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Markets & Economies

Gauging the Impact of Federal Funding Cuts on Municipal Bond Sectors

Many sectors appear well situated to weather the potential effects of planned fiscal changes.

Key Points

- Recent news regarding planned funding cuts to U.S. government programs and other fiscal changes has prompted questions from investors about the potential impact on municipal bond sectors, including healthcare, higher education, housing, and airports.
- We believe certain factors may help mitigate the potential for significant impacts, including strong post-pandemic financial conditions and diversified revenue sources for many issuers, and broad political support for programs such as Medicaid.
- While certain segments of the market are more exposed to federal funding changes, we do not anticipate substantial near-term impacts from these reductions.
- The changing U.S. fiscal spending backdrop highlights the importance of professional management, in our view, especially regarding credit research, security selection, and sector allocation.

As the first quarter of 2025 draws to a close, many of the key factors that drove the performance of the municipal bond market in 2024 remain firmly in place. Municipal yields continue to hover near their highest levels of the last decade, offering investors attractive tax-free income regardless of potential moves by the U.S. Federal Reserve. Meanwhile, strong demand from mutual funds and separately managed accounts continues to absorb near-record levels of supply, and the credit backdrop of the market remains healthy.

Recently, we have received questions from investors about shifts in fiscal policy and cost-cutting initiatives introduced by the new U.S. administration. Below we summarize the implications for key municipal sectors, including mitigating factors that we believe are likely to help reduce potential risks.

Hospitals

The healthcare sector, primarily the Medicaid program, is a focus of the administration's planned spending cuts. However, we do not expect program reforms that would have a meaningful impact on credits in the sector, such as block grants or changes to state-directed payments. Rather, we expect more targeted cuts focused on cost-savings that do not directly impact beneficiaries or restrict access to care. These could include adding work requirements, cutting Medicaid administrative spending, or lowering the federal match for the expansion population over several years. While such actions would be negative for the sector, we believe hospitals could absorb any financial impact given strong 2024 performance and robust liquidity.

Higher Education

Most universities have diversified revenue streams that include tuition, endowment income, and private grants, providing resilience against fluctuations in federal funding. Additionally, many institutions have strengthened their financial positions following pandemic-related challenges, with improved liquidity metrics and robust expense management, that provide further buffers against potential funding cuts. There is some speculation that Pell grants (federal financial aid awards to students) could be affected if the U.S. Department of Education were to be eliminated. However, given that cuts to these grants would place a significant burden on college students, we consider it more likely the administration of the grants would be transferred to a different federal agency. Lawmakers are also considering capping or reducing federal Direct student loans, which could depress enrollment, largely at the lower-tier colleges.

Another area of concern is potential changes to taxes for endowments under consideration. Congress is discussing increasing the excise tax on net investment income from 1.4% to as high as 21%, as well as expanding the applicability of the tax from only the wealthiest private universities to a broader range of institutions. While expansion of the tax would represent an incremental headwind for the sector, the impact will generally be felt by only the strongest institutions, which benefit from significant market presence and resources. These universities may be forced to offset the reduction in revenue with cuts to financial aid, scholarships, research, or the general operating budget.

Due to President Trump's proposed cuts to federal research funding, research universities with R1 designations (the highest levels of research activity) may need to reconfigure research programs rather than face credit deterioration. There is a small subset of research-focused public and private universities that derives a material portion of operating revenue from federal grants. However, these institutions typically have strong balance sheets, which will allow them to weather potential credit impacts.

Grant Anticipation Revenue Vehicle Bonds (GARVEEs)

These bonds are backed by expected reimbursements through the federal Highway Trust Fund. Current authorization, classified as mandatory spending, runs through September 30, 2026. While reauthorization faces uncertainty, the sector has demonstrated resilience in the face of past expiring authorizations, as multiple short-term extensions have allowed for uninterrupted highway funding. In addition, explicit or implicit state backstops provide downside protection in the event of a significant shift in federal policy. States currently have strong financial positions and reserves to bridge any potential gaps, while the amount of outstanding GARVEE debt tends to be relatively low relative to outstanding state debt. For example, in addition to the pledge of federal highway reimbursements, the State of Virginia (general obligation bonds rated AAA by S&P) also provides a formal backstop in the event federal reimbursement is insufficient. Virginia has $768 million in outstanding GARVEEs as compared with roughly $12.0 billion in outstanding state tax-supported debt. As such, supporting the GARVEE debt, if needed, would not be overly burdensome to the state.

States

Medicaid is the largest category of spending for state budgets, making up 30% on average. We do not anticipate material changes to Medicaid due to political challenges associated with program reductions. Furthermore, any federal funding cuts would likely be phased in gradually, allowing states time to adjust their programs. States have various levers they can pull in the face of federal cuts, including increasing their share of spending, reducing enrollment or benefits, or lowering the rates paid to healthcare providers. Fortunately, states currently enjoy historically robust rainy-day funds, following strong post-pandemic fiscal performance, which would allow them to handle any reduction in federal funding. We believe states that expanded their Medicaid programs under the Affordable Care Act would face greater pressure from federal funding reductions. However, many of these states have set aside reserves to address potential federal policy changes. There is a possibility that the burden of funding for programs cut or downsized by the federal government could shift to states, such as the National School Lunch Program or the Supplemental Nutrition Assistance Program, currently administered by the U.S. Department of Agriculture Food and Nutrition Service.

Large states such as New York and California anticipate receiving tens of billions in grants under the Infrastructure Investment and Jobs Act and the Inflation Reduction Act for water infrastructure, public transit, roads, and bridges. Without federal funding, these programs would either be cut or require additional state or local debt issuance. As of this time, funding has not been interrupted.

K - 12 Education

Federal subsidies for early learning and school lunch programs for low-income families represent a small portion of school budgets and would not materially impact most municipal obligors. However, cuts would disproportionately affect low-income districts unable to self-fund these programs, potentially leading to enrollment losses if children stopped attending school due to lack of meal access.

Housing

State and local housing authorities generally have very strong credit quality due to strong underwriting standards and loan portfolios. Cuts to core U.S. Department of Housing and Urban Development (HUD) programs are unlikely given broad support for affordable housing. Rental assistance payments were confirmed to be exempt from the funding pause, but permanent cuts to programs like Section 8, HOME block grants, or federal housing tax credits would have negative impacts mainly on small or one-time issuers that use these incentives to finance multifamily housing construction or conversion. While there may be some impact on a small number of issuers, we do not believe it will have a meaningful effect on the broader municipal market.

Federal Leases

Recent headlines have highlighted efforts to reduce office space leased by the General Services Administration (GSA), including buildings like the NASA headquarters. These cuts could potentially impact municipal bonds backed by these leases, which are often taxable and lower quality. We do not invest in GSA-backed securities, which represent a very small part of the overall market.

Airports

Federal funding for airports primarily supports capital expenditures and not operations; any funding declines would likely be offset by increased municipal bond issuance, which is the main mode of financing for large airports. Furthermore, the credit quality of airports remains robust, characterized by strong liquidity and revenues that are not tied to passenger volume.

A Final Word

We continue to believe that municipal bonds offer attractive valuations and strong fundamentals. Headlines from Washington regarding federal funding cuts have the potential to create uncertainty and may lead to volatility in certain sectors. We have a team of sector-focused credit analysts dedicated to analyzing fundamentals in their designated areas. By and large we expect limited impacts to credit quality due to the funding changes discussed here.

We would also note that potential impacts to the valuation of municipal bonds from news reports on funding changes—relative to the actual impacts to credit quality—are likely to lead to attractive opportunities for research-driven active managers.

Sectors not included in this list are not expected to be materially impacted by proposed federal funding cuts at this time.

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Glossary & Index Definitions

Rainy-day funds, also known as budget stabilization funds, allow states to set aside surplus revenue for use during unexpected deficits.

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