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Special Report:

## The Credit Impact Of U.S. Budget Sequestration

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# The Credit Impact Of U.S. Budget Sequestration

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THE U.S. ECONOMY, COMPANIES, AND STATES AND MUNICIPALITIES ARE PREPARED, By Beth Ann Bovino, New York

The \$85 billion in federal sequestration cuts that have taken effect and Washington's deadline later this month to prevent nonessential government functions from shutting down could have far-reaching, although probably shallow, effects on the U.S. economy. However, a number of threats remain to the U.S. economic rebound.

### SEQUESTRATION WON'T IMMEDIATELY AFFECT U.S. DEFENSE CONTRACTOR RATINGS

For the Department of Defense (DoD), sequestration means about \$500 billion less to spend over the next 10 years. For the remainder of fiscal 2013, sequestration will result in approximately \$45 billion of cuts to the DoD's budget authority. However, it does not affect funds that prior budgets have already appropriated but have not yet been spent, so the impact will be gradual at first. But it will undoubtedly have impacts to varying degrees on the nation's defense contractors.

### CREDIT FAQ: U.S. BUDGETARY UNCERTAINTY CLOUDS THE OUTLOOK FOR SMALL DEFENSE CONTRACTORS

Planned cuts to U.S. defense spending, the looming threat of sequestration, and the wind down of operations in Afghanistan are likely to affect the revenues and earnings of all U.S. defense contractors. However, smaller defense contractors, with annual revenues ranging from a few hundred million dollars to a few billion dollars, are likely to see a greater impact on credit quality because they have less-diversified operations and fewer financial resources than their larger counterparts.

### RATINGS ON U.S. FOR-PROFIT HEALTH CARE COMPANIES REMAIN STABLE DESPITE SEQUESTRATION'S EFFECT ON MEDICARE PAYMENTS

Standard & Poor's has taken an in-depth look at how the cuts will affect the ratings on U.S. for-profit health care companies because these companies have exposure to Medicare, which faces a 2% reduction in payments, beginning April 1. However, we are not taking any immediate rating actions directly related to this cut.

### SEQUESTRATION IS ANOTHER BUMP IN THE ROAD TO RECOVERY FOR U.S. STATE AND LOCAL GOVERNMENTS

With federal sequestration cuts of \$85 billion likely taking effect beginning March 1, we anticipate uneven credit implications throughout the state and local government sector. We anticipate the effects of federal sequestration will be mildly negative in broad terms, but they have potential to apply more acute credit pressures to specific jurisdictions. But even in these instances, credit deterioration is not a foregone conclusion.

## SEQUESTRATION UNLIKELY TO HURT MUNICIPAL INFRASTRUCTURE ISSUER CREDIT QUALITY

We believe the sequestration cut will unlikely to harm the credit quality of public finance infrastructure issuers, such as municipal water and wastewater utilities, transportation authorities, public power agencies, or even federal power entities like the Tennessee Valley Authority or the Bonneville Power Administration. We see sequestration itself as a neutral credit event for infrastructure issuers, depending on the legal provisions contained in their respective bond documents.

## MUNICIPAL ENTERPRISES TO BE PRESSURED BY SEQUESTRATION; PUBLIC HOUSING AUTHORITIES ARE AFFECTED MOST DIRECTLY

We believe that the federal budget sequestration will likely have varying effects on the municipal enterprise sectors. The federal government's activity in the housing market includes operational subsidies, rent subsidies, mortgage insurance, loan purchases, and loan securitization. Nearly all municipal housing transactions have at least one form of this support, so the impact of budget sequestration and tax increases on municipal housing would be multifaceted.

## THE SEQUESTER DEBATE LOOKS LIKE AN OLD MOVIE RERUN

On March 1, the first \$85 billion installment of the \$1.2 trillion in mandated budget cuts took effect. The continuing resolution will expire on March 27, which means that, unless Congress makes no additional appropriations, nonessential functions of the government will grind to a halt. The good news is that, in our view, the underlying momentum in our economy will help it withstand these drags on growth. The bad news is that if these budget cuts kick in, the economy would slow unnecessarily, at least for a while.

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