Sequestration and the Municipal Bond Market

The Budget Control Act put in place automatic procedures to reduce discretionary and mandatory spending that are now scheduled to take effect and continue through 2021. If fully implemented, these procedures will require equal reductions (in dollar terms) in defense and nondefense spending. For 2013, the reductions are to be achieved by automatically canceling, or sequestering, a portion of the budgetary resources for most discretionary programs as well as for some programs and activities that generate mandatory spending.

The $85 billion in sequestration of federal spending authority is only 0.5% of U.S. GDP, although the economic impact will be felt more heavily in areas with a higher presence of federal government employees, contractors, and related businesses. The cuts are split equally between domestic and defense spending in dollar terms but, in percentage terms, the cuts are higher on the defense side including civilian personnel and defense contractors.

MTAM believes that sequestration will present both economic and fiscal challenges to state and local governments, hospitals, and other public sector issuers, which have already faced significant pressures in recent years. However, any credit impact should be isolated, and no near-term internal rating actions are forecasted. We continue to believe that broader cuts that the federal government may implement as it confronts deficit reduction are the larger concern for municipal bond credits.

MTAM believes most areas with large federal government and/or military concentration are well-equipped to handle the potential impact. The possibility of the sequester has been known for some time and we expect that state and local governments have assessed and, in some cases, developed contingency plans to handle its effects as well as the risk of federal deficit reduction more broadly. However, some smaller localities that are heavily dependent on federal activity will be more vulnerable to the economic and revenue impact of the sequester than states and larger, more diverse, municipalities. In such cases, we will pay particular attention to how entities respond to maintain budget balance. We view the impact on economically-sensitive revenue from reduced spending on federal programs, particularly the military in affected areas, will be greater than the direct impact of cuts to state and local municipalities.

Because the largest federal aid programs to the states (including Medicaid) are exempt from the cuts, federal aid reductions to states and local governments are expected to be less than 1% of overall state and local revenues. Grants on special education, housing, and social service programs are not exempt. Cities with high populations of residents that take advantage of those programs may thus feel more impact. However, these grant levels are small compared with overall budgets and we anticipate some programs will be reduced or eliminated rather than backfilled.

Direct federal funding comprises only 4% of local government revenue in aggregate (according to data provided by the U.S. Census Bureau for fiscal 2010), so aid reductions should not have much direct budgetary impact. School districts derive 9% of their revenues from direct federal aid and may be more affected by cuts than other local governments. States themselves are likely to see little net fiscal impact, as MTAM believes most of their reductions will be passed through to local units.

States that backed Republican Mitt Romney for president are among the most vulnerable, a comparison of a report by the Pew Center on the States to the 2012 electoral map shows. Federal spending is 5.3 percent of a state's gross domestic product on average, according to the report. Of 20 states plus the District of Columbia where federal spending accounts for a higher percentage of the GDP, 12 voted for Romney in November.

Yet pro-Obama states might feel a deeper impact, the Pew report shows. The three places where federal spending is nearly 20 percent of GDP -- Virginia, Maryland and the District of Columbia -- favored Obama in 2008 and 2012. The District of Columbia and neighboring suburbs in Virginia and Maryland are particularly vulnerable due to the multitude of defense agencies and contractors located in the region. New Mexico and Hawaii, two states that rely upon federal spending for more than 10 percent of their GDP, also favored Obama in both elections.

Impact on other Public Finance Sectors

Hospitals are facing a 2% reduction in payments from Medicare due to sequestration. While Medicare comprises 40% of hospital revenues, we believe the reduction should be manageable, as many hospitals use conservative assumptions surrounding governmental reimbursement in their budgeting process. During the sluggish economy, hospitals have been able to maintain sound operating performances due to strong expense control. However, cost-cutting opportunities are becoming rarer.

The U.S. Department of Housing and Urban Development's public housing capital fund budget, which provides for debt service on some bonds, will be subject to the sequester. However, the reduction amounts are seen as absorbable, given high debt service coverage levels. For the higher education sector, the main concern centers on the receipt of federal research grants. While a decrease in the level of receipts will pose some disruption, we expect the large research institutions that are the primary recipients of these grants to have the ability to absorb this potential funding reduction.

With respect to the U.S. transportation sector, sequestration is expected to have limited initial impact. Airport funding cuts may cause travel delays as air traffic controllers and security personnel are furloughed. Should this scenario play out, passenger activity at airports could decline as travelers seek alternative options, resulting in decreased airport facility and related revenues. We believe it is unlikely that such revenue reductions would exceed downside scenarios already factored into current internal ratings.

At ports, dredging activities by the U.S. Army Corps of Engineers could be slowed, and grants for security and other projects could also be affected, although credit quality is not likely to be weakened. Regarding transit entities, the impact is expected to primarily be on capital projects that may be slowed as federal support declines. Fuel tax revenues that flow into the Federal Highway Trust Fund to support Grant Anticipation Revenue Vehicle bonds are not expected to be sequestered.

Conclusion

While the direct impact of sequestration on municipalities will be limited to sectors and issuers (such as Build America Bonds) that are dependent on federal spending and payments, the drag on GDP growth may keep downward pressure on high-grade municipals.

The ultimate impact of sequestration will not be felt all at once. Expenditures like unemployment benefits will get affected right away, but furloughs, delayed flights, and national park closures will take weeks or months to take hold. This means both that the impact will be felt more gradually, and that there is still time to avoid the worst consequences of sequestration. MTAM believes the impact of sequestration on a state-by-state level will be affected to a significant degree by how the states manage the lower levels of federal funding. Some states will be more effective than others at handling the cuts.