



Fiscal Cliff Effects Will Slow U.S. Growth But Avoid Plunge Into Recession

October 2012

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Executive Summary

In his latest review of the U.S. economy, Standish Global Macro Strategist Tom Higgins describes the likely growth impact of the tax and spending actions set to take effect on January 1. Tom predicts that since neither the Democrats nor the Republicans will want to be accused of sending the economy into recession, the two parties will agree to postpone the debate on major issues such as entitlement and tax reform, while allowing for a temporary extension of most of the tax cuts and a renewal of key spending provisions. This will amount to stepping back from the cliff, but will still create a fiscal drag of about 1.4% on GDP growth for 2013. The Fed's third round of quantitative easing should partially offset this by mitigating financial conditions and supporting the housing market. U.S. credit markets, he says, have historically weathered low growth environments relatively well with positive returns. However, the longer legislators wait to reach some agreement on avoiding the fiscal cliff, he adds, the greater the risk of another bout of market volatility before the end of 2012.

"Monetary policy is no panacea."

- U.S. Federal Reserve
Chairman Ben Bernanke

Fiscal and monetary policies are at odds in the United States. Imagine two men in a boat rowing in opposite directions. At one end is U.S. Federal Reserve Chairman Ben Bernanke and at the other is the U.S. Congress. Mr. Bernanke's task is all the more difficult because he has a smaller oar, given the zero bound on interest rates, and he is rowing against the current created by ongoing deleveraging in the U.S. household sector.

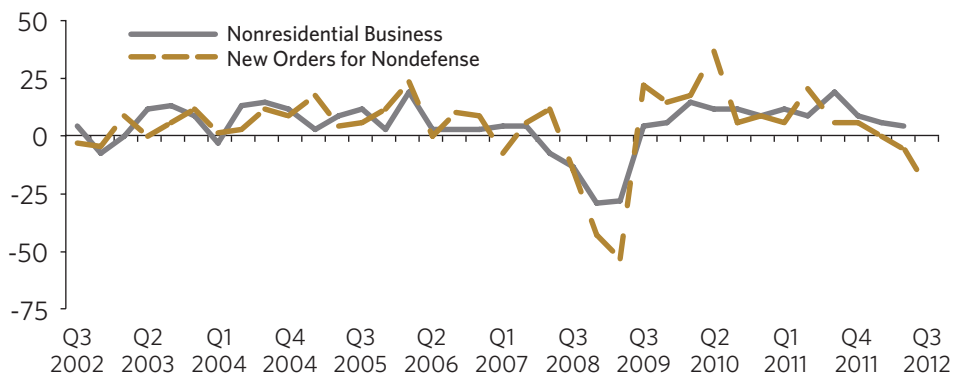
Despite these adverse conditions, the Fed Chairman and his colleagues on the Federal Open Market Committee have persevered. In September, the Fed announced an open-ended asset purchase plan targeting mortgages (i.e., a third round of quantitative easing, or QE3). The central bank will buy \$40 billion of agency mortgage-backed securities per month with no predetermined end date.



At Standish, we expect some compromise on the size of the ultimate deficit reduction package, but we still believe actions amounting to a fiscal drag of 1.4% of GDP will be implemented at the beginning of next year.

In addition, the Fed has committed to increasing asset purchases unless the outlook for the labor market improves “substantially.”¹ In the minutes from its meeting, the Fed cited concerns about the impending fiscal cliff as one of the reasons it decided to adopt a more aggressive policy stance. Unless the government takes action to change course, tax hikes and spending cuts amounting to 4.8% of GDP will go into effect on January 1st under the Budget Control Act of 2011. According to the Congressional Budget Office (CBO), this would likely result in a U.S. recession.² Indeed, there is already evidence that the uncertainty surrounding the fiscal cliff has caused businesses to become more cautious about investing and hiring.

Exhibit 1 - Core New Orders Lead Business Investment by 3 to 6 Months



Source: Bureau of Economic Analysis & Census Bureau as of September 2012.

At Standish, we expect some compromise on the size of the ultimate deficit reduction package, but we still believe actions amounting to a fiscal drag of 1.4% of GDP will be implemented at the beginning of next year. The Fed’s QE3 program is intended to partially offset the downside risks to the economy by easing financial conditions and supporting the recovery in housing. However, as the Fed Chairman himself has acknowledged, monetary policy is not a panacea for what ails the U.S. economy. Instead, most of the fiscal policies necessary for improving the medium-term growth outlook are in the hands of the Congress and the President. Below we explore the Standish base-case scenario for the fiscal cliff and the potential implications for fixed income markets.

¹ Federal Open Market Committee Policy Statement, September 12-13, 2012.

² “Economic Effects of Reducing the Fiscal Constraint That Is Scheduled to Occur in 2013,” Congressional Budget Office, May 2012.

Fiscal Cliff Lowers 2013 Growth Outlook

Our base case for the fiscal cliff assumes that the status quo prevails in Washington in which Democrats and Republicans are forced to share power, but disagree on the appropriate mix of tax hikes and spending cuts necessary to restore fiscal balance in the medium term. We do not see much room for cooperation, but we also doubt that either party will want to be held responsible for engineering a U.S. recession by allowing the entire \$807 billion in deficit cutting measures to take effect.³ Therefore, it is our view that the two political parties will agree to postpone the debate on major issues such as entitlement and tax reform, while allowing for a temporary extension of most of the tax cuts and a renewal of key spending provisions.

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Exhibit 2

	FY 2013	Calendar Year 2013	Percent of GDP
Proposed Deficit Reduction	607	807	4.90%
Most Likely Deficit Reduction	178	237	1.40%
Expiration of payroll tax reduction	95	126	0.80%
Taxes in the Affordable Care Act	18	24	0.10%
Other changes in revenue & spending	65	87	0.50%

2013 GDP Forecast			
	Trend Growth Post-2009	Consensus	Standish
	2.20%	2.10%	1.40%

Source: Congressional Budget Office as of May 2012, Bureau of Economic Analysis, Bloomberg.

There are a few exceptions to this rule. The first and largest is the two percentage point cut in the Social Security payroll tax, which has benefited U.S. households over the past year. This was meant only as a temporary measure to counter a perceived weakening of the U.S. economy at the end of 2010. Although growth remains lackluster, the U.S. economy does not appear to be headed for a recession. Moreover, the Social Security program is already underfunded, and extending the payroll tax reduction will only aggravate this shortfall. Thus, barring a significant deterioration in the growth outlook before year end, the payroll tax deduction is unlikely to be extended, which is projected to subtract \$126 billion, or 0.8% from GDP in 2013.

³ On a fiscal year basis (October to October), the fiscal consolidation implied by the Budget Control Act of 2011 amounts to \$607 billion. However, here we focus on the calendar year (January to January) fiscal adjustment, which amounts to \$807 billion, since we are interested in the impact of economic activity in 2013.

We are hopeful that policy makers in Washington will abandon the automatic spending cuts and tax hikes associated with the Budget Control Act of 2011 in favor of tax and entitlement reform to restore budgetary balance in the medium term.

Then there is the Medicare payroll tax increase and the new surtaxes on dividends and capital gains for high income taxpayers associated with the Affordable Care Act. These measures would subtract an additional \$24 billion or 0.1% from GDP in 2013. Unless the Republicans sweep the Presidency and the Congress, these tax increases seem likely to go into effect in order to pay for expanded healthcare coverage. Finally, there are other changes to revenue and spending that are not detailed by the CBO, which amount to roughly \$87 billion and will subtract 0.5% from GDP. Hence, under our base-case calculation, the U.S. economy will suffer a fiscal drag of roughly 1.4% of GDP next year.

In our view, in the absence of this fiscal drag, the U.S. economy would likely grow somewhere between 2.0% and 2.5%. This is in line with the average annual growth rate of 2.2% that has prevailed since the economic recovery began in mid-2009. We posit that the largest impact on growth from the fiscal cliff will occur at the beginning of next year given the negative quarter-to-quarter comparisons. The good news is that we anticipate a return to trend growth by the end of 2013. Even so, we still expect U.S. real GDP growth to decelerate from 2.1% in 2012 to 1.4% in 2013. This is significantly lower than the 2.1% Bloomberg consensus forecast for next year, suggesting that markets may be overly optimistic, which can increase the risk of volatility.

Credit Can Do Well in Low Growth Environment

We are hopeful that policy makers in Washington will abandon the automatic spending cuts and tax hikes associated with the Budget Control Act of 2011 in favor of tax and entitlement reform to restore budgetary balance in the medium term. Such a development would make us much more optimistic on the growth outlook. Yet, thus far, neither side appears to be moving in that direction. Therefore, we believe we will end up with the suboptimal result we described above and that U.S. economic growth will suffer as a result.

The silver lining may be that U.S. corporate credit markets have historically weathered low growth environments relatively well.

The silver lining may be that U.S. corporate credit markets have historically weathered low growth environments relatively well. Indeed, over the past two decades, both U.S. investment grade and high yield bonds have posted positive excess returns when U.S. economic growth is running between 1% and 2%. However, investors should be aware that the longer legislators wait to reach some agreement on avoiding the fiscal cliff, the greater the risk of another bout of market volatility before year end. Beyond that, the Fed's commitment to holding rates low for longer seems likely to continue to push investors out of Treasuries and into riskier assets, including U.S. corporate credit.

Exhibit 3

US Real GDP Annualized Quarterly Change	Investment Grade (IG)			High Yield (HY)		
	IG OAS Spread	Total Return	Excess Return	HY OAS	HY Total Return	HY Excess Return
	(bps)	(% Monthly)	(% Monthly)	Spread (bps)	(% Monthly)	(% Monthly)
-2 or below	394	-0.1	-1.4	1343	-1.8	-2.6
-2 to 0	219	1.5	0.7	820	2.7	1.4
0 to 1	110	1.3	0.1	467	0.8	-0.04
1 to 2	161	1	0	634	0.9	0.3
2 to 3	120	0.8	0	495	0.7	-0.1
3 and above	96	0.6	0.1	404	0.8	0.5

Source: Barclays as of September 2012. Note: OAS = Option Adjusted Spread.

Thomas D. Higgins, PhD, Global Macro Strategist

Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. He is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

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