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*Fiscal Cliff:
Making Decisions in Crisis*

Part I

Antecedent counsel is provided as internal guidance to our portfolio managers and analysts. This counsel is not a forecast and has a longer time horizon than our commentaries. We use this guidance to inform our fundamental analysis, having measurable impact on our model inputs. Antecedent counsel should assist our clients in understanding our analysis and strategies.

The Walrus and the Carpenter

“The time has come,’ the Walrus said,
“To talk of many things:
Of shoes—and ships—and sealing-wax—
Of cabbages—and kings—
And why the sea is boiling hot—
And what the [Fisc’ Cliff] brings.”¹

Framing the Fiscal Problem

Having lost touch with mainstream America, neither the Republican nor the Democratic Party enjoys much governing ability. Second, politicians struggle to function as leaders, regardless of competence, as a result of party disengagement. Third, left to their own devices, politicians will respond to their individual incentives. Bringing these observations together, neither party platform nor leadership vision will provide as much guiding force as the incentives of each politician, sometimes individually and other times in coalition.

Our preferred framework to interpret choices of these politicians in response to their incentives is strategic decision theory, or game theory. In strategic decision theory, there are four powers that we assess to understand investment opportunities and risks:

Endowment Power – the source of resources supporting one’s ability to wage a strategic engagement. Endowment Power includes vision, money, political capital, nuclear warheads, etc.

Threat Power – the ability to threaten credibly the multiple players in the strategic engagement, including self-inflicted collateral damage, to such a degree that they must modify their decisions and actions to the benefit of the threatening player.

Risk Tolerance – the ability to incur risk and to walk away from negotiations without a deal.

Coalition Power – the ability to form and evolve coalitions that benefit one or more players and marginalize other players.

Power Balance in the Fiscal Game

November 6 delivered Republicans more of a bad night than it handed Democrats a good night. The Republicans were clear losers in terms of strategic powers in the political game theater, while Democrats were marginal winners.

The Republican Party power decline was substantial:

Endowment Power declined significantly. Much political capital was burned and there is very little to show for it. Numbers in the Senate and House have declined. The platform, or “brand” if you will, has been partly repudiated and the vision that it afforded has vanished. The election has left the Republican Party grasping for a platform that will be more successful than that of the 2012 elections. The Republicans are likely to experience a couple of years of internecine challenges, leaving their Endowment Power severely pared.

¹Through the Looking-Glass and What Alice Found There, Lewis Carroll, 1872.

Threat Power declined significantly. Threats sourced in vision unify players and increases the will to incur collateral damage as they threaten other players. A trouncing of the vision during a weak economy depletes Threat Power.

Risk Tolerance increased slightly. Clearly, the Republican Party and Republicans have less to lose now that they have lost. They can and will likely tolerate more risk as they explore platform options to ascertain popular resonance.

Coalition Power declined substantially. Republican Party coalition partners were substantially weakened. Residual coalition powers are likely to be revealed over the coming weeks during midlevel party elections and the subsequent run by current House Speaker John Boehner for another term. What damage have these partners incurred?

- **Tea Party:** less than a third of Senate candidates endorsed by the Tea Party won, dashing Republican desires for Senate control. Firebrand fiscal conservatism failed to garner House success similar to that of midterm elections. The Tea Party is not dead, but it is a severely wounded coalition partner.
- **Christian Right:** November 6 could not have been much worse; they showed up in force, but it was not enough. Not only was President Obama reelected, but Maryland and Maine also voted for same-sex marriage by popular majority and Washington and Colorado supported recreational marijuana. Kevin Wright, a pastor at Foundry United Methodist Church, aptly interpreted the outcome for the Inter Press Service news, "It's not that these young people have any less use for the Bible, but rather that they are adopting a fuller faith . . . towards social justice." Obama did well among evangelicals, better than in 2008, capturing a narrow majority of the Catholic vote, even after the ObamaCare contraception altercation. The Christian Right cannot be counted on to deliver votes and has been rendered a much less influential coalition partner.
- **Grover Norquist's Entourage:** The Taxpayer Protection Pledge, signed by nearly all Republican congressmen, opposes increases in marginal income tax rates for individuals and businesses, as well as net reductions or eliminations of deductions and credits without matching reduced tax rates.

Unlike Newt Gingrich's "Contract for America," the all-or-nothing pledge strategy failed to deliver when required, dealing Norquist a debilitating blow. Moreover, interpretations of words like "increase," "rate," (average, marginal, etc.), and "matching" are all subject to interpretation and will evolve. Congressmen will be loath to rely on the pledge to protect their coalition flanks.

The Democratic Party power increase was marginal:

Endowment Power increased slightly. Absence of a party election platform means no mandate, despite what the early rhetoric implies. Unless post-election posturing alters the picture, the election was more lost by Republicans than won by Democrats, lessening the political capital and vision endowment accruing to the Democratic Party. However, the Democrats won and added House and Senate seats, affording a slight boost to Endowment Power.

Threat Power increased slightly. Perhaps the only boost to Democratic Party Threat Power is Republican Party vulnerability.

Risk Tolerance is ambivalently influenced, depending on Obama's individual motivation. Obama has less to lose now that he is in his second term; he does not need to concern himself with reelection. Thus, he can walk away from negotiations without deals. However, Obama's second-term objective could be driven by either legacy or ideology. If by ideology, then his risk tolerance will be greater as there will be no great loss in accomplishing nothing. However, if he leads by legacy, then he risks his legacy and has much less risk tolerance. Currently, we believe that he will lead with legacy in mind. As has been much reported, his choice for Treasury secretary will send an early signal of whether he will govern from a foundation of ideology or of legacy.

Coalition Power is unchanged. Obama has never been much of a coalition builder; however, Senate Majority Leader Harry Reid and Obama have been an occasionally viable coalition for chipping away at Republican power. Whether this can lead to effective progress toward resolving fiscal issues is still to be determined.

There are two important coalition players that influence both parties' fiscal cliff strategies. First, mainstream media, barring Fox News, has been and will continue to

Strategy Implications

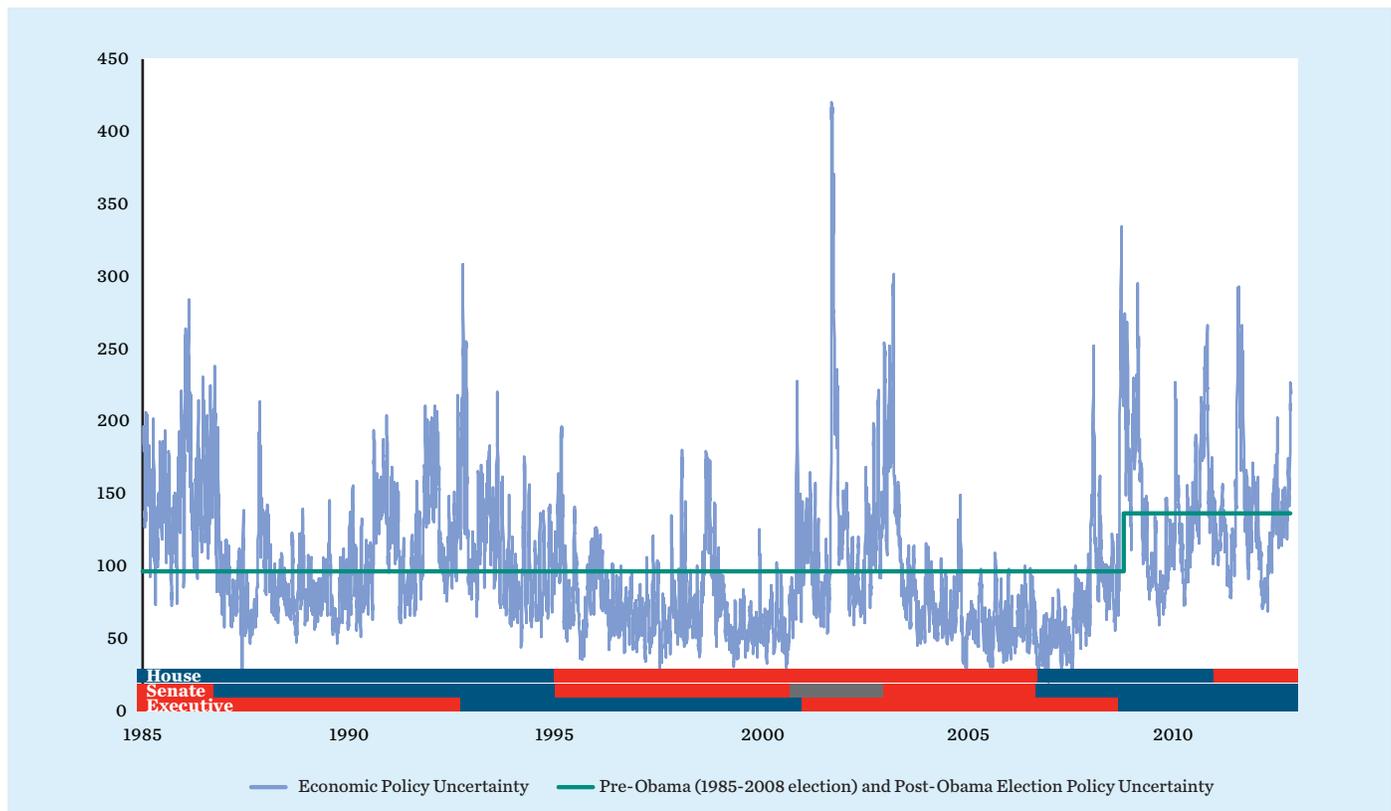
Our financial market experience leads us to wonder whether, without pressure from financial markets, policymakers can voluntarily come up with the political will to resolve this crisis any better than the Europeans have been able to resolve theirs. Based on our game theoretical construct, we suspect slow and occasionally violent progress, but more progress than experienced in Obama's first term.

Republicans have been weakened significantly by the election and will be a more conciliatory player in the fiscal cliff game, yet the Democrats have been only marginally strengthened. If Obama decides to lead toward a legacy, as we currently believe and would be signaled by the rumored appointment of Erskine Bowles as Treasury secretary, then he has a powerful incentive to resolve the fiscal cliff, advance long-term debt reduction, and burnish the future of ObamaCare. The coming months will likely witness an extension of the current end-of-year cliff and future progress toward permanent debt reduction, based on Obama's terms and the Democratic Party's predominantly Keynesian economic beliefs. On the other hand, if Obama decides to lead by ideology, the domestic fiscal situation will deteriorate dramatically.

	Republican Party	Democratic Party
Endowment Power	↓↓	↑
Threat Power	↓↓	↑
Risk Tolerance	↑	--
Coalition Power	↓↓	--
Net Change in Party Power	↓↓↓↓↓	↑↑

be a Democratic Party coalition partner. The media will likely push toward ideological-based governance, and while the Senate and House Democrats are likely to oblige, it is uncertain whether Obama will follow suit. Second, the anti-fiscal brinksmanship coalition that has emerged among business and foreign leaders is increasingly powerful and influential. From the outset, the balance of influence of the media and the anti-fiscal brinksmanship coalition will support fiscal cliff delay and subsequent progress.

U.S. Policy Uncertainty Index



Source: www.policyuncertainty.com/index.html

Regardless, the overwhelming uncertainty that has dominated the last few weeks of the campaign season will dissipate, but the lack of business experience in Obama's inner circle will sustain the high level of uncertainty that has marked his entire first term.

Awaiting a signal of Obama's second-term intentions, we expect enhanced market volatility and continued threatening communications from each party. However, we expect less brinksmanship and more fiscal progress than currently are priced into domestic assets and the U.S. dollar. We expect equities to deliver near-normal returns with higher-than-normal volatility, not an overwhelming endorsement for the S&P 500. We expect the safe-haven support of Treasuries to dissipate over time, but there is little immediate impetus for higher yields. Lastly, the U.S. dollar is less likely to experience protracted weakness as a result of withering political confidence, at least relative to what is currently anticipated and priced.

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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