MAY 2012

INVESTMENT UPDATE

The capital markets hate uncertainty. Even if the news is likely to be bad, the markets tend to improve once all the bad news is out in the open, for all to see—the "devil that you know," and all that.

Right now, investors are nervous as they await the resolution to some pretty important issues. These include, among others, the fate of the European Monetary Union, due to the recent anti-austerity elections in France and Greece, and significant fiscal and monetary policy decisions here at home.

First, let's take a look at Europe.

There's a growing sense of *déjà vu* this spring, as we seem to be repeating the pattern of both 2011 and 2010, when the markets began the year full of enthusiasm, only to be spoiled by bad news out of Europe. This year, the focus is mainly on Greece and France, where recent national elections showed the voting public pushing back on the austerity measures previously agreed to in both countries. Now, there are significant differences in these two countries—clearly, Greece is Europe's problem child, prone to bouts of dishonesty, petulance, sleaze, and all-around bad behavior. France, on the other hand, has one of the stronger economies in Europe, with a banking system that by and large avoided most of the excesses of the last decade.

And yet, voters in both countries registered their displeasure with the direction each country is taking. They aren't happy about cuts in wages and benefits, and aren't convinced that there's any relief in sight. There's a growing sense in both countries that politicians have been forcing through policies that are more burdensome to the common man than to those in power. They want policies that focus more on growth than on cutting costs.

Of the two, France is far more deserving of our sympathy. Like Germany (albeit to a lesser extent), France is shouldering a disproportionate share of the cost of propping up the weaker economies in Europe, including programs to subsidize cheap funds for the banks, as well as direct loans to the governments of the weaker players, including Greece. Nevertheless, the political shift to the left in France has not been welcomed by the global capital markets, and has resulted in another round of de-risking trades, as investors shed corporate stocks and bonds and run to the warm embrace, and miniscule yields, of US Treasuries. It is notable, however, that in contrast to the experiences of the past couple of years, bank stocks and bonds have held up pretty well (at least until JP Morgan's surprise announcement of a $2 billion trading loss) during this period. The relatively solid performance of banks this time around is attributable to a significant reduction of private sector exposure to sovereign credits, as the European Central Bank began accepting lower-quality assets as collateral in exchange for Euros.

Meanwhile, at this point, Greece is operating without a government. The May 6th elections gave no party a clear majority; as with most parliamentary systems, the leading minority parties must try to form a coalition government, or else face another round of elections. Given their poor performance in the elections, a pro-austerity coalition is highly unlikely. Meanwhile, the future of Greece's status as a member of the European Monetary Union is in serious jeopardy. Unless certain benchmarks are met, Greece will not receive vital funds from its creditors (made up of the "troika" of the European Central Bank, the IMF and the European Commission), and will almost certainly run out of money before the end of the summer.

Ever since cracks began to form in the European Monetary Union in 2010, we've been operating under the assumption that the EMU would use nearly every means necessary to keep Greece in the Union; we no longer believe that to be true. On top of the national elections in France and Greece, last week's state election in Germany may force Chancellor Angela Merkel to soften her firm support of a unified (i.e., Greek-inclusive) Eurozone. Meanwhile, public statements by some of the leading monetary and political leaders in Northern Europe seem to be shifting from "maintaining the integrity of the entire Union" to publicly talking about how a Greek exit would not mean the end of the Euro. The ongoing fear is that a Greek exit would create a domino effect if other weak countries seek their own way out, especially if it's a large economy like Italy or Spain. European leaders would be wise to use the next few months to prepare themselves, and the world financial markets, for a Greek exit, along with firm plans on how to keep the lid on the remaining members of the Union. Greece can, with some degree of pain, be financially "ring-fenced," but Italy is an entirely different matter.

Meanwhile, the US is facing its own elections in a few months, and listening to the candidates chew on each other is proving to be a temporary distraction from examining our fiscal challenges. The US economy, which has been propped up by multiple Federal programs designed to boost growth and spur borrowing and investment, faces what is being called a "fiscal cliff" after the November elections, as stimulus programs are due to be replaced by budget cuts and tax hikes. How big is this so-called cliff? As the table at the top of the next page (courtesy of Merrill Lynch Global Research) indicates, it's not just big, it's gigantic.

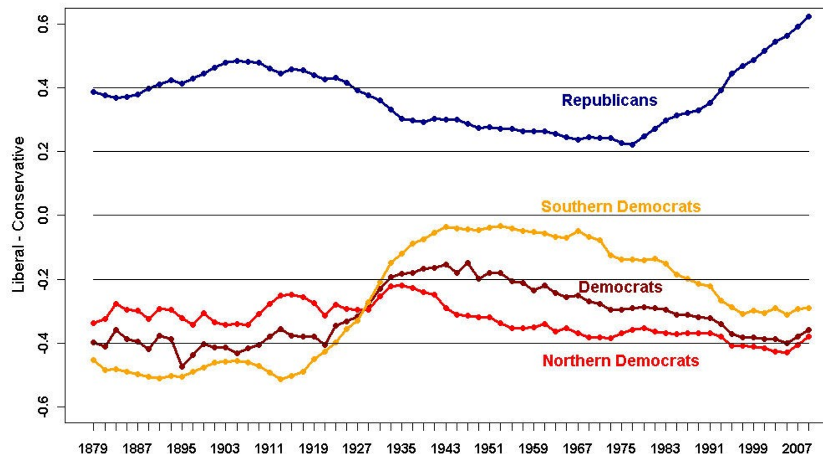
INVESTMENT UPDATE CONT.

Chief among these is the expiration of the so-called "Bush tax cuts," which are estimated to increase revenue (and cost taxpayers) $180 billion in 2013. Then there is the automatic adjustment of the alternative minimum tax and the expiration of the payroll tax "holiday" which Congress reluctantly passed a few months ago; these two alone add up to $240 billion. Adding on other miscellaneous tax policy changes results in a fiscal drag of $470 billion annually, which is equivalent to 3% of US GDP. That exceeds most economists' estimates of 2013 GDP growth, right there.

Tax Increases:		
	Bush tax cuts	$180 bln
	AMT	120 bln
	Payroll tax	120 bln
	Tax extenders	20 bln
	Obamacare	20 bln
	Business expensing	10 bln
Pending expiring programs:		
	Extended UI	40 bln
	Medicare doc fix	20 bln
	Other programs	40 bln
Pending spending cuts:		
	Sequester	110 bln
	Initial debt plan	40 bln
Total:		**$720 bln**
% of GDP		**4.60%**

But there's more—an additional $250 billion in expiring benefit programs and mandatory spending cuts that kick in as a result of last year's debt ceiling negotiations. All told, Merrill estimates the total fiscal impact to be in the neighborhood of $720 million—a fiscal drag equal to 4.6% of US GDP (Morgan Stanley has produced a similar study with only slightly lower numbers, totaling $665 billion).

Obviously, this would be a huge hit to the economy and could easily push the US back into a recession. But policymakers are aware of these risks, so there will be heated negotiations at the end of the year, with Congress split (as usual) on priorities: spending cuts or tax reform. On taxes, it seems unlikely that the entire Bush tax cuts will expire; Obama has promised to hike the rate only on those making over $250,000 per year, and Romney has stated that he will not raise income tax rates at all. Similarly, AMT is likely to be scaled back, as it has been nearly every year over the past decade, and there could be some wiggle room on the payroll tax extension. And so on, with many of the mandatory spending cuts likely to be negotiated away. Most economists believe that the end result will be a fiscal drag equal to approximately 2% of GDP, give or take a percent.



Which brings us back around to our original point: We don't know what the outcome will be, and the chances of a really bad outcome cannot be ignored. Uncertainty is the norm given our semi-functional Congress (motto: "At least we're not Greece!").

Assessing the possibility of Congress driving us off a fiscal cliff is extremely difficult, a fact supported by the work of the University of Georgia's Keith Poole (see: www.voteview.com). As the bottom chart demonstrates, Congress (this chart shows the House, but the numbers are similar for the Senate) is more polarized today than it has been since at least 1879, with Republicans registering a reading of almost 0.6 (on a scale of -1.0 to 1.0, liberal to conservative) and Democrats at nearly -0.4. Dr. Poole and his team compiled every roll call vote taken by every member of Congress over this time period to determine the degree of polarization/moderation among its members.

One of the interesting findings is that while the Republican Party has clearly lost its "middle," so have the Democrats, but for different reasons. Moderate- to-conservative Southern Democrats have been replaced, especially in the last few elections, with more ideologically conservative Republicans; northern Democrats have been fairly consistent in their liberalism, but the ideological middle of the Democratic Party, as represented by the Southern Democrats, has largely been voted out of office. The result has been political paralysis. To quote Dr. Poole: *"With almost no true moderates left in the House, and just a handful remaining in the Senate, bipartisan agreement to fix the budgetary problems of the country are now almost impossible to reach."*

This is a startling shift from the early 1980s; again, Dr. Poole: *"During Ronald Reagan's administration, about half of the members of Congress could be described as moderates…[and they were] able to forge major bipartisan agreements to cut taxes in 1981, raise taxes in 1982, fix Social Security in 1983 and pass immigration reform…[as well as] major tax simplification in 1986."*

Today, businesses and investors sit on their hands waiting for these decisions to be made. We can deal with bad news, but no news leads us to fear the worst. It's time Washington got its act together. All we need to do is look across the Atlantic to see how bad it can get if we don't.