DELTA ASSOCIATES

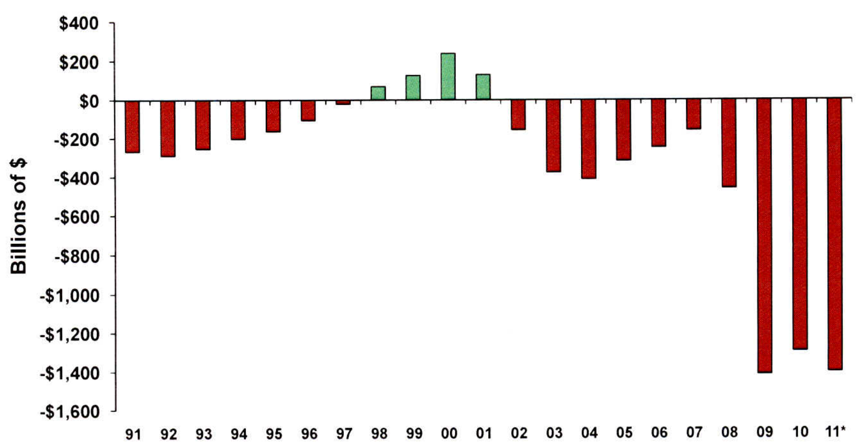
THE FEDERAL BUDGET AND ITS IMPACT ON THE WASHINGTON METRO AREA

(A View on August 4, 2011)

The Congressional Budget Office (CBO) anticipates the U.S. budget deficit for 2011 will total $1.4 trillion. (See Figure 1.) The U.S. budget deficit was $1.3 trillion in 2010, down from $1.4 trillion in 2009. Gaining Federal budget balance has generated concern by both political parties. A split Congress and the election of many new representatives in 2010 who campaigned on the promise to cut spending has sparked heated debate on how to reduce the deficit. This debate peaked in late July as the world watched a dysfunctional government finally reach a deal on deficit-reduction and the debt ceiling, which was passed and signed into law on August 2.

Figure 1

Federal Budget Deficit



Source: OMB, CBO, Delta Associates; August 2011.

* Projected by CBO as of May 2011.

The Federal Budget and the Debt Ceiling

With the debt-ceiling debate finally coming to a close in early August, here is what the deal contains:

- Debt ceiling raised by up to $2.4 trillion ($400 billion immediately, with up to $2 trillion to be "earned" based on future spending cuts)
- Discretionary spending cuts: $917 billion over ten years
- No tax increases
- A special bipartisan Congressional committee set up to reach a goal of $1.5 trillion in added budget cuts by Thanksgiving, with a minimum of $1.2 trillion in new cuts. If this committee fails, automatic cuts of $1.2 trillion will kick in – half in defense and half in domestic programs. (See Figure 2.)

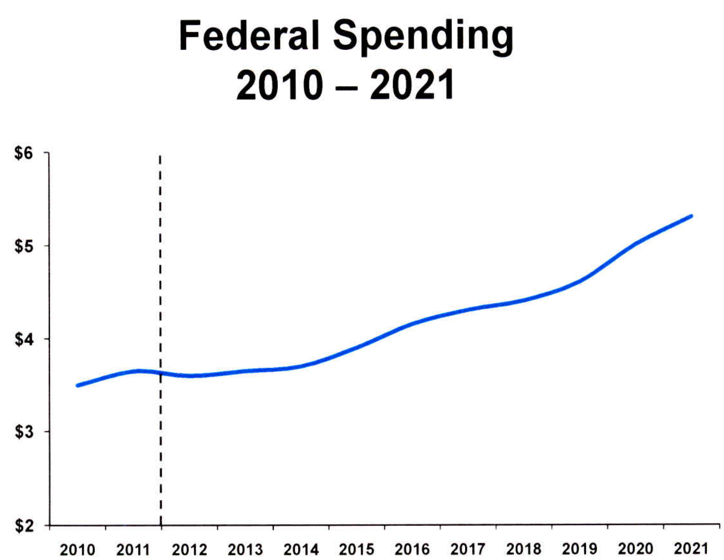
Figure 2

August 2011 Budget Deal Type of Spending	Budget Cuts (Total for 2012-2021)
Discretionary spending – initial cuts	$917 billion
Discretionary and mandatory spending – later cuts	Approx. $1.2 trillion
Total cuts over ten years	Approx. $2.1 trillion

Source: CBO, Delta Associates; August 2011.

The cuts begin to take effect in Fiscal Year 2012. The cuts likely will be back-ended, not evenly spread. But while the cuts will make a dent in the deficit over the next few years, they will not cause Federal spending to decline. According to the Center on Budget and Policy Priorities, Federal spending is still set to rise from approximately $3.5 trillion in 2010 to $5.3 trillion in 2021. ***As a result of the August 2011 agreement, the rate of increase in Federal spending will decelerate, but spending will not actually be reduced. This is an important takeaway for those particularly concerned about the Washington area's economic future.*** (See Figure 3.)

Figure 3



Note: 2012-2021 are projected. Assumes maximum cuts are made by bipartisan Congressional committee and Bush tax cuts for the rich are allowed to expire in 2012.
Source: Center on Budget and Policy Priorities, *Washington Post*, Delta Associates; August 2011.

Budgets for 2011 remain under the influence of legislation passed in March: a $38 billion reduction from earlier levels. Of the $38 billion in budget cuts, $21 billion is in discretionary spending with a balance of $17 billion in mandatory spending. The departments experiencing the deepest cuts include Transportation/Housing at a $12 billion (or 18% of 2010 budget) reduction and Commerce/Justice at an $11 billion reduction (or 17% of 2010 budget). ***Of note for the Washington region, the plan for 2011 included saving the much needed $150 million in Federal funding for WMATA.*** The Department of Defense was allocated a $5 billion increase to $513 billion from 2010 levels – one of only a few agencies receiving an increase in spending. The increase will continue to fuel operations and maintenance, procurement, research and development, and health programs. Given the focus on deficit reduction, every dollar in the defense budget moving forward will be scrutinized. Under the August 2 deal, up to $600 billion in cuts could be to Defense Department programs, depending on the recommendations of the joint Congressional committee.

2012 Federal Budget and Long-Term Spending

Details of how budget cuts will be implemented under the August 2 deal are not available at this writing. With the 2011 budget resolved earlier this year, Democrats and Republicans are currently refining their approaches to the 2012 budget.

President Obama's budget framework, announced in mid-April 2011 after GOP backlash on his original 2012 proposed budget, would reduce the deficit by $2.5 trillion over the next decade – reducing security and non-security discretionary spending by $130 billion and $450 billion, respectively. (See Figure 4.)

House GOP budget chairman Paul Ryan proposed an alternative budget, which passed the House in April 2011, but is unlikely to pass the Democrat-controlled Senate. The GOP plan would reduce the deficit by $4.0 trillion over the next decade – reducing non-security discretionary spending by $1.7 trillion and increasing security spending by $90 billion. The Democratic and Republican plans will undoubtedly be altered by the August 2 deal and the budget-cutting requirements it imposes.

Figure 4

Fiscal Year 2012 Budget Framework from April 2011 (To Be Altered by August 2011 Deal)			
Proposed Federal Spending	**Obama 2012 Budget Request**	**Obama New Framework**	**House GOP Proposal**
Security Spending (in billions)	+$350	-$130	+$90
Non-Security Discretionary Spending (in billions)	-$250	-$450	-$1,700
Deficit Reduction through 2021 (in trillions)	$0	$2.5	$4.0
Total Deficit at 2021 (in trillions)	$9.5	$7.0	$5.5

Source: *Washington Post*, Delta Associates; August 2011.

Federal Austerity's Impact on the Washington Metro Area

How will Federal government austerity impact the Washington metro area – in terms of employment, Defense contractor spending, and the GSA leasing that dominated the office market during 2010?

Impact on Federal Hiring

Federal budget austerity measures, no matter how they play out for 2012 and beyond, will impact Federal hiring in the Washington metro area. During the past five years, the Federal government added jobs at a 2.2% annual rate. ***During 2009 and 2010, Federal employment increased 3.6% and 4.9%, respectively. Due to budget cuts, we project hiring will slow to a muted pace of 0.6% per year through 2015.*** (See Figure 5.)

Although Federal hiring is projected to slow, the private sector is expected to rebound. The Computer Systems Design/Services sector (a division of the Professional/Business Services sector) is projected to grow jobs at a 4.0% pace through 2015, compared to a 3.5% rate during the past five years. The Finance and Insurance sector is projected to gain jobs at a 2.4% annual rate through 2015, compared to a 1.3% decline during the past five years.

Figure 5

Industry	Projected Hiring in the Washington Metro Area 2011-2015 Annual Average Job Growth	5-Year Historical Annual Average Job Growth
Federal government	0.6%	2.2%
Professional/Scientific/Technical Services	3.6%	1.8%
Computer Systems Design/Services	4.0%	3.5%
Finance and Insurance	2.4%	-1.3%

Source: BLS, EMSI, Dr. Stephen Fuller, Delta Associates; August 2011.

Impact on Defense Contractor Spending

In early August 2010 Defense Secretary Robert Gates announced plans to cut spending on contractors by 10% annually over the next three years. Although Gates has been replaced by Leon Panetta, these budget cuts are expected to remain in play. With Congress eager to trim the deficit, Secretary Gates reported in early January 2011 a refined, scaled-back plan to shave $145 billion over the next five years. The plan focuses on eliminating wasteful or inefficient spending, which sidesteps cutting defense program spending. Gates proposed reinvesting the savings into more effective high-priority programs.

The reduction in wasteful or inefficient spending will focus on salary freezes, reducing defense staff and military personnel, and changes to Tricare, the military health care program. However, some programs will be cancelled, including:

- Raytheon's surface-launched advanced medium range air-to-air missile
- Lockheed Martin's non-line-of-sight missile system
- General Dynamics' expeditionary fighting vehicle

Although the above program cuts could be a hardship for the named contracting companies, the programs on the cancellation list are not material contributors to the revenues or earnings of the contractors, according to Standard & Poor's. Programs impacted by these cuts are being cancelled or restricted as they are over budget, behind schedule, or are no longer needed.

Standard & Poor's believes the impact of Gates' proposed budget savings plan on defense contractors will be minimal, as these companies have program diversity (focusing on other Federal programs outside of defense) along with solid financial standing. Although less diversified companies could feel the pinch, they also could benefit from new programs. Notwithstanding some potential opportunities, there has been a lot of concern on the part of smaller contractors, with less lobbying clout, regarding whether they will be squeezed out of future work.

Impact on GSA Leasing

President Obama has tasked GSA to efficiently use space it occupies in order to save $3 billion by 2012. This announcement comes on the heels of GSA's biggest office leasing spree in the Washington metro area during 2010. GSA's leasing activity accounted for approximately 60% of the total 6.4 million SF of net absorption during 2010. As leasing from the private sector declined during the recession, leasing activity from the Federal government ramped up.

GSA's game plan to reduce costs includes:

- Disposing of unused properties
- Eliminating leases that are not cost-effective
- Creatively reusing existing space
- Exploring alternative and virtual work strategies

For example, as part of its initiative to dispose of unused properties, GSA sold a vacant 119,000 SF Class C building at 7550 Wisconsin Avenue in Bethesda/Chevy Chase during the 3rd quarter of 2010. The asset sold for $12.5 million ($105/SF) at auction, well below market expectation. The new owners plan to renovate the building into Class A office space. The disposing of vacant properties should benefit the metro area – as these properties will be renovated/repurposed and ultimately leased – which will help to lower the vacancy rate and improve overall market conditions.

GSA continues to have a handful of sizable requirements for space on the market in the Washington metro area. Although we expect the Federal government to remain an active tenant during 2011, ***this activity should moderate compared with 2010.*** Of note, the Department of Homeland Security's requirement of approximately 1.2 million SF has been put on hold. However, despite cutbacks, Dodd Frank legislation will increase government demand for space as the FDIC implements 44 regulations in addition to new or enhanced enforcement authorities. This could pick up demand from law firms, as they advise on the new regulations. By 2012 and beyond, we expect Federal government leasing to return to more normal levels of 15% of total SF leased, compared to 29% of total SF leased during 2010. But by then, we expect the private sector to be further into recovery and for expansion to take up the slack.

Conclusion

Overall, the battle to reduce the Federal deficit will have an impact on the Washington metro area, as Federal hiring growth slows and GSA reins in leasing activity. ***We have accounted for a very slow-growing Federal establishment in our employment estimates through 2015.*** However, as the Federal government scales back, the private sector is set to rally – rebounding from weaker years and adding new jobs to the metro area through 2015 at an above-average pace, which will generate demand for office space.

As shown in Figure 6 we believe the metro area will create 37,700 jobs per annum over the next five years. While this is substantially better than the past few recessionary years, it is at quite a reduced pace from expansionary periods, as shown in Figure 7 – this due to the moderating influence of Federal austerity in the period ahead.

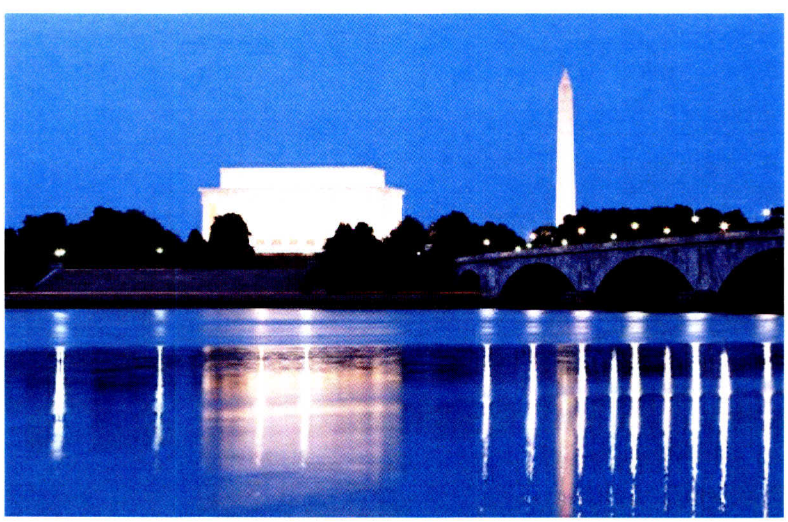
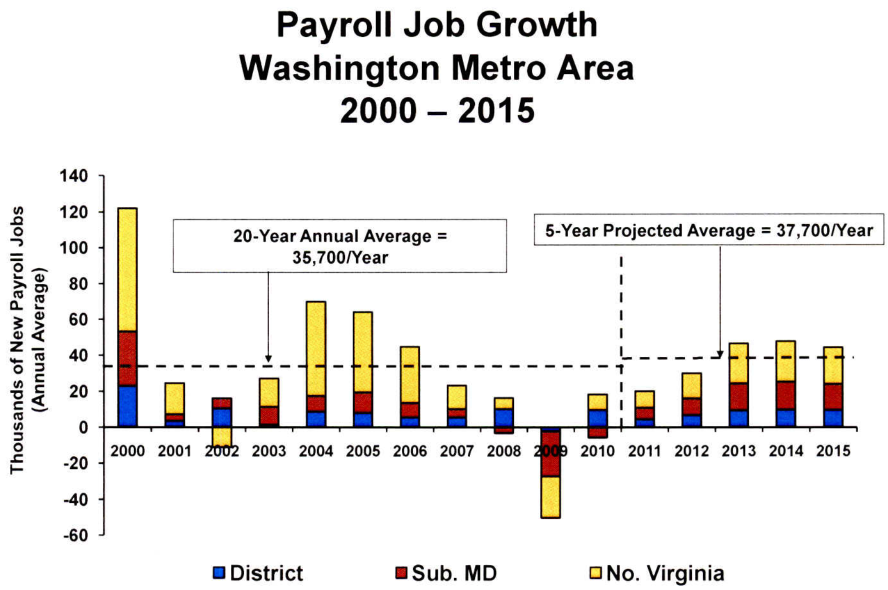


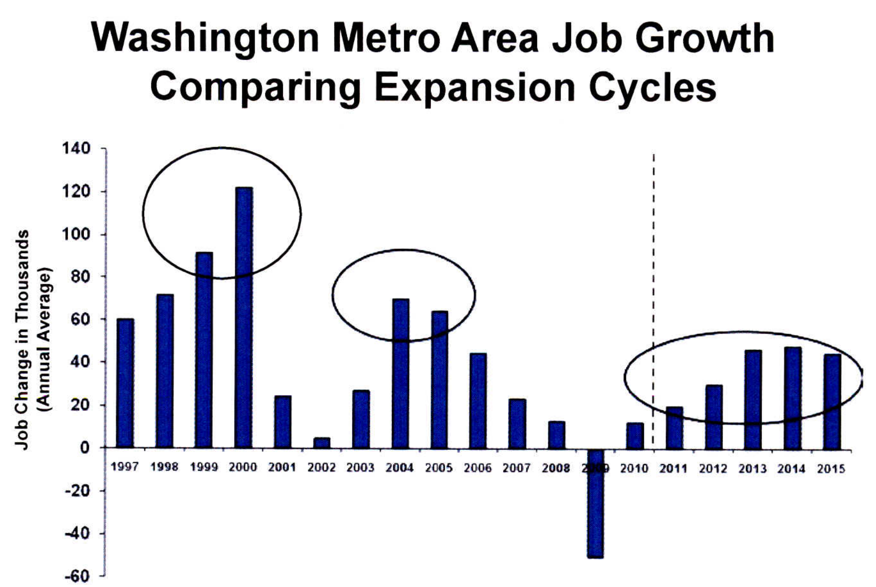
Figure 6



Source: Bureau of Labor Statistics, Delta Associates; August 2011.

But more to the point, 37,700 jobs per annum can support a healthy commercial real estate market.

Figure 7



Source: Bureau of Labor Statistics, Delta Associates; August 2011.