

The Sequester

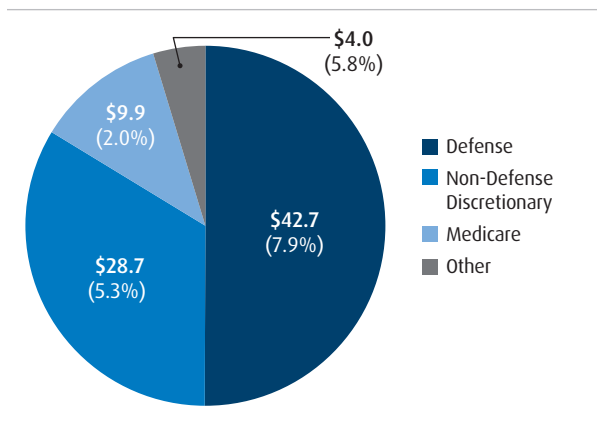
How it came to be and what it now means

The first use of sequester dates back to the Gramm-Rudman Act of 1985. The current sequester is a result of the fury and flurry of activity surrounding events in late summer 2011: the S&P downgrade of U.S. debt and raising of the debt ceiling. In order to raise the debt ceiling, a deal was struck to “sequester” a “super committee” with equal representation of senior Republican and Democratic leaders to solve our fiscal dilemma. The committee was charged with developing and proposing a solution to our complex fiscal problems: spending, taxing, entitlements, etc. The committee failed to reach an agreement. As a result, the pre-agreed-upon fall back plan triggered automatic, across the board spending cuts totaling roughly \$1.2 trillion spread equally over nine years from 2013 to 2021—or \$109 billion per year.

In the fiscal cliff negotiations at the end of 2012, the start date of the spending cuts was re-set from January 1 to March 1, 2013, leaving only seven months until the current fiscal year of the government ends on September 30. So the total 2013 “stated” target for spending cuts is \$85 billion, but due to delays in implementation, etc., actual cost cuts by the end of the fiscal year are likely to be noticeably lower than \$85 billion. The terms of the spending cuts require 50% to come from each

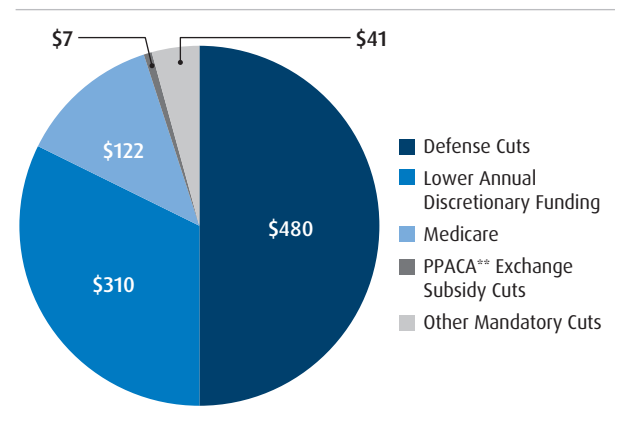
of the defense portion of the budget and the “discretionary”/ non-defense portion. The estimated fiscal drag on the U.S. economy from both the fiscal cliff and the sequester is estimated to range from 1% to 1.5% for 2013. Note that entitlements such as Medicare, Medicaid and Social Security are untouched, with the exception of Medicare cuts of 2%. **See Charts 1 and 2.**

Chart 1 | 2013 Cuts (\$Bn and Budget %)



Source: Congressional Budget Office

Chart 2 | 2013–2021 Cuts (\$Bn)*



Source: Bipartisan Policy Center
 *Excludes reduction on debt interest
 **Patient Protection and Affordable Care Act (PPACA)

Table 1

Agency	% Cut*	Impact Examples
Agriculture	4.6%	<ul style="list-style-type: none"> Furlough of 1/3 workforce Potential impact on meat and poultry inspection
Defense	7.9%	<ul style="list-style-type: none"> Civilian hiring freeze Reduced troop training Delayed maintenance of ships and aircraft
Homeland Security	4.6%	<ul style="list-style-type: none"> Furlough of TSA officers and Secret Service agents Reduced hours and furloughs for Border Patrol agents and Customs officers
Small Business Administration	4.6%	<ul style="list-style-type: none"> Reduced loan activity Counseling services reduced
Transportation	4.6%	<ul style="list-style-type: none"> Furlough of 47,000 FAA employees

Source: Senate Appropriations Committee; Research Partners

*Since the cuts occur mid-fiscal year 2013, some say the cuts amount to about 9% for non-defense agencies and about 13% for Defense.

Impact on Agencies

Obviously, big categories like defense and discretionary have important subcomponents. The table above highlights a few key governmental agencies and the approximate percentage reduction in their budgets. One or two general areas are also itemized where cost cuts might be made and some potential impacts. Where employment is being reduced, 30–60 days’ notice is frequently required, so the cost effect is not immediate and, in many cases, employees will be furloughed and work fewer days/hours.

Impact on States

In addition to the effects on agencies, there are some highly differentiated impacts across states that have a high concentration of their economies either tied to defense activities or to providing services to the federal government, including IT consulting, hardware and software support, legal counsel, etc. In several states, 10% or more of their economies is tied to work for the U.S. government. The panel to the right shows that breakdown.

Top 5 States with Highest Defense Exposure

Hawaii	14.6%
Alaska	10.5%
Maryland	9.8%
Virginia	9.8%
District of Columbia	9.8%
Kentucky	8.0%

Top 5 States with Highest Discretionary Spending Exposure

Maryland	10.0%
Virginia	10.0%
District of Columbia	10.0%
New Mexico	9.2%
Idaho	4.9%
West Virginia	3.8%

Source: The Pew Center on the States

Chart 3 | Returns: January 2013

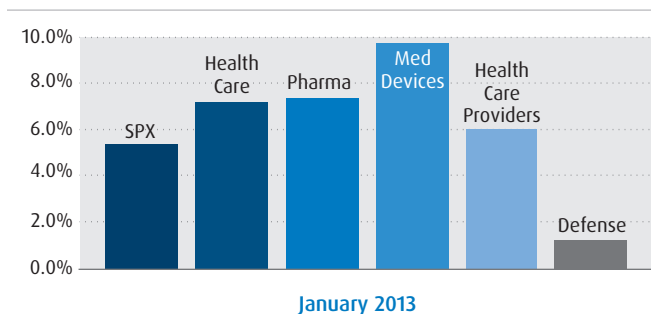
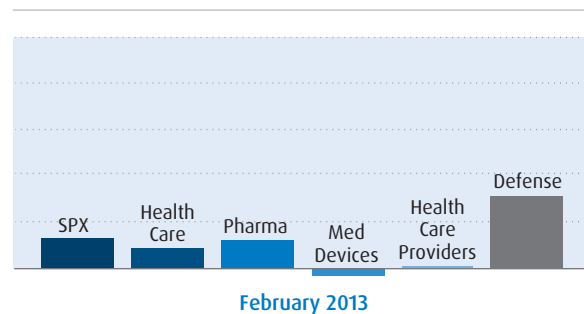


Chart 4 | Returns: February 2013



Source: Bloomberg. S&P 500® Index, iShares S&P Global Healthcare ETF, iShares U.S. Pharmaceuticals ETF, iShares U.S. Medical Devices ETF, iShares U.S. Healthcare Providers ETF, iShares U.S. Aerospace & Defense ETF

Impact on Sectors/Industries

It is unclear how all this might be decoded by the stock market in specific sectors or industries, such as defense, health care, etc. It is interesting to note that, while the headlines surrounding both the fiscal cliff and the sequester have been front and center for a couple of months, the stock market continued higher. Many market pundits have worried about how defense stocks and selected components of health care such as managed care companies, hospitals and device makers would fare. Charts 3 and 4 above illustrate the January and February performance for the S&P 500 and select ETFs that represent industries for defense and health care.

Where do we go from here?

The bigger question is: so where does this all go from here? There are two more dates of importance where battle lines might be drawn and the debate might enlarge. The first of those dates is March 27, 2013—the date the Continuing Resolution (CR), a resolution that permits government spending to continue, comes due. Most commentators suggest that Congress will approve the CR and current funding demands will be met. The next date is when we bump up against the debt ceiling again—estimated around late July or early August. That may be the time when the parties use that issue as the opportunity to push for entitlement and tax reform.

It is extremely important to remember that the current sequester, other than a modest reduction in Medicare payments, leaves open for debate and decision the much bigger priority of important reforms to entitlements and taxation. These are overdue—long overdue!

This is not intended to serve as a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. Information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy. This publication is prepared for general information only. This material does not constitute investment advice and is not intended as an endorsement of any specific investment. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek advice regarding the appropriateness of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investment involves risk. Market conditions and trends will fluctuate. The value of an investment as well as income associated with investments may rise or fall. Accordingly, investors may receive back less than originally invested. Investments cannot be made in an index. **Past performance is not necessarily a guide to future performance.**

BMO Global Asset Management is the brand name for various affiliated entities of BMO Financial Group that provide trust, custody, securities lending, investment management, and retirement plan services. Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions. Products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. BMO Financial Group is a service mark of Bank of Montreal (BMO).

Investment products are: **NOT FDIC INSURED — NO BANK GUARANTEE — MAY LOSE VALUE.**

© 2013 BMO Financial Corp. 13-326-008 (3/13)



A part of BMO Financial Group