Municipal Market Comments

Ascent Investment Partners

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Federal Budget Cut Impacts on Munis Unclear

Last Fall's failure by the Congressional "Supercommittee" to craft a plan to reduce the federal budget deficit by $1.2 trillion over the next 10 years has triggered a provision that requires mandatory cuts in the federal budget starting next year. The ultimate effects on the municipal bond market, while still unclear, could range from neutral (at best) to quite negative, depending on the details of how such cuts are implemented in individual agencies and departments. As always, we can make general observations about municipals as a market, but each individual issue is a function of its own unique demographic, economic, financial and political fundamentals. The specific impacts on any particular issuer or bond can only be determined by examining the details of the ultimate outcome of the federal budget cuts through the lens of the individual issuer.

Congress passed the Budget Control Act of 2011 to end the August 2011 debt ceiling crisis – the fight which prompted S&P to downgrade the rating of the United States to AA+ from AAA. Included in the Act was the provision that if the Congressional Joint Select Committee on Deficit Reduction (the "Congressional Supercommittee") was unable to agree on a deficit reduction plan, automatic spending cuts, known in the Act as "sequestrations," would be implemented in the federal budget beginning in January 2013. The provisions of the Act require $1.2 trillion of federal spending over 10 years be eliminated.

Because Congress has made no progress on cutting the federal budget deficit and satisfying the requirements of the Act, the sequestration provision of the Act now risks being triggered on Jan. 1, 2013. Of the cuts, 50% have to come from defense spending and the other 50% from domestic discretionary spending. If the sequester is triggered, and if it is implemented as designed, the states that would likely be most at risk for credit impacts would be those heavily dependent on federal funds for social services (i.e., Medicare) and for military-related economic activity. Moody's singled out five such states currently rated Aaa – Maryland, New Mexico, South Carolina, Tennessee and Virginia – by changing their outlooks to negative in August 2011 as a result of the threat of the U.S. government shutdown. Separately, Bloomberg recently examined military spending by state and identified Virginia, Hawaii and Alaska as the states that are most dependent on defense spending (as a percentage of state GDP).

While it is easy to say that one state might be more dependent on federal defense spending than another state, beyond the broad state-level impacts it is extremely difficult to predict specific issuer impacts. Cuts that are made will be realized over a ten-year time period, allowing substantial time for governments to plan. Likewise, members of Congress fight very hard to defend their local bases and contractors, so the ultimate location of any real cuts could largely be determined by Congressional politicking. Case in point, there has been discussion among Republican Congressmen about trying to pass legislation that would limit or eliminate the mandatory defense cuts under a sequester scenario. We cannot handicap what the likelihood is that such an effort could succeed, but that could be one way in which the direct fiscal impacts of "mandatory" budget cuts could be blunted.

We can make some broad observations on the types of issuers that could be most at risk from across-the-board federal budget cuts. Generally speaking, larger issuers with higher credit ratings will be better positioned to weather federal funding cuts with little or no impact on their credit quality. Smaller issuers or those for whom federal funding represents a large percentage of revenues would be at greater risk of budget pressure and rating impact. As always, it is necessary to evaluate issuers individually to determine to what extent they might be vulnerable. More generally, though issuers at relatively higher risk could include:

- Higher education issuers (individual universities or state systems) that depend heavily on federal grants or funding (i.e., large research universities).
- Health care issuers of all types (large research hospitals; health care institutions reliant on National Institutes of Health funding; stand-alone hospitals; small rural hospitals and other health care providers that depend heavily on Medicare and Medicaid reimbursements).
- Local school districts serving poorer populations that are relatively more dependent on federal aid for school lunches and for federal program funding.
- States that are relatively more reliant on federal Medicare funding or federal military spending.
- Transportation issuers that are relatively more reliant on federal transportation funding, especially urban transit systems.
- Local issuers with a disproportionately high concentration of military support facilities; military contractors; or federal agency employers in their economic and employment bases.

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