BBH STRATEGY INSIGHT

Bad moon rising: Navigating uncertainty in federal-exposed municipal credit

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When it comes to credit, we don't shoot for the moon. Instead, we seek durability, which we view as resilience to a wide variety of economic and political circumstances. Over the last year, federal aid, once viewed by our team as a source of credit strength, has become increasingly politicized. As a result, sectors and credits with large exposures to the federal government – through the local economy, appropriations, or grant funding – now face increased uncertainty. We also expect to see a shift in the funding burden away from the federal government. Consequently, there's a bad moon on the rise for some, including states, local governments, and other not-for-profit entities.

The impact of the One Big Beautiful Bill Act

The One Big Beautiful Bill Act (OBBBA) became law in July 2025, and with it came sweeping tax and policy provisions with implications for municipal credit. Medicaid cuts of $900 billion by 2034 and significant changes to the Affordable Care Act (ACA) grabbed headlines. The changes include more stringent eligibility requirements for enrollment, a reduction of the provider tax cap in Medicaid expansion states, and new limits on state-directed payment programs. The cumulative impact of these modifications will ultimately include less covered lives, lower reimbursement rates for providers, and less federal dollars flowing in support of Medicaid-related programs.

Two major municipal bond sectors will bear the brunt of these changes: states, especially those that have expanded Medicaid coverage, and not-for-profit hospitals.

States

Federal aid comprises roughly one-third of total state funding. Of this federal aid, Medicaid comprises nearly 70%, while the rest is split across many areas, including education, healthcare, infrastructure, and social assistance programs. Although state exposure to the federal government is high, we expect most state credits to remain strong. As sovereign-like entities, states possess broad economies and autonomy over taxation of their residents to raise revenue. States also have significant abilities to manage their expenditures, although, as Pennsylvania's recent four-month budget impasse demonstrates, state legislators can face practical constraints when attempting to balance their budgets without cutting access to critical care. In addition, most states have large reserves which can help buffer a decline in federal support. Future budget decisions will ultimately determine the extent to which states can sustain meaningful financial support for affected care and patients.

Not-for-profit hospitals

The OBBBA's changes to Medicaid and the ACA will also impact not-for-profit hospitals. The sector has faced numerous headwinds over the past five-plus years, from the COVID-19 pandemic, which resulted in significant reductions of nonemergent procedures; to a historically tight labor market for medical professionals; to inflation for drugs, personal protection equipment, and other supplies. The fallout from the OBBBA will hit hospitals on multiple fronts. First, the number of covered lives will diminish with work requirements. As a result, hospitals may need to take on additional self-pay and charity care patients. Second, reimbursement rates and supplemental funding will decline, which will compress margins. Both states and hospitals have about 18 months to two years to prepare for the changes, but funding gaps loom large.

Other impacted areas include higher education, transportation projects, the housing sector, and Federal Emergency Management Agency (FEMA) funds.

Higher education

Colleges and universities will see a modest increase in endowment tax, dependent on asset levels per student, and a curtailment of federal student loan programs. The pressure goes further, as higher education institutions also face political uncertainty that may suppress international applicants and potential cuts to grants and research funding. Without commensurate spending cuts and tuition increases, these institutions will likely experience tighter margins and drawdowns in reserves or endowment assets.

Transportation initiatives

The administration has increasingly politicized its support of state and local governments as well. Transportation projects, which can be supported by federally-backed bonds and often rely on federal appropriations, can be particularly sensitive to shifts in the political landscape. This year, two transportation initiatives in New York City, congestion pricing (CBDTP) and the Gateway tunnel project under the Hudson River, have come under fire from Washington, D.C. We do not own bonds backed exclusively by CBDTP revenues.

Housing

The housing sector has also experienced its share of headlines this year. The administration voiced its desire to privatize Fannie Mae and Freddie Mac and end their post-2008 Global Financial Crisis (GFC) conservatorship. Such a policy shift could have a disruptive impact on the housing market and lead to higher mortgage rates for homebuyers. State housing finance authority bonds could see their bond ratings lowered, which could also increase authorities' borrowing costs. We anticipate, however, that existing bonds will be grandfathered into an implicit guaranty in the event of privatization. We expect our state housing finance authority bonds to remain strong with robust underwriting standards, adequate overcollateralization, and currently high levels of federal guaranties either through federal mortgage insurance or mortgage-backed securities (MBS).

FEMA

Lastly, local governments in areas prone to natural disasters and climate change events have long benefited from FEMA in the wake of tragedy. In 2016, we wrote an article titled "Mother Nature Versus Credit." In it, we discussed how credits receive a layer of protection following a disaster from FEMA which provides states and local governments with critical operating and financial support to recover and ultimately rebuild. Historically, FEMA funds have covered upwards of 75% of eligible costs of damages. While aid is never guaranteed, FEMA has long been a core government function and consistently and reliably assisted during natural or man-made disasters. The current administration has voiced its intention to dismantle FEMA following the hurricane season, leaving the future of aid to local governments recovering from disasters much less certain.

Market outlook and key takeaways

Credit fundamentals reached a high-water mark last year on the back of pandemic aid and the Inflation Reduction Act (IRA), during which time federal money flowed more freely. But now the taps have been turned off. Despite meaningful uncertainties, many lower-rated bonds remain priced to perfection, with looming risks not reflected in current valuations. Fortunately, higher-quality bonds with nonstandard structures continue to offer attractive risk-adjusted yields.

Following periods of easy money like we saw at the height of the pandemic, we often expect a period of increased fiscal austerity. This occurred after the GFC when many governors were elected promising spending cuts. While we structure our portfolios with credits that can withstand policy changes, we must admit we did not anticipate such a change to our view of federal appropriations. We are particularly cautious as this "bad moon" rises on the horizon. Outside of contractual guarantees, federal support is not what it used to be. We will continue to rely on our research and abide by our criteria to help keep our portfolios insulated from risk. Looks like we're in for nasty weather.

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Risks

Investors should be able to withstand short-term fluctuations in the equity and fixed income markets in return for potentially higher returns over the long term. The value of portfolios changes every day and can be affected by changes in interest rates, general market conditions and other political, social and economic developments.

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