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[S&P: U.S. State And Local Government Credit Conditions Outlook: Economic Growth Outlook Dims Amid Rising Global Uncertainty.]

Economic data since March remain consistent with S&P Global Ratings' forecast for continued slow growth. The United Kingdom's vote in late June to leave the European Union added to an already uncertain global economic setting and is likely to weigh indirectly on U.S. GDP. Consequently, we have lowered our real GDP growth forecast for 2016 to 2.0% from 2.3%. The effects are likely to dissipate over time and result in only a modest revision to our forecast for 2017 growth to 2.4% from 2.5%. Fortunately for state and local governments, the key drivers of U.S. economic growth—consumer spending and the housing sector—are largely a function of domestic demand. Nevertheless, the uptick in uncertainty stemming from Brexit and slow GDP growth in the first quarter has led us to raise our risk of recession estimate over the next 12 months to 20%-to-25% from 15%-to-20%.

For most state and local governments, the new fiscal year began on July 1, in the wake of financial market shockwaves unleashed by the Brexit vote. Although equity markets initially tumbled in the immediate aftermath of the U.K. vote, they subsequently rebounded. Still, the tendency for markets to experience bouts of volatility has become a theme for 2016. This has cast a modest pall over the revenue outlook for state governments in particular, which tend to be more reliant on personal income taxes than their local government counterparts. Most states still project that tax revenues will increase in fiscal 2017, but at a slower pace than in 2015 and 2016. We also perceive that state revenue forecasts are subject to greater risk as a consequence of the increased financial market volatility. In addition, market volatility that struck in late June is likely to undermine investment returns for state and local government pension systems with a July 1 fiscal year. The California Public Employees' Retirement System (CalPERS), for instance, reported that its investments earned just 0.6% for fiscal 2016, far short of its 7.5% assumed rate of return. We expect the trend toward weaker investment returns seen in fiscal 2015 and 2016 will translate to upward pressure on pension contributions for state and local governments, further squeezing their fiscal positions.

Overview

- Our revised forecast anticipates slower economic growth in 2016, at 2.0% from 2.3% as of March;
- The risk of recession has increased to 20% to 25% from 15% to 20%;
- Key supports to economic growth remain consumer spending and the housing market;

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