MUNICIPAL CREDIT IMPLICATIONS OF A FEDERAL GOVERNMENT SHUTDOWN

There have been 14 federal government shutdowns since 1981 with nine lasting more than one business day. While federal employee furloughs and interruptions in federal aid distributions may cause very short-term adjustments for municipal issuers, based on past experience, we believe that a federal government shutdown that lasts beyond a few weeks would have minimal impact on the creditworthiness of municipal bond issuers. While very unlikely, an extended shutdown beyond the 2018-2019 event that lasted 35 days would create further interruption to municipalities, although we feel even that scenario would be manageable, particularly for the high-quality issuers that Appleton invests in.

SECTOR IMPLICATIONS

The following sectors have elevated reliance on federal payments:

- **Military, Section 8, and Public Housing** – Debt service is typically covered by federal grants or appropriations, which could be interrupted. We do not have exposure to any of these sectors. Most issuers are small, there is single-site risk, and some military debt must be issued on a taxable basis.
- **Federal Lease Facilities** – Debt service is covered by lease payments made by various federal entities. We do not have exposure to this sector. Ratings are typically low-investment grade and the leases often require extension prior to bond maturity.
- **GARVEEs** – Appleton does have some exposure to the GARVEE sector although we remain confident in our holdings based on the following factors. Federal Highway Administration distributions continued for GARVEE issuers during past shutdowns, as the funding program is a multi-year authorization act, granted special "Contract Authority" (funding currently authorized through 2026). In addition, some GARVEEs deposit debt service 12 months in advance, others have reserve funds, and some are secured by a backup pledge of revenues by the issuing State, providing additional layers of protection.
- **Mass Transit, Higher Ed, Healthcare & Airports** – All of these sectors have some level of federal payment reliance. However, revenue diversity, robust liquidity, and budget flexibility would provide ample offsets in the event of a prolonged government shutdown. Notably, Medicaid and Medicare are non-discretionary, and funding is expected to continue to flow during a shutdown.

REGIONAL IMPLICATIONS

States and Local Governments would also likely experience a minimal level of interruption during a federal government shutdown. That said, certain regions are more exposed due to a greater number of federal employees, federal contracts, and federal spending on goods and services. For the more exposed credits highlighted below, we believe even a protracted shutdown (>30 days) would still be very manageable.

- **District of Columbia** – According to BLS data, D.C. is home to more than 191,000 federal employees, 24.7% of the District's total employment (national median is 1.7%). This level of federal employment reliance has obvious consequences in the event of a shutdown and potential furlough. However, the District has weathered past shutdowns prudently and retains more than $4 billion in available reserves.
- **Maryland, Virginia and West Virginia** – although less exposed than D.C., these States and local counties still have an above average reliance on the federal government and ancillary businesses to support economic activity. Nonetheless, the region is known for well managed municipalities with many counties and cities enjoying AAA ratings. We are confident in the stability of the regional issuers in which our clients are invested.
- **Hawaii and Alaska** – Headlines may point to these states as highly exposed to a shutdown due to reliance on federal employees. However, we note that federal employment in Hawaii and Alaska is primarily military focused and Department of Defense payments would likely continue in the event of a shutdown, thereby minimizing the financial impact.

PREREFUNDED BONDS

While not specific to municipal credit conditions, it is important to raise implications a potential Moody's downgrade of U.S. Treasuries could have on Prerefunded bonds. With S&P and Fitch already rating the U.S. one notch below the top tier, a downgrade by Moody's would likely result in a downgrade of all re-rated Prerefunded bonds backed by U.S. Treasury or Agency collateral. While falling below a "AAA" rating would generate headlines, we believe the municipal market would continue to hold Prerefunded bonds in high regard given the strength of the collateral.

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