoming battle over the current short-term federal funding extension, which expires on March 27. Expect to hear a lot about the potential doomsday effects of a government shutdown between now and then.

In this federal funding environment, where do we see the threats to state and local issuers of municipal bonds? Sectors that are relatively more dependent on federal discretionary spending are at the greatest risk of seeing revenue impacts. The extent to which any reductions would have materially negative impacts is a longer-term question that must be examined on an issuer-by-issuer basis. The bonds we see at the greatest immediate risk from sequestration are taxable Build America Bonds (BABs) that contain par calls with loose call triggers. As we discussed in the Jan. 14, 2013 *Municipal Market Comments*, these BABs have already seen declines in market price and some may now be called at par by the issuers. Investors could potentially experience substantial market losses on bonds purchased with high premiums.

For other issuers we expect potential impacts to be less acute and to be spread over a much longer time period. Issuers at all levels are well aware of how federal spending changes could impact them and have been planning how best to adapt to any actual reductions. Moody's and S&P have both published a number of reports over the past two weeks discussing in broad terms the potential for negative impacts on municipal bond ratings from sequestration. In their views, the greatest impacts loom for the following categories of issuers:

- State and local Governments that are highly dependent on federal activity. This would include issuers located near centers of federal government activity, such as the metro Washington D.C. area (northern Virginia, Maryland, etc.).
- State and local housing agencies.
- Transportation issuers. Of particular concern would be bonds backed solely by federal grants (i.e., GARVEES) or issued by regional and local transit agencies that depend heavily on federal funds. Another area of concern could be smaller non-hub airports that depend more heavily on federal aviation funds.
- Hospitals. Though sequestration specifically exempts Medicare funding, hospitals that receive federal health and research funding could be at risk of revenue reduction.
- Higher Education. Research institutions that receive relatively high amounts of federal research funding could see a larger impact on revenue flows.

We do not anticipate the rating agencies taking any action on ratings in the immediate future due to sequestration. If and when actual cuts are announced and begin to be implemented, we would anticipate rating outlook changes that give issuers time to address changing funding levels.

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