

Business as Usual in Washington

The political dysfunction in Washington has been front-and-center in recent months, showcased by a 16-day government shutdown, a last minute deal to avoid a U.S. debt default, and a controversial and botched rollout of the President's signature healthcare plan. Any remaining trust that Americans had in the government has undoubtedly been shaken by these events, reinforcing the uncertainty surrounding our country's future. While it is difficult to quantify the full impact of these events on the economy, suffice it to say that consumers and businesses tend to delay spending decisions when they do not know or trust the rules of the game. This has likely been a contributing factor to the below average growth we have experienced recently and the ongoing need for ultra-loose monetary policy to offset these fiscal restraints. In this month's MAInsights piece, we will discuss the dynamics behind the political impasse and its impact on the economic and market outlook for 2014 and beyond.

Is political dysfunction the cause or effect of a troubled economy?

While it is true that politics have hampered the recovery over the past few years, it is also worth considering whether we would have this level of dysfunction if it were not for the tenuous state of the U.S. economy today. In other words, we may be focusing so closely on our year-to-year progress that we lose sight of the decades of over-consumption and over-promising that created the enormous debt and entitlement problem in the first place. Of course, much of the excessive borrowing and leverage was a result of government policies that incentivized such behavior (i.e. Fannie Mae & Freddie Mac, tax incentives, lax regulation), but nonetheless, the debt burden was largely created by excesses in the private sector of the economy. It became the government's problem when they were forced to step in to bail out failing institutions, undertake massive deficit-spending, and commit to ultra-loose monetary policy to prevent a depression. In effect, these measures transferred the massive debt in the consumer and banking sectors to the government's balance sheet, resulting in a dramatic rise in the level of public debt from \$10 trillion in 2008 to over \$17 trillion today (more than 100% of annual U.S. GDP). This debt burden, combined with a daunting forecast for entitlement spending over the next 30 years, has made each budget negotiation and debt ceiling increase that much more complicated. We raise this point not to abdicate

politicians of their responsibility in the current dysfunction, but instead to point out that we are in a complicated position primarily because of an over-levered, aging economy that needs repair.

What is really holding us back from solving our long-term fiscal problems?

The first roadblock to a healthier financial outlook is the economy itself. It is becoming more apparent that we face structural economic headwinds in the form of an aging demographic and slower growth in the working-age population. After averaging 1.4% growth between 1970 and 2010, the working-age population is expected to grow just 0.36% annually in the current decade and a meager 0.18% annually between 2020 and 2030. Meanwhile, the number of people qualifying for entitlement benefits is rapidly increasing, with the 65 and over age group projected to grow from 13% of the population in 2010 to 16% by 2020 and 19% by 2030. As a result, we are facing a widening gap between the number of people receiving benefits and the number of people paying into the system. In the 1950's, the ratio of covered workers to social security recipients was 16:1; today the ratio is down to 3:1 and is projected to fall to 2:1 by 2030. The aging of the baby boomer generation, longer life expectancies, lower fertility rate, and slower immigration are all contributing to this dynamic, making it less likely that the country has the potential to grow fast enough to control our deficits without fiscal adjustments being made.

The second roadblock to a healthier financial picture is the lack of public support to make adjustments to government spending and entitlement benefits. In a system where elected officials just want to get re-elected, the majority support of their constituents is of ultimate importance. When it comes to maintaining benefits versus reducing the deficit, a Pew Research Center poll found that 55% of Americans would prioritize maintaining Social Security and Medicare benefits over cutting the deficit while only 34% of Americans would prioritize cutting the deficit. In a separate poll on increasing, maintaining or cutting spending to various programs, 87% of Americans believed spending on social security should be either maintained or increased. In addition, of the 19 programs included in the poll (i.e. defense, entitlements, education, healthcare, etc.), only providing aid to the world's needy received a majority support for spending cuts. This research illustrates the public's deep aversion to spending cuts and desire to keep or increase entitlements. In this context, it appears politicians will have a tough time convincing their constituents that sacrifice is a good thing for the long haul.

If the first two reasons were not enough, the elevated partisanship in Washington is the third issue holding us back from a solution. Never before have we seen such an inability of the two parties to work together on solutions, and once again, the widening ideological gap in Congress only reflects what is occurring within the American public. Another study by the Pew Research Center showed that, over the past decade, there has been a significant decline in the number of “moderate” Republicans and Democrats, with a greater percentage from both parties now voting as self-described “liberals” or “conservatives”. This deepening divide in ideology has manifested itself in widening differences in opinion between Republicans and Democrats on nearly all issues. In fact, the study showed that the average percentage gap between opinions on 48 different issues was now at 18 percent – twice the gap found in surveys between 1987 and 2002. This increased level of polarization makes a bipartisan reform package nearly impossible within the current structure of the Republican-controlled House and Democrat-controlled Senate. While a near-term deal appears very unlikely, we are still hopeful that our democratic system can create solutions in the coming years. As Winston Churchill famously stated, “Democracy is the worst form of government, except for all those other forms that have been tried from time to time.” Ultimately, we believe reforms will be made – it just may take some pressure from the markets to justify them.

If a long-term fix is unlikely in the near term, what does the continued dysfunction mean for the economy and markets?

For the economy, the uncertainty surrounding tax rates, the debt ceiling, healthcare, and our long-term financial outlook will likely keep a lid on the economy until there is more confidence that solutions in Washington are possible. If corporations are wary of the future, they will delay investments and hiring decisions in order to protect profit margins and meet earnings expectations. While the impact of this caution is negative for the broad economy, equity investors care more about profits and dividends, so they should continue to view this dynamic in a fairly positive light. Additionally, a slower growth profile for the economy portends a slower exit by the Fed from QE and its zero interest rate policy, and thus, investors will need to look beyond traditional, safe investments to generate income and decent returns. For these reasons, we remain constructive on the near-term outlook for equities heading into 2014.

Thinking longer-term, however, the implications of failing to address our long-term fiscal deficits are clearly more worrisome. As the world's reserve currency, the U.S. has enjoyed virtually limitless demand for U.S. Treasuries over the past few decades and it has certainly taken advantage of that status. But now, with over 30% of our \$17 trillion in public debt owned by foreign governments, any doubts about our credibility would have an impact on the demand for our debt and the U.S. dollar. In fact, we are already starting to see the largest foreign investor, China, cutting back on their Treasury holdings in favor of other currencies and precious metals. In the short run, the impact of this credibility gap is negligible because the Fed is buying 75% of new Treasury issuance, but if they decide to pull back on their accommodation in a significant way, the weaker demand for Treasuries outside the Fed could become even more apparent and cause upward pressure on our borrowing rates. This type of credit event is certainly a risk to the economy and markets, but in some sense, it could also be the jolt that politicians need to finally make long-term reforms a priority. Either way, we will continue to monitor this situation very closely as it will play an important role in determining the long-term outlook for the markets.

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