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[Fitch: USPF Exposed to the Same Factors Pressuring the US Sovereign]

Fitch Ratings-New York-12 August 2021: US Public Finance (USPF) ratings are subjected to the same macroeconomic and structural factors that underlie the Negative Outlook on the United States' Long-Term Foreign Currency Issuer Default Rating (IDR) of 'AAA' says Fitch Ratings. Most USPF ratings are not explicitly tied to the US sovereign rating, except when bond repayment depends on federal agencies or instruments. However, federal policy actions have direct and indirect ramifications for the operating environment of states, local governments, and revenue-supported entities, which over time could influence the risk profile of the sector.

The Negative Outlook on the US sovereign rating reflects ongoing risks from fiscal deficits and real interest rates to its public finances and debt trajectory. A further meaningful increase in debt could lead to a downgrade. Deterioration in governance represents a further risk, reflecting in part a lack of bipartisanship and difficulty in formulating policy and passing laws in Congress.

Although there are numerous policy and funding links between USPF issuers and the federal government, USPF issuers benefit from the significant autonomy inherent in the US federal structure. Legal and fiscal powers enshrined in the US Constitution devolve broad powers to states, most notably fiscal powers. Government frameworks below the state level follow similar patterns, with substantial fiscal powers delegated to local governments to deliver general services and to public and not-for-profit entities to fund public services through their own revenue powers.

Future actions by the US government to rein in the nation's very high debt burden by curtailing spending could directly affect USPF credits that rely on federal funding for certain programs, particularly Medicaid, housing subsidies and grants, higher education grants and student loans, and the Highway Trust Fund. USPF ratings assume sufficient flexibility to respond to reduced federal funding, although service mandates or decisions to backfill lost federal funds with own-source resources could affect operating performance over time.

Local governments bear the added risk of absorbing both federal spending cuts and state tightening that could follow a round of federal spending cuts but their typically broad budgetary tools and high reserves help offset this constraint. Lower infrastructure investment could also affect credits longer term if states, local governments and revenue-supported entities must ultimately bear the full burden for expansion or restoration of infrastructure.

Beyond funding effects, a weakening of the US government's credit quality could have wider reverberations on USPF finances. Higher interest rates would make debt issuance costlier for USPF issuers. Weaker public finances could diminish the reach and effectiveness of countercyclical actions, leaving USPF issuers vulnerable to deeper downturns and slower recoveries.

A limited number of ratings with direct links to, or dependence on, the US sovereign credit retain the Negative Outlook on their 'AAA' rating, unless there are mitigants that reduce US sovereign exposure. These ratings with US rating links are municipal housing bonds currently rated 'AAA' and secured entirely, or predominately, by Fannie Mae and Freddie Mac mortgage-backed securities and pre-refunded municipal bonds where escrowed funds deposited with a trustee to advance refund the bonds are invested in US government obligations. Ratings on the latter bonds depend on the rating assigned to those securities, which are generally US treasuries or other bonds directly guaranteed by a US federal agency.