A Looming Fiscal Cliff

The Political Landscape, Historical Lessons and Likely Implications

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The looming adjustments to U.S. fiscal policy have received considerable media attention since the 2011 debt ceiling crisis. The term 'fiscal cliff' refers to a number of contractionary fiscal policy measures scheduled to become effective at the turn of calendar year 2012. The fiscal cliff in its entirety – what will become effective if a compromise cannot be reached – is quite sizable. Historically, the economy has coped with much larger contractions, though typically large fiscal consolidations in the U.S. have been enacted to address an overheated economy. In our judgment the economy can likely avoid recession under most scenarios apart from total gridlock in Washington. However, if partisan issues associated with the cliff cannot be resolved and gridlock persists it is likely a recession will ensue, albeit a recession that is reasonably mild. Corporations as well as investors have started to adjust to the likelihood of mildly contractionary fiscal policy in 2013, but risk assets such as stocks are likely to have some upside remaining. In our assessment, the risk associated with the fiscal cliff is not outsized compared to an unexpectedly hard landing in China or increased troubles in the Euro area. Much is uncertain and risks need to be managed as events unfold.

Fiscal Tightening and Battleground Issues

The table below details the major items comprising the fiscal cliff, as well as the amount of tightening expected to be associated with each line item. Note that the amounts below refer to the fiscal year from October, 2012 through September, 2013.

Figure 1: Fiscal Tightening and Battleground Issues

October 2012 — September 2013

Data source: Barclays Research as of September 2012 and the World Bank as of 2011

Item	Amount of Tightening (Billions)
2001/2003 Tax Cuts (Lower/Middle Income)	$120
2001/2003 Tax Cuts ($250K+ Incomes/Estates)	$60
AMT	$100
Payroll Tax Cut	$120
Emergency Unemployment Compensation	$30
Sequester Budget Cuts	$90
Affordable Care Act	$25
Medicare Payment Rates	$10
ARRA Spending	$20
Other Expiring Provisions	$75
Total	**$650**
Total (% of GDP)	**4.3%**

While the political landscape will determine which provisions and cuts will be effective in 2013, there are a number of key areas likely to be contentious regardless of the political dynamics. These areas include:

- **Tax Cuts:** President Obama's latest budget proposed extending the Bush tax cuts for lower and middle income earners but allowing those for higher earners to expire. Most

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Congressional Democrats concur. Meanwhile, the core Republican view will likely remain squarely opposed to such a "decoupling" of tax rates.

- **Sequester Budget Cuts:** In its current form, sequester cuts are split roughly equally between defense and non-defense budgets. However, Republican-led committees in the House of Representatives have recently proposed legislation to replace much of the defense portion with cuts to mandatory spending programs. The president and Democrats in the Senate are unlikely to agree.[1]
- **Affordable Care Act:** Commonly referred to as "Obamacare" in the press, the act is one of the most contentious issues in the current political landscape.

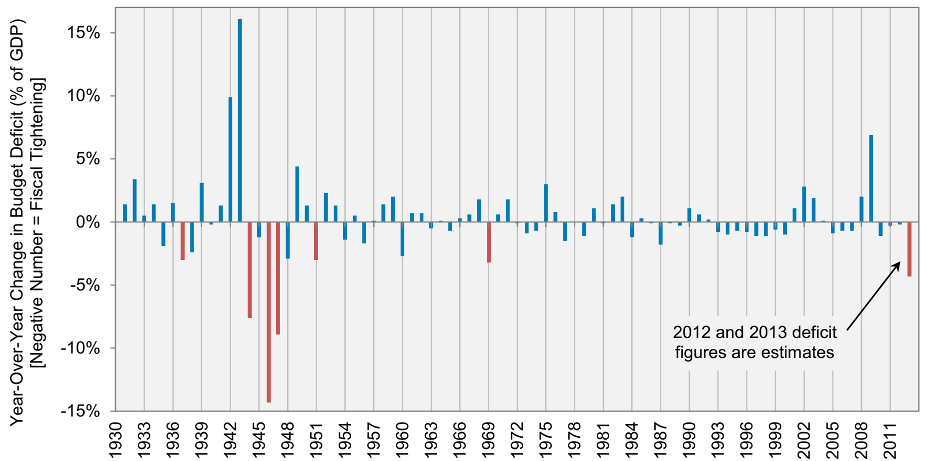
Historical Lessons

The U.S. economy has not been subject to the amount of tightening associated with the fiscal cliff for at least four decades, as demonstrated by the chart below, which highlights the year-over-year change in the U.S. budget deficit since 1930.

Figure 2: YoY Change in Budget Deficit 1930 — 2012

Bars shaded in red indicate years in which the year-over-year contraction in budget deficit had a magnitude greater than or equal to 3% of GDP

Data source: The White House Office of Management and Budget as of October 2012, Barclays Research as of September 2012 and the World Bank as of 2011

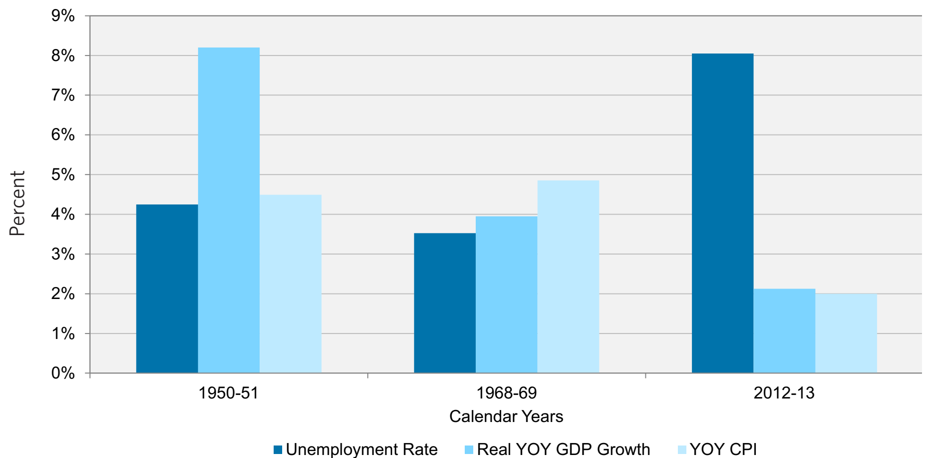


The most recent occurrence of year-over-year fiscal tightening in excess of 3% of GDP occurred in the fiscal year from 1968 to 1969[2]. The economic landscape during the late 1960s was, however, strikingly different to the global growth slump we are currently experiencing. In the late 1960s, a sweeping 10% surcharge on income and corporate taxes was implemented to pay for the Vietnam War buildup and also to counter a major inflationary boom that had been collecting steam since earlier in the decade. The tightening in 1969 forced the economy into a mild recession that continued through 1970, though this downturn was partly due to an auto strike that slowed manufacturing markedly. Similarly, in 1951, as depicted in the chart below, fiscal tightening occurred at a time of high inflation, booming real GDP growth, and very low unemployment.

Figure 3: Economic Conditions and Fiscal Consolidation 1950-51, 1968-69, and 2012-13

Note that the unemployment rate, GDP growth and CPI for calendar years 2012 and 2013 are forecasts based on Bloomberg's survey of economists at the time of publication. The chart shows the average of each economic metric for the two calendar years highlighted in an effort to encompass the environment surrounding the U.S. fiscal year, which does not align with the calendar year

Data source: Bloomberg as of October 9, 2012



1 The sequester budget cuts were introduced as part of the Budget Control Act, which concluded the prolonged debt ceiling debate in August 2011 with the aim of providing a fallback scenario should policymakers in the "super committee" fail in negotiations to trim the budget (which they did). The sequester budget cuts discretionary spending within the defense budget (10%), non-defense (8%), Medicare (2%) and other non-exempt spending (8%).

2 Data source: The White House Office of Management and Budget as of October 2012

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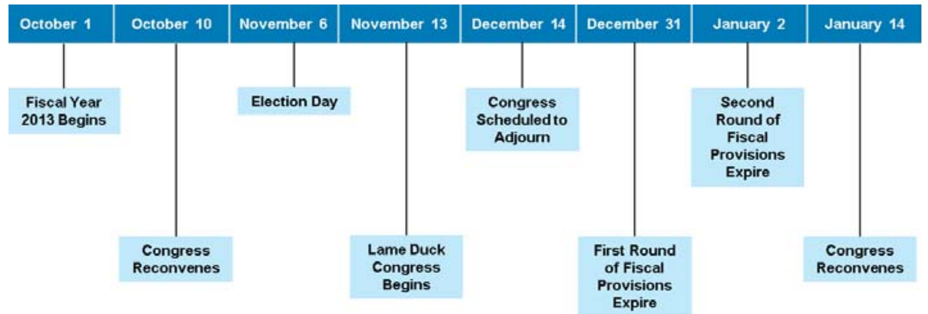
Prior to the two occurrences highlighted above – and ignoring the fiscal mistakes of the Great Depression era – the largest period of fiscal consolidation in U.S. history occurred in the 1940s. This period resulted in an almost 35% cumulative contraction in the budget over five years[3], a massive reduction by any standards. Contrary to our current environment, all of these historical situations involved fiscal adjustments that were designed to counter high inflation and GDP growth. Also, in all of these historical examples the change in fiscal policy had a contractionary effect on the U.S. economy. What is less clear is the magnitude by which the economy can be expected to contract as a result of a given change in the budget balance. The economy did experience three years of negative GDP growth from 1945-1947[4] as a result of the massive fiscal consolidation of the 1940s, however even this magnitude of change did not drive the economy into depression: GDP was posting annual growth rates of almost 9% by 1950, just two years after the tightening cycle ended.

No doubt there are examples of successful stimulative fiscal consolidations – such as those in Scandinavia and Canada in the 1990s – but in these examples the reduction in long-term interest rates that occurred as a result of the consolidation ended up being highly stimulative to the economy. These foreign examples are in stark contrast to the current U.S. environment: U.S. rates are already very low by historical standards and the Federal Reserve has been aggressively trying to stimulate the economy via three bouts of quantitative easing. Regardless of the near-term negative impact on economic growth suggested by demand-centric macroeconomic analysis, we do acknowledge that several prominent economists would argue that a reduction in the deficit has a strong medium—and perhaps even short-term—impact on economic growth. Their reasoning would focus on the positive impact from embarking on a path of sustainable long-term government finances. Similarly, these economists would argue that consumers and investors would reduce their cautionary savings intended to cover tax increases in the future. While policy makers and the majority of investors don't seem to subscribe to this line of thinking, history could still prove them right or the contractionary impact on the economy could be mitigated.

Figure 4: Political Events Around the Fiscal Cliff



The Political Landscape

With a dynamic political environment in the U.S. at the moment it is difficult to gauge the likelihood of either candidate's success. Current electronic markets' pricing of the congressional and presidential runoffs[5], shown below, seem to have a Congress split between the two parties as the most likely scenario, although there is a small likelihood of a Republican sweep. It should be noted that electronic pricing of presidential probabilities is very dynamic, fluctuating multiple percentage points on some days, and has swung more than 10 percentage points since the beginning of October.

Figure 5: The Political Landscape As of October 29, 2012

Data source: Iowa Electronic Markets

Senate	House	Probability
R	R	7.8%
R	D	0.2%
D	R	83.9%
D	D	1.0%
Other	Other	7.1%

Presidency	Probability
R	40.3%
D	59.7%

3 Data source: The White House Office of Management and Budget as of October 2012
4 Data source: Bloomberg as of October 2012
5 Data source: Iowa Electronic Markets as of October 29, 2012

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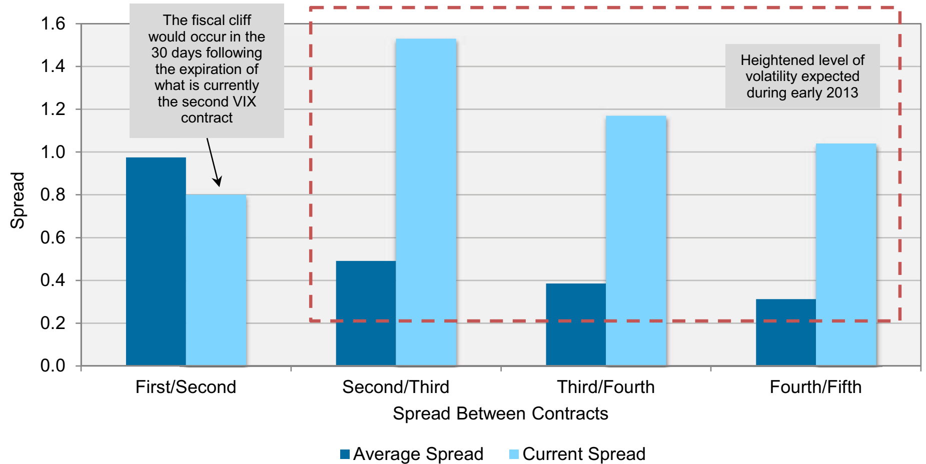
The uncertainty surrounding the political situation and decisions associated with the fiscal cliff is demonstrated by the current term structure of Chicago Board Options Exchange Volatility Index (VIX). This index is calculated using forward looking implied volatility of S&P 500® Index options, and provides insight into the market's expectation of future volatility. The current term structure of VIX futures indicates that the market is expecting roughly average volatility between now and January, a period encompassing the presidential election and implementation of the previously discussed fiscal provisions at year end. However, following the January expiration – when the makeup of the legislative branches will be finalized, the president will be inaugurated, and Congress reconvenes – the heightened spread between contracts expiring in early 2013 indicates that the market expects an increased level of volatility during this period.

Figure 6: Comparison of Spread Between VIX Futures Contracts
As of October 11, 2012

Average spreads calculated using data since the beginning of 2009,

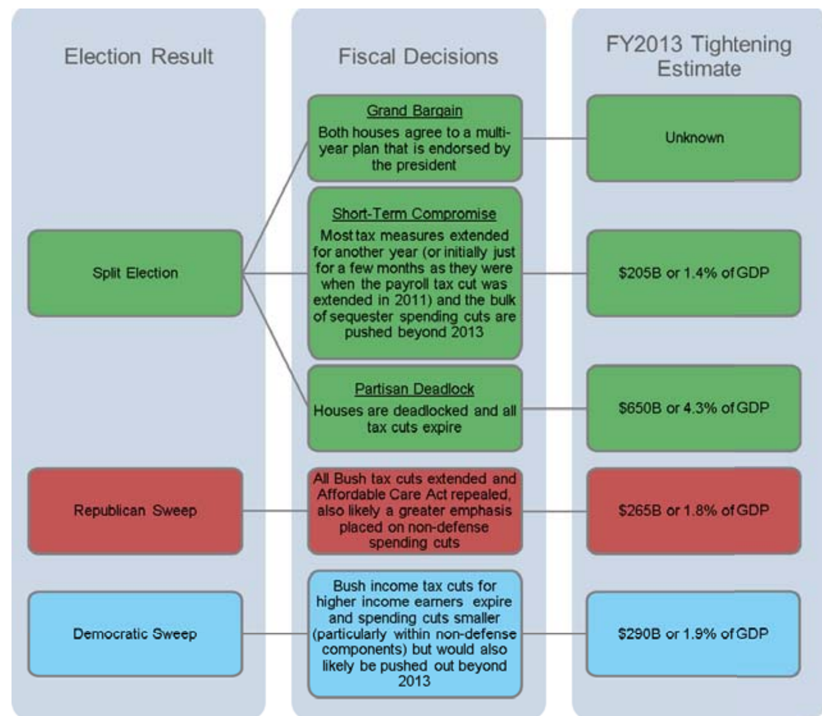
Data source: Bloomberg



Given the key issues identified previously, below we show a range of tightening estimates for fiscal year 2013 as a function of the possible election results. It should be noted that the estimates are expressed as a percentage of GDP, and are for fiscal tightening and not the actual knock-on effects on U.S. real GDP growth during 2013. Also note that at the current rate the U.S. will again hit the current debt limit near the end of calendar year 2012. The U.S. Treasury should be able to use the extraordinary measures it employed in 2011 to buy time until late February 2013, but the debt limit adds a further degree of uncertainty around the issue of the United States' fiscal situation.

Figure 7: Election Results, Fiscal Decisions and FY2013 Tightening Estimate
As of September and October 2012

Data sources: Barclays Research as of September 2012 and the Bipartisan Policy Center as of October 2012



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While all the sweep scenarios outlined in Figure 7 are of course possibilities, given the aforementioned market pricing of the elections it seems most likely that we find ourselves in one of the scenarios shaded in green. Of these scenarios, 'partisan deadlock' is unlikely for any group of politicians – regardless of how much disagreement exists between them – given the subsequent fiscal shock to the economy and the likelihood of a resulting recession so soon after emerging from the recent financial crisis. In our judgment, reaching a grand bargain along the lines of a Simpson-Bowles plan by the end of 2012 is similarly unlikely given the polarizing agendas of the two main political parties. Of the scenarios outlined in Figure 7 – regardless of whether it is a split election or a sweep – it is evident that we should expect fiscal tightening in the range of 1.4% to 1.9% of GDP. Considering the history of changes in the budget deficit discussed previously, it is immediately apparent that this degree of tightening is not extraordinarily large by historical standards. It is certainly not a level of consolidation where we view a recession as a foregone conclusion, as some media coverage would have us believe.

Estimates of Economic Impact Show a Range

Below we highlight a range of the estimates for the U.S. fiscal multiplier, drawing on a range of both academic and industry sources. There is a divergent set of views on the actual multiplier, which is included in the third column. If anything, one theme is again clear: that decreases in government spending or increases in taxes have contractionary implications for realized GDP growth.

Figure 8: Estimates for the U.S. Fiscal Multiplier As of October 2012

Data sources: Romer and Romer, The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks, March 2007; Barro and Redlick, Macroeconomic Effects from Government Purchases and Taxes, September 2009; DeLong and Summers, Fiscal Policy in a Depressed Economy, March 2012; Barclays Research, The Only Certainty is Uncertainty, June 2012; HSBC, U.S. Elections Multi-Asset Special, September 2012; Bank of America Merrill Lynch, Fiscal Cliffhanger, May 2012

Source	Research Grouping	Fiscal Multiplier Estimate	Period	Comments
Romer and Romer	Academic	3.0	10 quarters	Tax increases only
Barro and Redlick	Academic	0.4-0.5	Contemporaneous	Changes in defense spending
Barro and Redlick	Academic	0.6-0.7	Two years	Changes in defense spending
DeLong and Summers	Academic	0.8-1.5		Increases in government spending
Barclays Economics Research	Industry	0.7	One year	
HSBC	Industry	0.5-0.8	One year	
Bank of America Merrill Lynch	Industry	Roughly 1.0		Spending multiplier slightly greater than 1.0 and tax multiplier slightly less than 1.0
Congressional Budget Office	Industry	0.0-0.4		Corporate tax provisions
Congressional Budget Office	Industry	0.1-0.6		Upper income tax cuts
Congressional Budget Office	Industry	0.3-1.5		Low to middle income tax cuts

Other than the possible outlier to the high side provided by DeLong and Summers, most industry and academic experts assume a fiscal multiplier in the vicinity of 0.8 for a one year timeframe. Indeed, policy makers in Washington are well aware of the different magnitudes of fiscal multipliers depending on the area of the budget, and will no doubt attempt to minimize the effects on the economy as a result of changes on the fiscal front. If we take into account the range of likely possibilities for fiscal contraction discussed as part of the political landscape – which estimate a range of fiscal tightening between 1.4% and 1.9% of GDP in all but the 'partisan deadlock' scenario – we can then use this 0.8 to calculate a shock to GDP growth of between 1.1% and 1.5%. Assuming that the economy would otherwise maintain the 2.2% average quarterly growth realized for the second half of 2011 and the first half of 2012[6], we arrive at a range of 2013 GDP growth estimates somewhere between 0.7% to 1.1%. This range is not one of a thriving economy, but one that is expanding nonetheless. Even for the highly unlikely 'partisan deadlock' scenario – which could result in a fiscal shock of as much as 4.3% of GDP – the resulting 1.2% of GDP contraction in 2013, while not a rosy picture to consider, is certainly not a doomsday scenario.

While the fiscal cliff is due to take place as the calendar year rolls over from 2012 to 2013, a recent survey released by the National Federation of Independent Business indicates that

6 Data source: Bank of America Merrill Lynch as of October 2012

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the economy has already begun to enter a period of adjustment ahead of the expected changes in fiscal policy. The survey ranks issues associated with the fiscal cliff second and fourth in a ten-item ranking of "critical" problems facing small businesses in the United States. Note that these two issues did not even rank in a previous version of the same survey undertaken in 2008. In a similar vein, J.P. Morgan recently released a report highlighting that 61% of its American clients have confirmed that the fiscal cliff and the uncertainty revolving around the tightening are already affecting their hiring plans[7].

Figure 9: National Federation of Independent Business Survey on Issues Facing Small Businesses

As of October 6, 2012

Data source: The Economist, Give Us A Brake, October 6, 2012

Issue	Respondents Saying Issue is "Critical"	2012 Rank	2008 Rank
Cost of health insurance	52%	1	1
Uncertainty over economic conditions	**38%**	**2**	**NA**
Cost of fuel	35%	3	2
Uncertainty over government actions	**35%**	**4**	**NA**
Unreasonable government regulation	34%	5	6
Federal taxes on business income	30%	6	3
Tax complexity	29%	7	5
Frequent changes to federal rules	24%	8	15
Property taxes	24%	9	4
Stat taxes on business income	24%	10	7

Asset Prices and Cliff Risk

Figure 10 shows the dynamics of earnings-per-share (EPS) growth for calendar years 2012 to 2013 and 2013 to 2014. As is evident from the chart, expected earnings growth from 2012 to 2013 has dropped almost 150 basis points since the beginning of this year, from a peak close to 12.0% to a current level of 10.5%. During this same period, expectations for earnings growth for 2013 to 2014 have remained generally stable, fluctuating between 11.0% and 11.5%. As depicted in Figure 11, during this same period from the beginning of 2012, expectations for calendar year 2013 GDP growth have similarly been revised downwards, by 50 basis points from 2.5% to 2.0%. Are these changes to the fundamentals and Wall Street estimates in-line with historical norms?

For the period encompassing 1989-2011 we observe the following contemporaneous relationship between unexpected U.S. earnings changes and changes in consensus expectations for US GDP growth:

*Data source: Consensus Economics and Mellon Capital proprietary data as of October 16, 2012

$$\frac{\text{Unexpected changes in forward-looking earnings per share over the next 12 months}}{\text{Changes in consensus expectations for GDP growth over the next 12 months}} \cong 2.75^{*}$$

Using this historical relationship, the 50 basis point reduction in 2013 GDP expectations roughly aligns with a 150 basis point reduction in earnings for the same period. So it is promising to see that adjustments to the fundamentals are supported by top-down estimates for GDP growth by "the Street", and to note that both the fundamentals and Wall Street analysts have been adjusting expectations in advance. However, given our previous discussion of the most likely implications for GDP growth as a result of the fiscal cliff – where we provide a range of likely GDP growth for 2013 somewhere in the range of 0.7% to 1.1% – we find that the market may be somewhat underestimating the implications of the cliff on GDP growth.

It is important to note that even though the peak swing in expected earnings growth this year involved a 2% reduction, U.S. stock prices actually rallied significantly, posting double-digit gains for the year to this point. Stock market gains during this period were ultimately a result of the market's positive reaction to perceived systemic risks in the United States (bottoming out of the housing market and further quantitative easing), in Europe (announcement of the ECB's Outright Monetary Transaction facility to address the periphery, especially Spain) and China (continued 7%+ growth).

7 Data source: The Economist, Give Us A Brake, October 6, 2012

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Figure 10: Bottom-Up Calendar Year EPS Growth As of October 16, 2012

Data source: Mellon Capital proprietary data

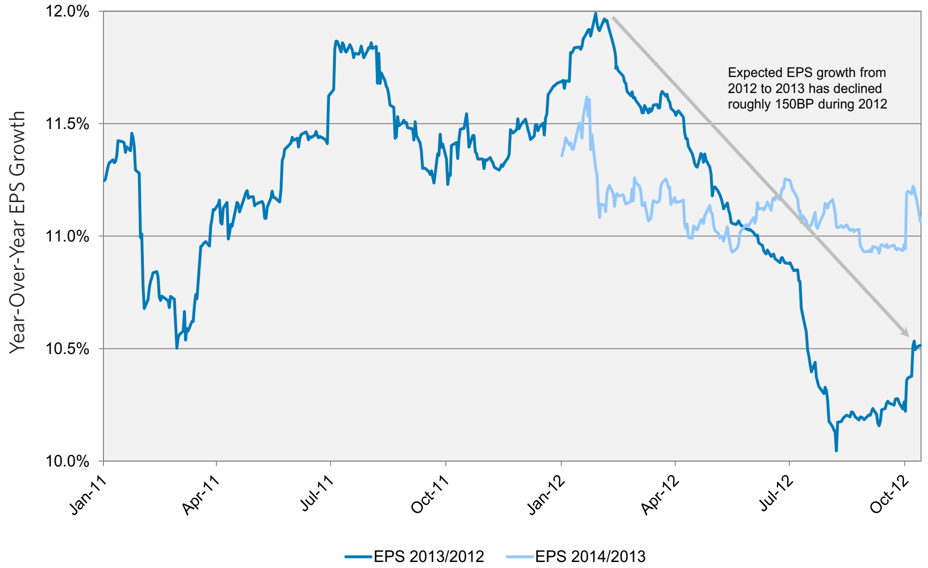
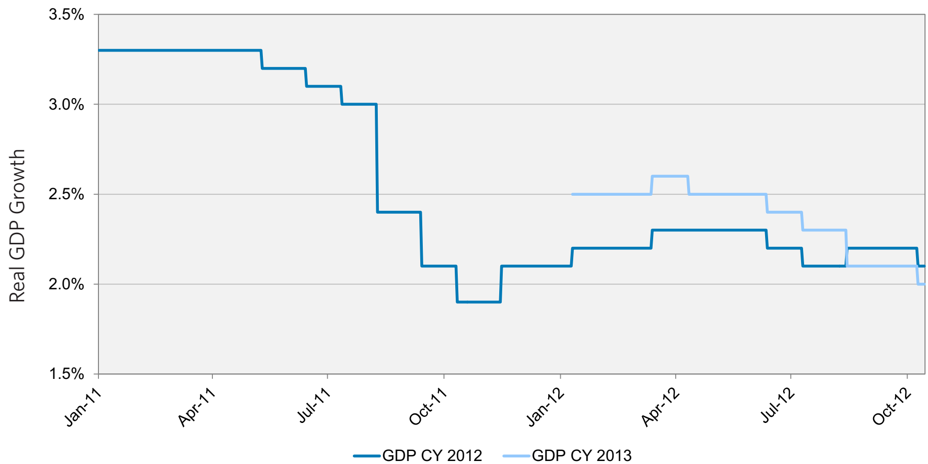


Figure 11: Consensus Economics GDP Estimates As of October 16, 2012

Data sources: Consensus Economics and Mellon Capital proprietary data



What Can We Expect?

While the fiscal cliff is no doubt a significant event for the U.S. and the global economy, the issues at hand have received much attention since the debt ceiling debacle of 2011, and the market has had time to prepare itself. While we do anticipate a period of heightened volatility as the issues in Washington are hashed out—the term structure of VIX futures attests to this—for the coming year, we ultimately expect the direction of risk assets to be determined by other exogenous surprises to the market, such as further contraction in China or continued infighting in the Euro area. Prolonged 'partisan deadlock' would no doubt bode poorly for the markets, but even in that situation we anticipate that politicians would eventually be forced to accept some form of compromise, as happened in 2008, with the eventual launch of the Troubled Asset Relief Program (TARP). As a result of the most likely cliff scenarios we envisage positive U.S. GDP growth in 2013 and modest fiscal consolidation by historical standards, an environment which we expect to be constructive for risk assets in general.

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