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*Fiscal Cliff:
Making Decisions in Crisis*

*Part III: From Fiscal Cliff to
Debt Cliff and Budget Cliff
and Sequestration Cliff*

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Fiscal Cliff Resolution

The December 31 fiscal cliff was averted, but by the narrowest of conceivable margins. The resolution is consistent with our November analysis, but the narrowness leaves much to be resolved and prolongs uncertainty through March. The fiscal cliff deal resulted in:

- Budget sequestration delayed until March 1
- The top marginal income tax rate was increased from 35% to 39.6% (43.4% with the ObamaCare tax) for individuals with annual incomes over \$400,000 and for couples over \$450,000, and the dividend and capital gains rates set at 15% and 20% (23.8% with ObamaCare) below and above the stated income levels. Income tax rates for lower incomes were made “permanent”
- Personal exemption phase-out (PEP) tax deductions and credits for individual incomes over \$250,000 and couples above \$300,000 end
- Estate taxes increased to 40% of the value above \$5,000,000 with a “permanent” decrease for lower values
- “Permanent” alternative minimum tax (AMT) fix
- The two-year-old 2% payroll tax holiday expired, returning the Social Security payroll tax to 6.2%
- One-year unemployment benefits extension
- Capital expenditure expensing, an immediate deduction, lapsed
- One-year freeze on scheduled physician payment cuts, the Medicare “doc fix”

The narrow deal addresses a few basic tax issues and delays the substance of spending cuts. Washington has hopped from the fiscal cliff to the debt cliff, delaying substantive negotiations until February and March. Moreover, our assessment of the fiscal cliff provisions concludes that they are more growth-inhibiting than growth-encouraging.

BASE Jumping¹ the Debt, Budget, and Sequestration Cliffs

The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed, lest Rome become bankrupt. People must again learn to work instead of living on public assistance.

– Cicero, 55 BC

From the perch of today, it is unclear whether Cicero is suggesting ignorance is the state of *political man* or political man is really *economic man* responding to incentives. We side with the latter. What incentive do politicians have to balance the budget and reduce debt? Since they either will be long gone or can blame their predecessors when problems arise, they have very little incentive to act decisively. What incentive do people have to work when they can live on public assistance? Apparently, after more than 2,200 years, they have very little incentive. Perhaps

history will neither repeat nor rhyme, but don't bet on it. After all, as Milton Friedman correctly stated, I am careful spending my money and less careful spending someone else's money, but someone other than me spending someone else's money, the realm of the politician, will spend like a drunken sailor. The giver and the beneficiary of this largess have zero incentive to complain.

Three dates and the encroaching debt ceiling focus our attention:

- Treasury Secretary Tim Geithner's last day is **January 25**, and he will be succeeded by Jacob Lew.
- The debt ceiling has been reached and the government is taking extraordinary measures to meet financial commitments. According to the Bipartisan Policy Center, a Washington think tank, its ability to use such measures is anticipated to end in late **February or early March**.
- The new and improved budget sequestration date, at which time spending programs will be compulsorily curtailed, was delayed until **March 1**.
- The last federal budget was signed into law in September 2007 by President Bush. The budget process is in shambles and the current continuing resolution, allowing government to function in the absence of a budget, expires on **March 27**.²

Spending Behavior

		<i>Who is Spending?</i>	
		Me	Someone Else
<i>Whose Money?</i>	Mine	Very Careful	Not so careful
	Someone Else's	Not so careful	Like a Drunken Sailor

1 Extremely risky jumping from inappropriate promontories, such as (B)uilding, (A)ntennas, (S)pans, and (E)arth. Perhaps the world is returning to its BASE jumping origins. Apparently, in 1912, Franz Reichelt pioneered the craze by launching from the Eiffel Tower to test his coat parachute invention. He died. The federal government now attempts inventive jumps from fiscal heights. Stay tuned.

2 With the Congressional Budget Act of 1974, the Senate and the House pass annual budget resolutions in the spring, setting a framework for spending, taxation, and other fiscal items in the coming fiscal year. They also lay out general plans for the next four years. Appropriations bills are introduced periodically to allocate funds for specific purposes.

The period from the fiscal cliff resolution to the debt cliff resolution will be characterized by uncertainty and strategic negotiations that all investors must navigate, whether they are macro, equity, or fixed-income oriented. Uncertainty driven by federal policy shifted above its long-term average with the 2008 election. The 2012 election suggests a sustained level of policy uncertainty, and debt cliff negotiations will heighten it.³

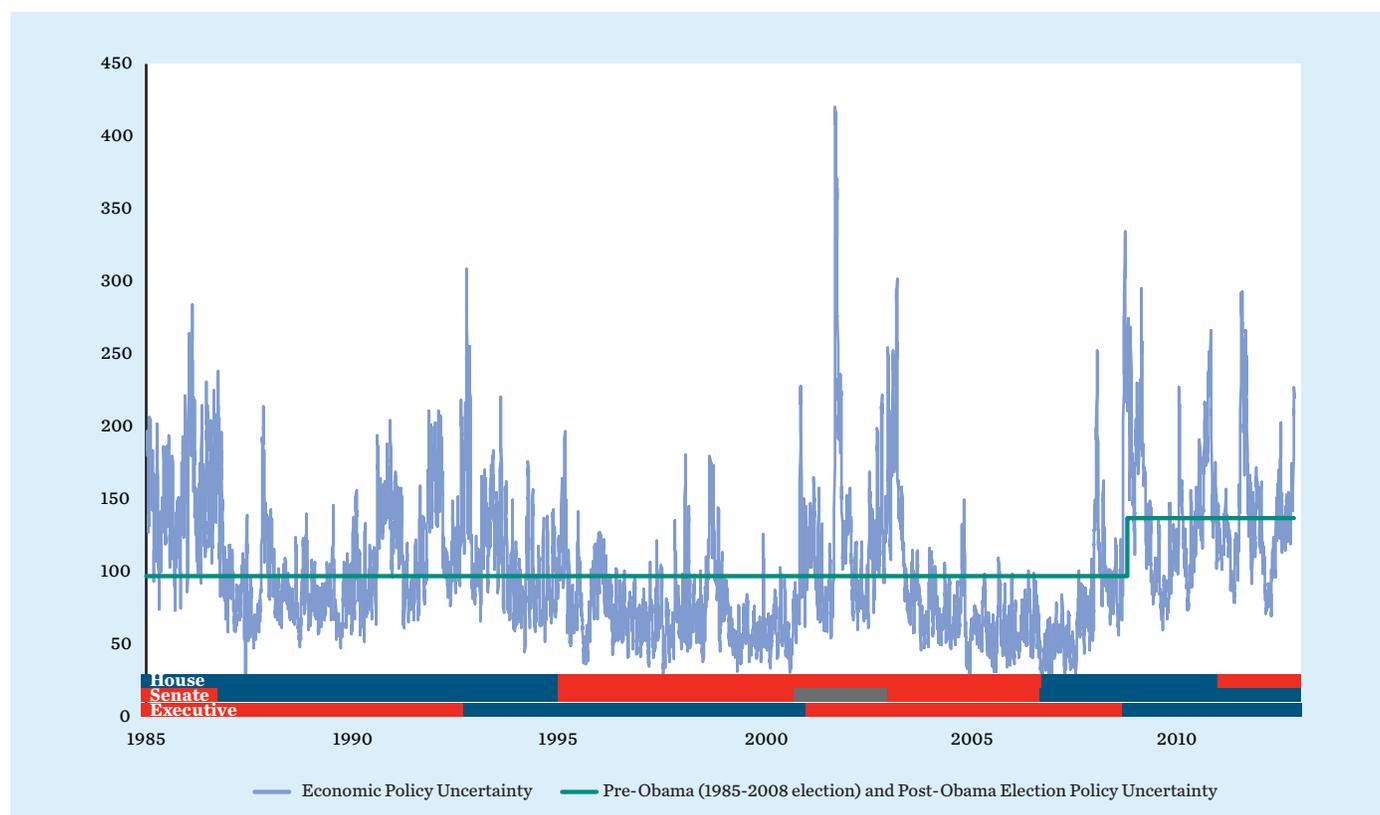
It is probably no surprise that policy uncertainty since the November 2012 election has been relatively high.

The encroaching deadlines and political battles will sustain high uncertainty. In this environment, capital spending will be delayed or foregone. Duke University's quarterly CFO survey asked whether a 0.50% reduction in their company's borrowing cost would lead to additional capital investment. Of the 667 CFOs queried, 647 (97%) said "no." When asked why, they referred to slow growth and uncertainty as

prohibitive factors. In fact, the Federal Reserve's quantitative easing (QE) policies were considered one of the uncertainties that caused them to avoid capital expenditures. The nature of the fiscal cliff resolution that was forged will do nothing to spur real economic growth through investment.

Private consumption, too, is unlikely to be a growth contributor. First, because of the late finalization of the fiscal cliff resolution, first-quarter tax refunds estimated to be more than 1% of nominal GDP will be delayed. Second, all households, especially ones considered upper-income, will experience higher marginal tax rates.⁴ Unlike temporary income supports, permanent changes in income due to permanent tax rate changes cause consumers to change their consumption behaviors. The tax changes ushered in with 2013's fiscal cliff resolution will cause consumption to decline relative to what it otherwise would have been. The amount of the reduction is unknown, but it is nearly certain. Third, the payroll tax holiday is

U.S. Policy Uncertainty Index

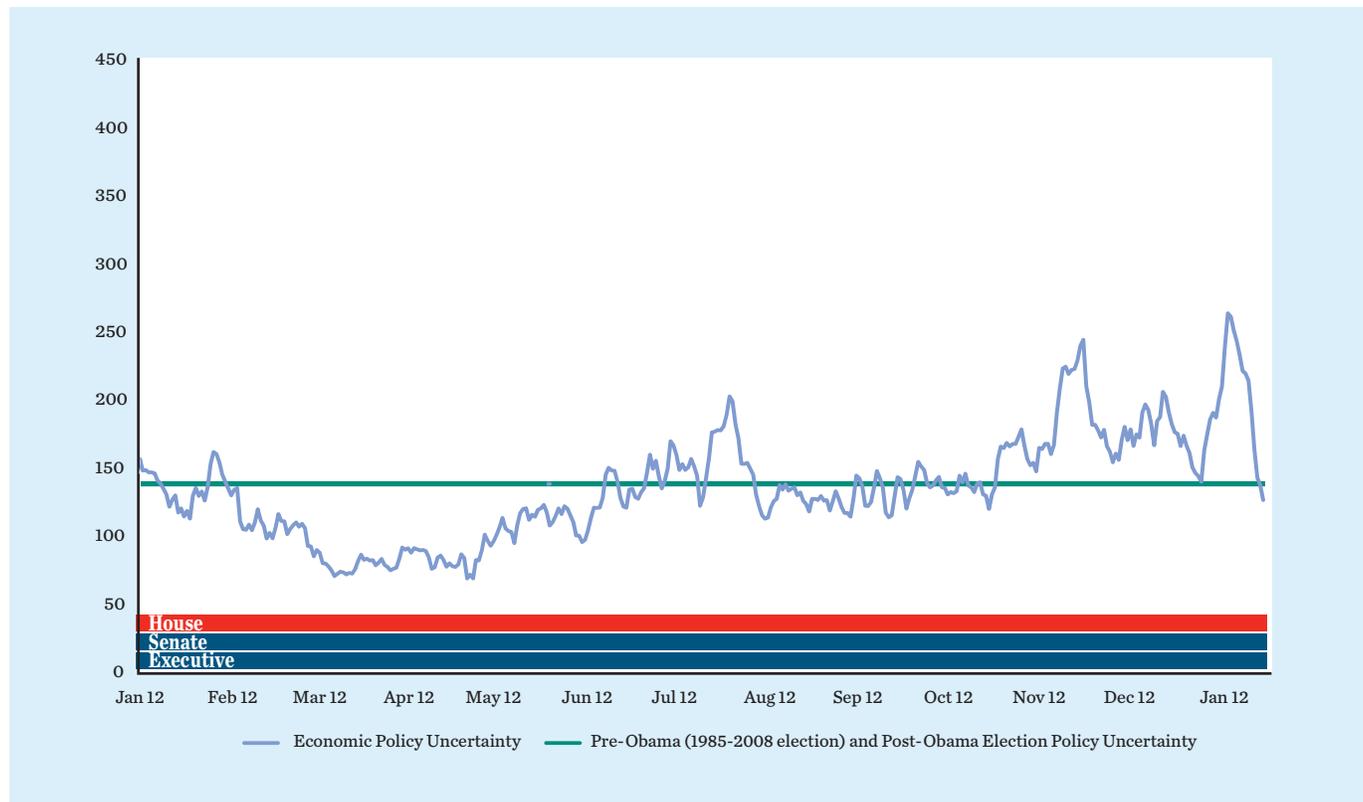


Source: www.policyuncertainty.com/index.html

³ Economic Policy Uncertainty Index provided by www.policyuncertainty.com. To measure policy-related economic uncertainty, www.policyuncertainty.com constructs indexes from three types of underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty.

⁴ Most households, even those below the upper-income threshold, will witness a permanent 3.8% ObamaCare tax increase. Upper-income taxpayers will compound this tax increase with higher marginal income and capital gains tax rates.

U.S. Policy Uncertainty Index



Source: www.policyuncertainty.com/index.html

expected to reduce take-home pay by 0.2% of nominal GDP. Combined, these consumption influencers will negatively affect nominal GDP by 1.5% or more.

Lastly, the government expenditure portion of GDP is unlikely to be a large contributor to growth when the government is operating on an expiring continuing resolution with a looming sequestration.

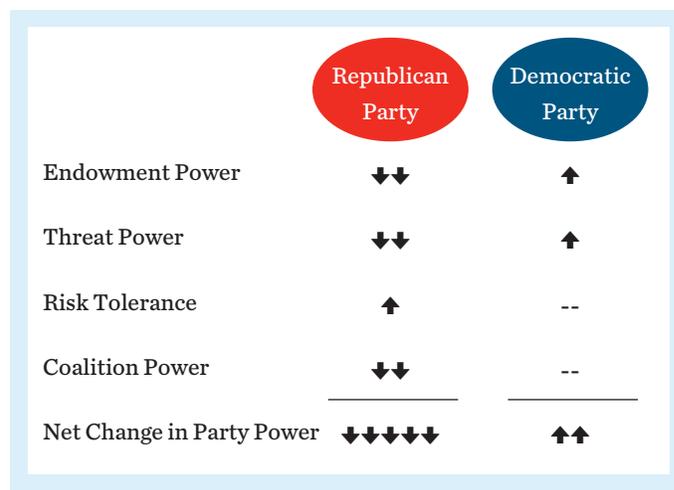
Yes, the first quarter, while presenting challenges not unexpected by markets, does not look promising for U.S. economic growth.

Let the Games Begin

Perhaps more important for investors than the uncertainty and concomitant growth inhibition is their fear and lack of understanding of political negotiations associated with the February and March deadlines. While we have spoken and written much over the past couple of years about the importance of game theory in the post-Cold War geo-

political environment and our use to navigate turbulent eurozone waters, the coming two or three months in the United States bring the topic close to our Chicago home.

Recalling our *Fiscal Cliff: Making Decisions in Crisis* article, the Republican Party exited the election with a vast reduction in negotiating power and the Democratic Party a small improvement.⁵ The following chart is reprinted from that document.



⁵ Antecedent Analysis and Strategy Counsel, *Fiscal Cliff: Making Decisions in Crisis, Part I*, Brian D. Singer, CFA, William Blair, Dynamic Allocation Strategies Team, November 2012.

Evidence of the power shift came with the revenue focus of the fiscal cliff resolution. Speaker John Boehner's abandonment of the "Hastert Rule" revealed Republican weakness on this matter. The Hastert Rule is a governing principle attributed to former Republican Speaker Dennis Hastert stating that the speaker would not bring a bill up for vote unless *a majority of the majority* would vote in its favor. Speaker Boehner abandoned this principle by allowing a vote on the fiscal cliff bill that garnered only 85 of 241 Republican votes. Since it required support of a majority of the minority, the Democrats, Hastert argued that it relinquished power to the Democrats. Boehner did this again a couple weeks later with a vote related to Hurricane Sandy.

Heading into the debt cliff negotiations, the Republicans have the additional consternation of a failed platform; lower taxes were too easily painted as pro-rich and anti-middle-class. The Republicans will evolve and test new platform ideas over this negotiation and the next couple of years as the national approaches midterm elections. Thus, we see the Republicans focusing on a platform of expenditure restraint and testing its power in the debt cliff negotiations. If it resonates with a populace that is increasingly concerned about federal profligacy, the Republican Party's endowment power could ratchet higher quickly.

As Geithner's **January 25** departure passes, we expect more executive office communications regarding the debt ceiling, the need for another continuing budget resolution, and the impending sequestration. Of course, these communications will endeavor to narrow Republican alternatives and make potential negotiating positions riskier. President Obama has executed masterfully in this capacity and, with the nomination of Jack Lew to fill Geithner's post, will remain a formidable negotiator.

The media is concentrating on the debt ceiling, which will likely need to be raised in **late February or early March**. The debt ceiling was enacted in 1917 to ease wartime borrowing and spending. Now it makes borrowing difficult and is used as a tool to restrain spending.⁶ As a potential limiter of federal spending, the Republicans are thought to be considering its use as a threat to extract spending concessions from Democrats. In fact, a specific connection is referred to as the "Boehner Rule": Any increase in

the statutory borrowing limit must be accompanied by spending cuts of equal value. While the Republican Party will use the Boehner Rule as a threat and attempt to extract some concessions from Democrats, it is a red herring in the current round of negotiations. Obama has won this infantry battle on the ground, and collateral damage from a showdown will fall primarily on Republicans. The Republican's risk tolerance is too low to sustain the damage. Acrimonious negotiations resulting in the August 2, 2011, and September 22, 2011, debt ceiling increases precipitated a 15% S&P 500 decline and garnered the ire of individuals, corporations, and leaders globally. Been there, done that, and don't want to go there again.

The **March 1** sequestration deadline is more interesting—the heavy artillery of this negotiating round. Sequestration is designed to force \$1.2 trillion of cumulative across-the-board spending "cuts"—from otherwise projected increases—through 2021. The cuts are about split evenly across defense and non-defense spending. The Defense Department is the single department that will suffer the most, about 11% this year. Behind the Defense Department is the Department of Education's 7.8% cut in 2013. The Democrats will threaten defense and sustain education cuts. Conversely, Republicans will threaten education (not a strong platform position) and sustain defense cuts. Both parties have threat power and risk exposure, but the Democrats continue to hold a stronger hand and, despite some concessions, will leverage this to their benefit. Further, from an endowment perspective, Obama has the presidential bully pulpit and he is adept at its use. We do not presume to know the outcome of these negotiations, but we suspect that weak spending reductions—accounting gimmickry will win the day—and a rollercoaster of first-quarter defense spending forecasts. There will likely be some additional tax increases and we may even be lucky enough to observe the partial rationalization of our tax code. However, since congressional power is coded into our tax rules, no investor should expect much growth-oriented progress.

Lastly, the nuclear engagement of these negotiations is continuing budget resolution approval on **March 27**. This is the Republicans' strongest front and the Democrats' greatest exposure. During the Obama administration,

⁶ Denmark is the only other country with a debt ceiling, but it is high and unrestrictive.

when the Democrats controlled both houses of Congress, our crack Washington leadership failed to approve a single budget. After the Republicans took control of the House, the probability of an annual budget went “down from zero.” The Republican-controlled House submitted several appropriations bills to the Senate for approval, but Senator Majority Leader Reid did not allow any of these to come to the floor for vote. Therein lies Republicans’ threat power, and they are positioning for the battle. Democrats can be painted as the budget transgressors and Republicans can test a powerful new spending reduction platform plank.

The federal government operates on an October 1 to September 30 calendar. Funds cannot be spent without congressional approval via the passage of annual budgets that ensure the operation of government departments. If Congress fails to pass such a bill, or the president fails to sign it into law, certain nonessential functions of the government will cease, as it is no longer allowed by law to spend money. To prevent the interruption of government services, Congress will often pass continuing resolutions. These authorize government agencies to spend at the current levels until either the resolution expires or an appropriations bill is passed. A continuing resolution must be passed by both houses of Congress and signed into law by the president.

The government has shut down a few times because of a failure to pass a budget or continuing resolution. In 1981, the government shut down for a half day (400,000 workers were sent home). In 1984, it shut down for one day with 500,000 sent home. In 1990, it shut down for a long weekend without much impact as workers were out of the office. In 1995 and 1996, there were two longer shutdowns; many services, from passports to parks, were unavailable or delayed.

In these negotiations, we fully expect the Republican Party to require spending constraint concessions before a continuing budget resolution is brought to the House floor

for approval. The Boehner Rule may be reconstituted in a form that ties budget approval to spending cuts. Since any failure to pass a budget will make government services unavailable, the impact will be immediately tangible to the ordinary citizen. Republicans will threaten a shutdown and attempt to pin the blame on the Democrats’ failure to approve or even vote on a budget.

Investment Implications

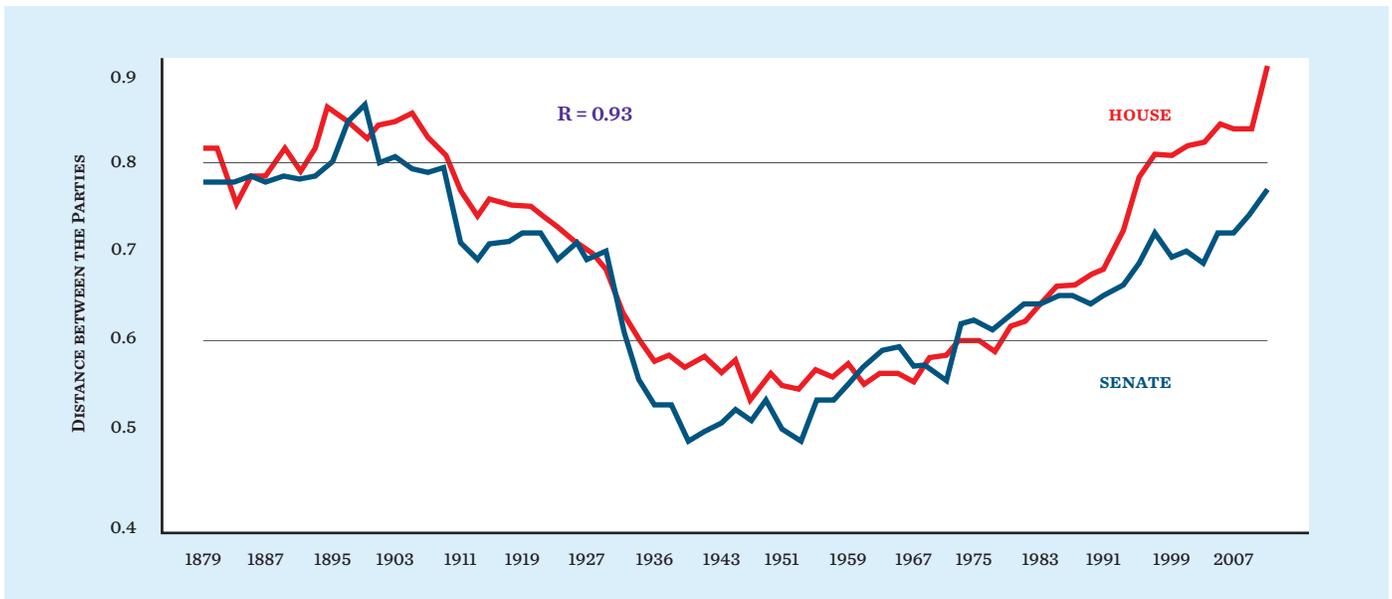
We believe that a resolution of the various sequestration, debt, and budget issues will occur, and more to the benefit of the Democratic than Republican Party. The public is increasingly aware of a growing deficit problem and will respond adversely to failure. Cass Sunstein, a University of Chicago professor, Harvard professor, and former Obama appointee, said in a Bloomberg interview that minimalism (leaving important matters undecided) and trimming (deciding on important matters by steering between polarized positions) will provide practical avenues to compromise.⁷ Given the current degree of political polarization, a “Grand Bargain” is less likely in this round and a baby step toward debt abatement will be made. However, we do not believe that it is in either party’s interest to compromise without a market-disrupting threat. Such a market disruption, not unlike that associated with the 2008 TARP vote but hopeful of much smaller magnitude, should be expected before an outcome is agreed. After March, the Obama administration can focus on legacy and continue to nibble its way toward a Grand, if Democratically dominated, Bargain.

For perspective, the following charts indicate the rising and current political party polarization in Washington. The higher the line—red for House and blue for Senate—the greater the political polarization. Since the 1800s, the U.S. House has never been so polarized. The Senate is polarized, but less so than 125 years ago.⁸

⁷ “How to Resolve Disputes, Maybe Even Gridlock,” Cass R. Sunstein, *Bloomberg View*, January 14, 2013.

⁸ “Forecasting Polarization in the 113th Senate,” voteview blog, September 10, 2012.

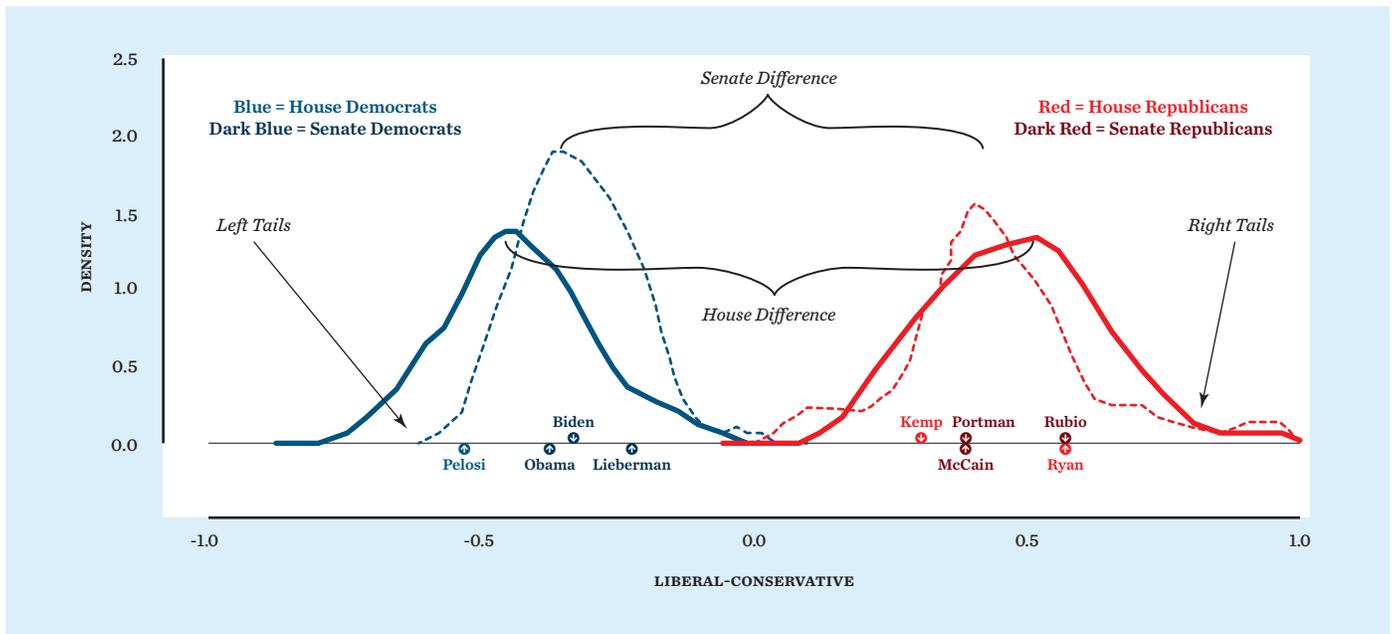
Party Polarization 1879-2011, Distance Between the Parties First Dimension



Source: polarized america/voteview.com

Polarization in the above graph is measured as the difference between the averages of the distributions below. The middle of the solid blue bell curve below is about -0.4 and 0.5 for the solid red curve. The difference is 0.9, the last point for the House above. The solid line below is the House, red for Republican and blue for Democrats, and it is spread wider than the Senate dashed line. The above chart simply shows the differences for House and Senate over time. Notice that the Republican Party in both the House and the Senate has members who are more extremely polarized to the right (the right tails) than the Democrats are to the left (the left tails). These tails portend huge threats that will likely be required to bring “outliers” to the table for agreement and require the minimalism and trimming that Sunstein predicts.

112th (2011-2012) Congress



We anticipate a significant threat, probably emanating from the Republican Party and associated with the continuing budget resolution. While assets are priced to entice risk-taking, caution against extreme policy outcomes is warranted.

About the Author



Brian Singer, CFA, is the Head of the Dynamic Allocation Strategies Team. Prior to joining William Blair and Company in 2011, he was the Head of Investment Strategies of Singer Partners, LLC. Mr. Singer was the former head of Global Investment Solutions and Americas Chief Investment Officer for UBS Global Asset Management. He was a member of the UBS Group Managing Board and Global Asset Management Executive Committee. Brian is a board member and former chair of the CFA Institute Board of Governors and is also a former member of the Research Foundation of CFA Institute Board of Trustees. He was elected to the Board in 2004 and previously served as chair of the Candidate Curriculum Committee. Brian serves on the Exeter College at Oxford University Endowment Investment Committee and is the chairman of the Milton Friedman inspired organization 'Free To Choose Network.' In 1991, Brian co-wrote a landmark update to one of the pioneering studies on asset allocation, *'Determinants of Portfolio Performance II: An Update,'* with Gary Brinson and Gilbert Beebower. In 2009, Brian was the lead author of *'Investment Leadership and Portfolio Management,'* Wiley Publishing.

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