

Investment Commentary—January 2013

2012 ended on a positive note in Washington and on Wall Street. A mere 90 minutes before the ball dropped in Times Square, the U.S. Senate voted 89-8 to approve a fiscal cliff deal negotiated between Minority Leader McConnell and Vice-President Biden. Earlier in the day the stock market surged in anticipation of the vote, capping off a year in which the S&P 500 returned a hefty sixteen percent.

The deal fell far short of the grand bargain that many investors (including yours truly) have been yearning for--a multi-trillion dollar deficit reduction package that would include a mix of revenue increases, discretionary spending cuts and entitlement reform. Once again President Obama and Speaker Boehner came close, only to have talks break down late in the game. Boehner passed the hot potato to the Senate, which then led to discussions between the Minority Leader and the Vice- President.

One could charitably characterize the McConnell-Biden deal as a key step in achieving a grand bargain piecemeal. Consider that in the summer of 2011, as part of resolving the (first) debt-ceiling crisis, Congress and the President agreed on \$917 billion in spending cuts. The McConnell-Biden deal has a net \$737 billion in deficit reduction, primarily resulting from tax increases on high-income Americans. In the meantime, the so-called "sequester," another piece of the 2011 debt-ceiling deal, remains in effect and absent Congressional action will reduce future deficits by a further \$1.2 trillion¹. That adds up to nearly three trillion dollars of deficit reduction², within shouting distance of the four trillion that is probably required to put the U.S. on a sustainable fiscal path³.

Of course, things aren't quite that simple. For starters, the sequester involves distasteful across-the-board cuts in domestic and defense programs. These arbitrary cuts can be avoided if Congress enacts alternative deficit-reduction measures. Ideally, such measures would include significant entitlement reform. Medicare and Medicaid spending in particular are poised to grow rapidly over the next several decades as baby-boomers age. For reasons of politics and equity, any changes to entitlements will be phased in gradually. It is essential to institute reforms soon if they are to bend

¹ The McConnell-Biden deal employed some gimmicks to defer it by two months but the sequester still awaits.

² Some recent estimates of aggregate deficit reduction over the last couple of years run higher. We're simply adding figures reported at the time of the relevant legislation.

³ Provided, for reasons articulated in the next paragraph, that a sufficient portion of the \$4 trillion comes from entitlement reform.

the spending curve fifteen to twenty years from now when baby-boomers will be hitting their peak years of health care consumption⁴.

A more ominous fly in the ointment is the debt-ceiling, which Congress will need to address in relatively short order. For all of the drama it provided, the threat posed by the fiscal cliff was child's play compared to the consequences of failure to raise the debt-ceiling, which failure would deliver a significant shock to the financial system⁵ and raise borrowing costs for decades to come. Just as the two parties came together on New Year's Eve with the clock ticking, we're inclined to think that the debt-ceiling will be raised in yet another last-minute deal. That said, the process of enacting the McConnell-Biden package may have complicated matters. In selling the legislation, Republican leadership advised GOP rank-and-file that they should concede on increased rates for upper-income taxpayers and "hold your fire" for the debt-ceiling negotiation. Meanwhile, Biden assured skittish Democrats who wanted Obama to drive a harder bargain on the fiscal cliff that the administration would absolutely refuse to negotiate with Republicans over the debt-ceiling. For the time being each side seems pretty dug in.

Goings-on in Washington aside, economic developments here and abroad have generally been encouraging. We say that with some trepidation having made similar comments a year ago and two years ago respectively. In each case growth in the U.S. appeared to accelerate late in the calendar year only to fade several months later. It's a pretty good bet that the pattern will be repeated as the McConnell-Biden deal forestalls much but not all of the increased taxes and lower spending baked into the fiscal cliff. In addition to the well-publicized tax increases on upper-income Americans, payroll taxes that were lowered by two percentage points in late 2010 have now reverted to higher levels. And as discussed above, the sequester will almost assuredly force more spending cuts, more tax increases or both. All of this will weigh on the U.S. economy for the first two or three quarters of the year.

After a likely sluggish first half though, there's reason to expect growth to once again accelerate. The main engine of economic activity will be something we've been touting for several quarters now—the recovery in residential construction. The vast oversupply of housing created in the early 2000s is rapidly dissipating. As a result housing starts (single-family and multi-family) have been growing for nearly two years now and accelerated over the last several months. After bouncing around the 600,000 mark in 2009 and 2010, annualized starts are now over 800,000. Even at that improved pace, construction is not nearly enough to keep up with household formation, which

⁴ Some on the left would object that what is required is not entitlement reform but steps to control medical costs. Yes and no. Yes, excessive inflation in medical costs is the biggest contributor to estimates of soaring deficits over the next several decades. And it's true that if we were to get medical costs fully under control, we might be able to leave entitlements alone otherwise and still stabilize the debt at a reasonable level. But that's a huge, huge if and one that would be foolish to rely on since by the time we know the answer it will be too late to act. More plausibly, a combination of aggressive medical cost control *and* entitlement reform per se is required.

⁵ Failing to address the fiscal cliff would, by comparison, have had very limited impact on the financial system. It would have dealt a blow to the U.S. economy, likely sending it into a mild recession. But that's about it.

should continue to grow for several years as many "echo boomers" (kids of baby boomers) are just now reaching young adulthood. Growing construction activity has yet to result in a significant increase in employment⁶, but that is very likely to happen over the next several quarters. State and local governments are poised to chip in as well, with Moody's chief economist expecting states and municipalities to add 220,000 jobs in 2013 after several years of shedding payroll to balance budgets. Later in the year, with any kind of reasonable resolution of the debt-ceiling and the sequester--not a given to be sure!--business investment should tick up as well. It's possible that once the effects of fiscal contraction wear off, GDP growth could reach 3% on a sustained basis which would feel pretty good compared to the more tepid 2.3% average of the last twelve quarters.

Meantime, China appears to be picking up a bit, with very healthy October and November industrial production data suggesting that the slowdown in the Chinese economy bottomed in the third quarter. Fourth quarter and 2013 GDP numbers won't be dramatically higher but at least they're headed in the right direction. Japan (yes, Japan!) may be on the upswing soon as well if incoming Prime Minister Shinzo Abe's ambitious plans bear fruit. After six years of weak leadership in Tokyo, Abe led a resurgent Liberal Democratic Party to a landslide victory last month on promises to resuscitate the economy by cajoling the Bank of Japan into adopting an explicit (and relatively high) inflation target and enacting a combination of near-term fiscal stimulus and longer-term reform. Six different governments in six plus years have left a great deal of low-hanging fruit for Abe to pluck as he puts his program in place.

The story in Europe is less sanguine than it is in Asia as the Eurozone continues to bump along the bottom of a painful recession. We've believed for some time that the beginning of the end of the sovereign debt crisis in Europe will come when German Chancellor Angela Merkel can say out loud what seems obvious to us: that German taxpayers will have to foot the bulk of the bill. On that score we're very encouraged that her Social Democratic Party opponent in upcoming German elections is stumbling badly. Merkel, already very popular, seems poised to win reelection by a wide margin, hopefully putting her in a position to take the sort of aggressive but difficult steps that might create light at the end of the tunnel.

In sum, there appears to be a gradual reacceleration of the global economy that is meaningful but fragile enough to be disrupted by missteps in Washington. Most likely, the threat of the debt-ceiling will recede and Congress and the President will resolve the sequester in a manner that pleases no one but avoids significant harm to the economy and chips away at future deficits. At that point the otherwise positive outlook for growth would come to the fore and bolster stocks. We're managing portfolios with that benign scenario in mind but cognizant that getting from here to there won't be easy, and there are likely to be times over the next month or two when Wall Street despairs of a solution to the debt-ceiling standoff and prices stocks accordingly.

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Boston, MA*

⁶ This may be an artifact of undocumented construction workers not captured by the BLS establishment survey.