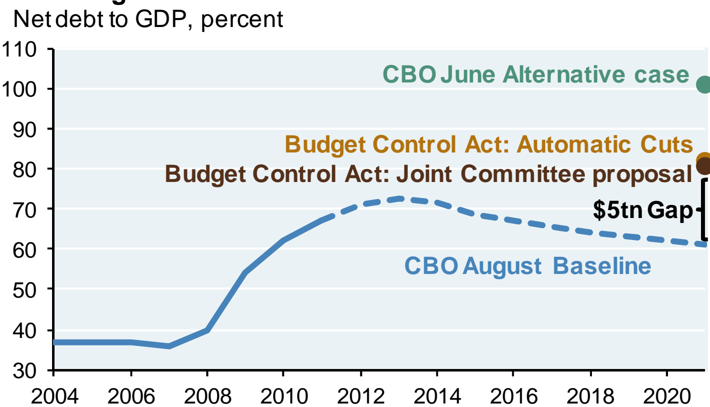
Topics: Why financial markets are paying close attention to the Joint Select Committee on Deficit Reduction

In August, the United States lost one of its AAA credit ratings, a designation first bestowed around 100 years ago. Since that time, financial markets have struggled to regain their footing, reflecting concern global investors have about the ability and willingness of both the US and Europe to tackle their respective fiscal challenges. With US federal debt approaching its highest level since the formation of the federal government in 1789 (other than during WWII and its immediate aftermath), rating agencies are taking a close look at rising US debt ratios and what the legislature does to contain them. The appetite of foreign central banks to accumulate Treasuries has provided the US with a reprieve; these entities, plus Federal Reserve holdings, now account for more than half of all Treasury bonds. But monetary policy in Asia and the Middle East is subject to change, and we have seen in Europe the suddenness with which sovereign debt can be re-priced by financial markets. From an investment perspective, the downgrade, government shutdown rumors and political impasse on deficit reduction are negatively affecting equity markets, business activity and consumer confidence. This note details 10 reasons why we believe financial markets will take a very close look at whether the Joint Select Committee on Deficit Reduction ("JSCDR") exceeds its $1.5 trillion deficit reduction target; simply reaches the target; undershoots the target, relying on sequestered cuts for the rest of the $1.2 trillion minimum; does not come to agreement and settles for sequestered spending cuts of $1.2 trillion; or worse still, introduces legislation to eliminate some of the sequestered cuts, as has been suggested in recent days.

[1] **The Budget Control Act represents progress, but does not yet set federal debt on a sustainable path**. As shown, the Budget Control Act reduced the trajectory of federal debt compared to the CBO's Alternative Case published in June 2011. However, even after incorporating the BCA, future debt ratios still rise into the low-80s as a percentage of US GDP. The CBO's August Baseline shows a *decline* in federal debt since it assumes three policy options that have not been implemented: sunset of all Bush tax cuts, an end to indexation of AMT to inflation, and reductions to Medicare doctor reimbursements which Congress has agreed to but never enacted. These three cuts and associated interest savings would amount to roughly $5 trillion in deficit reduction over a 10 year period. Congress might not pursue these options and chose a different set of deficit reduction measures and amounts; either way, it would take roughly $2 trillion on top of the $1.5 trillion in 10-year deficit reduction already assigned to the JSCDR to stabilize the federal debt. CEOs, corporate treasurers and entrepreneurs we talk to consistently mention a desire to see a declining trajectory of federal debt when discussing long-term capital spending and hiring plans.

U.S. long-term debt scenarios
Net debt to GDP, percent



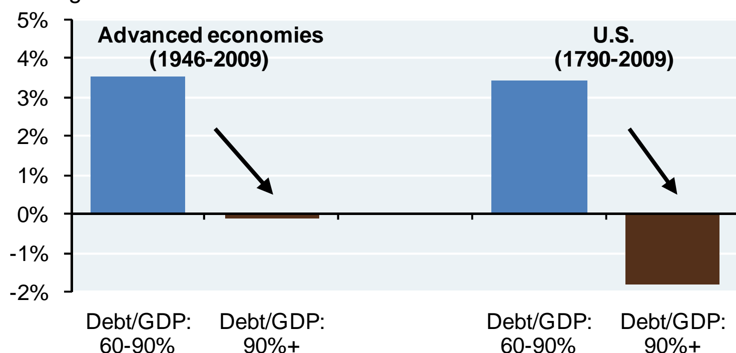
Source: Congressional Budget Office, J.P. Morgan Private Bank.

[2] Financial markets are focused on this issue since large deficits and debt levels can affect growth. There are plenty of debates in the economics community these days (e.g., why haven't monetary or fiscal stimulus multipliers behaved the way their supporters believed they would). One possible explanation is that fiscal stimulus loses its effectiveness when debt ratios rise too high. In the chart below, we summarize Ken Rogoff's findings that when debt ratios in the US and in other advanced economies have exceeded 90%, economic growth suffered notably. With the US federal debt ceiling now over 100% of GDP (on a gross debt basis) and projections of net debt rising above 80%, financial markets have reason to be concerned.

Supporting Rogoff's findings is a paper prepared by BIS economists for the Fed's 2011 Jackson Hole symposium[1]. In a study of sovereign, corporate and household debt over the last 3 decades, the authors find that at ~85% of GDP, government debt exerts a significant negative drag on growth. Their conclusion:

> "*the immediate implication is that countries with high debt must act quickly and decisively to address their fiscal problems. The longer-term lesson is that, to build the fiscal buffer required to address extraordinary events, governments should keep debt well below the estimated thresholds.*"

What fiscal austerity supporters worry about: 90% cliff
GDP growth



Source: "Growth in a Time of Debt", Carmen Reinhart and Kenneth Rogoff, January 7, 2010, National Bureau of Economic Research.

[1] *"The Real Effects of Debt", Cecchetti, Mohanty and Zampolli, BIS, presented at the Fed's August 2011 Jackson Hole symposium.*

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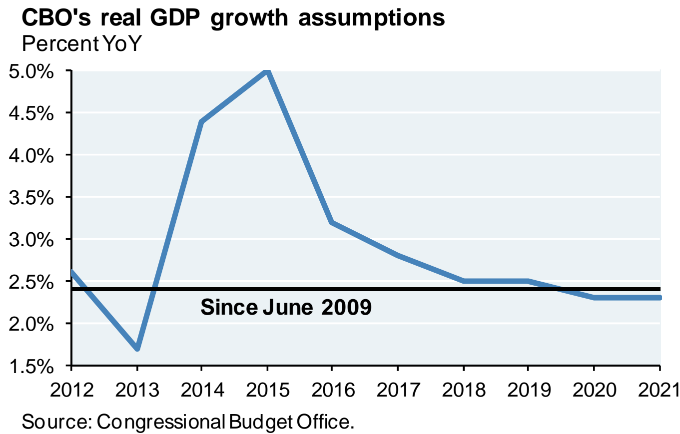
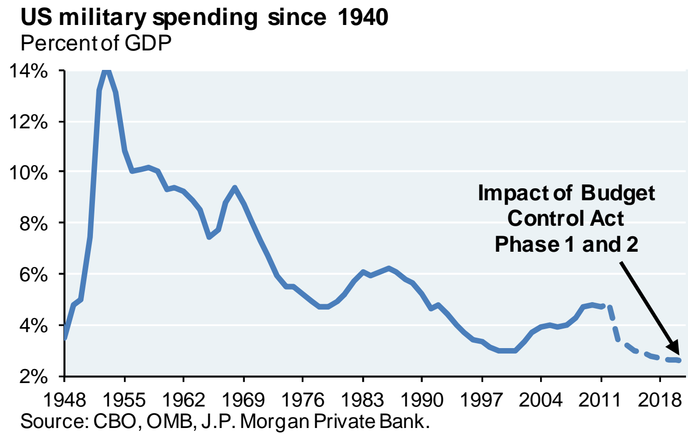
[3] If US growth does not pick up, debt ratios would rise further. The estimate of 83% net federal debt to GDP by 2021 includes CBO assumptions for growth shown in the chart below. CBO estimates include a spike to 5% in 2015, for reasons we have not seen explained. If US growth averaged 2.5% instead (resulting in lower GDP, lower government revenues and higher unemployment insurance), debt ratios could approach 90% by 2021. While we are hopeful that the US economy recovers more quickly, if the JSCDR doesn't reach $1.5 trillion in deficit reduction with the promise of more to come, there would be no room for error, and a chance of another round of downgrades. Despite S&P's computational error discovered during its downgrade and its poor track record rating housing-related securities, rating agency bashing by politicians is not a convincing rationale for investors to ignore the consequences of the rising federal debt. After adjusting for its error, S&P's downgrade logic still holds.



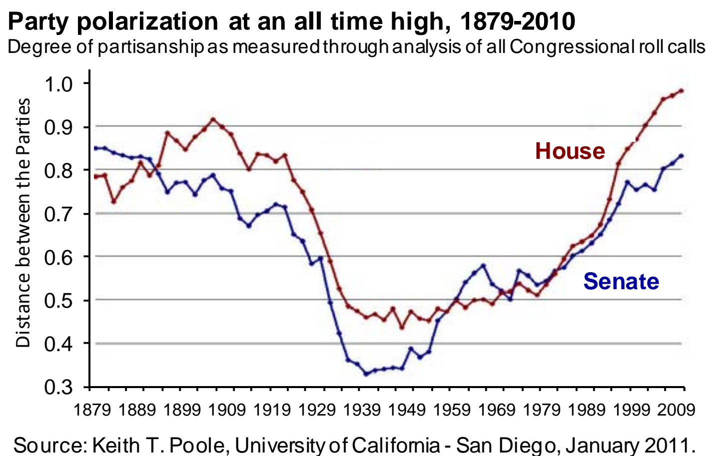
Source: Congressional Budget Office.



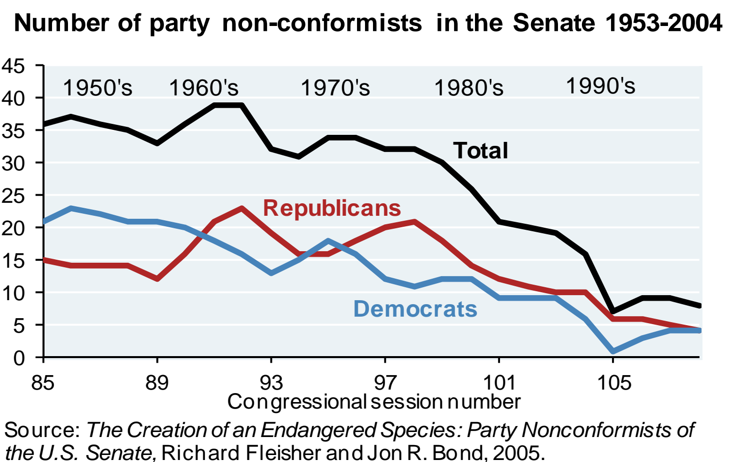
Source: CBO, OMB, J.P. Morgan Private Bank.

[4] Projections of military spending declines are unlikely to be seen as "real" deficit reduction. One item in the President's recent budget proposal was an assumed $1.1 trillion in savings from troop withdrawals out of Iraq and Afghanistan (so-called "OCO" spending). While this foregone spending *might* happen, it is not a legislated change, and is determined as much by geopolitics and uncontrollable circumstance as by the Congress. In addition, as shown in the chart above, the Budget Control Act *already* projects that non-OCO military spending as a % of GDP will fall to its lowest level since 1940, barely above the levels now spent by Japan and Germany after decades of demilitarization. As a result, financial markets are unlikely to ascribe a high likelihood to additional deficit reduction achieved primarily through lower *estimates* of future military spending.

[5] **It is not just S&P that is unnerved by the polarization of political parties**. Markets are aware of the polarization in the Congress, a trend that can be understood by empirical analysis of Congressional voting patterns. As shown below, the polarization in the House and the Senate is as high as it has even been, even higher than after Reconstruction, one of the most acrimonious periods in the country's history. A closer look at the Senate in particular (below, right) shows that the number of party non-conformists has plummeted. Without a political middle, there is a greater risk that the ideological divide between the parties cannot be bridged, leading to intermittent government shutdowns (or the threat of them[2]) and frequent market disruptions. While the difference between sequestered cuts and consensus cuts is only $300 billion over ten years, the ability of the JSCDR to achieve consensus will be painstakingly followed by market participants for these reasons.



Source: Keith T. Poole, University of California - San Diego, January 2011.



Source: *The Creation of an Endangered Species: Party Nonconformists of the U.S. Senate,* Richard Fleisher and Jon R. Bond, 2005.

[2] Financial markets are aware that the latest compromise avoiding a government shutdown was mostly a reflection of FEMA discovering that it had underestimated the amount of funds that it had on hand. So there wasn't a compromise at all, since Congress didn't need to make one.

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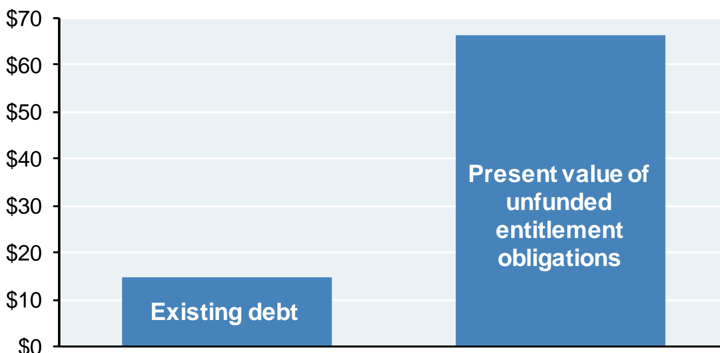
[6] Entitlements: where we are now. Market participants are increasingly focused on rising entitlements relative to other discretionary spending. First, some history. When Medicare was introduced in 1960's, it was described as "brazen socialism" in the Senate. When Truman proposed a national healthcare program in the 1940's, the plan was called a Communist plot by a House subcommittee. And when President Roosevelt introduced Social Security in the 1930's, he was branded as a Communist sympathizer by Republican Senators from Ohio, Pennsylvania and Minnesota, publisher William Randolph Hearst and Alf Landon (Roosevelt's GOP opponent in the 1936 Presidential election). So in 1969, when one quarter of Americans over the age of 65 lived in poverty, politicians showed courage in creating a larger social safety net. **However, it may take even greater courage to examine and adjust what they created.** In the late 1960's, the government estimated that Medicare expenses would grow by 7 times by 1990 (unadjusted for inflation); they grew by *61 times* instead. As shown in the table below, in section (a) healthcare spending has overtaken education spending; section (b) entitlements have grown sharply compared to growth in population, household income and overall government spending; section (c) price-sensitive medical spending (paid out-of-pocket) has collapsed; and section (d) more "productive" forms of government spending have fallen to an all-time low. David Walker, the former Comptroller of the US, refers to this as the "crowding out" of productive discretionary programs.

	Indicative entitlement trends: 1960-2010	1960	1970	1980	1990	2000	2009/10
(a)	Healthcare spending (% of GDP)	1%	3%	4%	5%	6%	8%
	Education spending (% of GDP)	4%	6%	5%	5%	6%	6%
(b)	Entitlement program enrollment (% of population)	N/A	18%	22%	25%	27%	29%
	Entitlement income (% of avg. pre-tax income)	N/A	8%	11%	11%	12%	15%
	Social Security spending (% of total federal spending)	N/A	15%	20%	20%	23%	20%
	Medicare spending (% of total federal spending)	N/A	3%	5%	8%	11%	13%
	Medicaid spending (% of total federal spending)	N/A	1%	2%	3%	7%	8%
(c)	Price sensitive out-of-pocket spending (% of healthcare spending)	48%	33%	23%	19%	14%	12%
	Medicare/Medicaid (% of healthcare spending)	N/A	18%	25%	26%	32%	35%
(d)	"Productive" federal spending (% of total federal spending)	N/A	68%	54%	46%	36%	32%
	Includes spending on defense, education, infrastructure and technology						

Source: Kleiner Perkins Caufield & Byers. 2009/10 reflects latest data point available.

[7] **Entitlements: where we go from here**. Financial markets generally look at financial statements which are governed by GAAP accounting, which requires accrual of future commitments. Countries and states are not bound by accrual accounting, leaving markets to wonder (and sometimes panic) when they find out what hasn't been accrued. The existing federal debt, which is already at elevated levels, does not include the present value of unfunded future entitlement payments. The authors of USA Inc have estimated this number at $66 trillion, which is 5 times the existing stock of federal debt (similar to other analyses from the National Center for Policy Analysis and the Federal Reserve Bank of Dallas). How much would tax rates have to rise to support entitlements growing at 5%-7% per year, with trend nominal GDP growth expectations of 4%-5%? First, the 2001 tax cuts would have to expire on all brackets, and then tax rates would have to be raised by the same amount on everyone. At that point, federal debt to GDP ratios would still be well above 2007 levels, but at least it would create some borrowing capacity to fund entitlement payments. The question is what such a policy would do to growth and employment.

The existing Federal debt is the lesser of 2 problems
Trillions, USD



Source: OMB, US Treasury, Center for Medicare & Medicaid Services, Kleiner Perkins Caufield & Byers.

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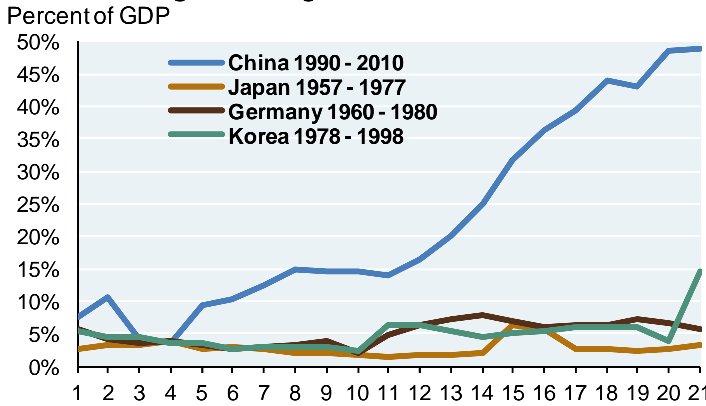
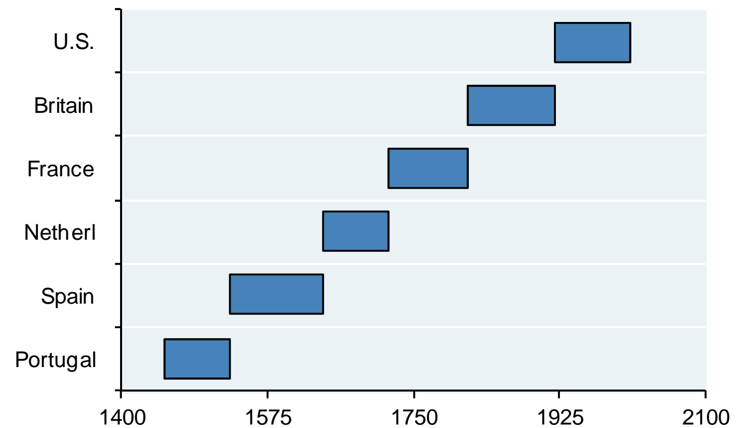
[8] **How long will China keep buying?** US Treasury markets have benefitted substantially from the appetite of Chinese and other central banks to accumulate Treasury bonds. As shown below, China's purchases of $1.5 trillion in Treasuries and Agencies is unprecedented, even when compared to other industrializing countries with managed exchange rates. While China has prospered by doing this (keeping its exchange rate cheap and exporting more), it is a policy that carries substantial risk, primarily in the form of higher Chinese inflation. As a result, it would be a mistake to expect this pace of reserve accumulation to last forever. Eventually, the US Treasury will once again have to rely on private markets to finance its deficits and stock of debt. Proactive work by the JSCDR will be needed to ensure that this transition is a viable one. Japan is illusory as an example of high federal debt and low interest rates: 93% of all Japanese government bonds are held by Japanese investors.



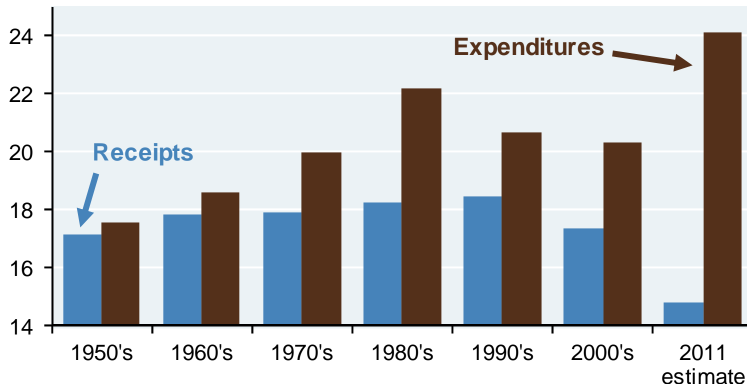
Source: IMF, BEA, The Cabinet Office, China National Bureau of Statistics, BBK, The Bank of Korea, J.P. Morgan Private Bank.



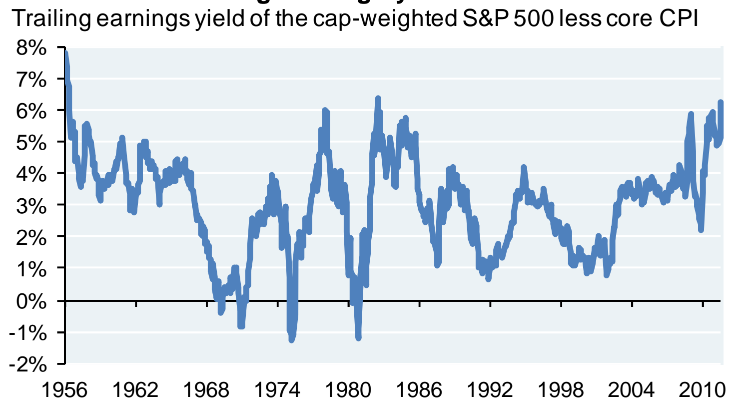
Source: Hong Kong Monetary Authority.

[9] **Risks to the status of the dollar as the world's reserve currency**. The primary reason that China accumulates Treasury bonds is that its central bank is looking for large, liquid, secure places to put trillions of their own currency. The most sensible place to find such an investment: the world's reserve currency. The percentage of global reserves held in dollars has not changed much recently (around 65%), nor has the percentage of global FX transactions denominated in dollars (85%). However, financial markets are well aware of the catalysts that led to the end of reserve currency status over the last few centuries. In general, they are: an over-extended fiscal budget, too much money-printing, declines in productivity, military over-extension and the inability to adjust to changing times, circumstances and adversaries. Financial markets understandably look at the actions of the Congress and the President on issues like these. The JSCDR's actions will be an important marker on the timeline of the United States and its ability to sustain its economic primacy of the last 100 years. For the record, as shown in the chart above, that's about as long as most reserve currencies last.

[10] **What economic model does the United States want to use?** One of the most frequently asked questions is this: why are price-earnings ratios so low? P/E multiples, adjusted for inflation, are at their lowest levels in decades. This reflects in part the concern that the United States hasn't figured out which model it wants to use; it mixes a European style welfare state with a libertarian tax regime. The JSCDR is being asked to figure out how to reconcile these two things, and until they do, financial markets are likely to remain in very uncertain territory, negatively impacting both consumer and business confidence.



Source: Office of Management and Budget, Congressional Budget Office.



Source: Robert Shiller, S&P, corporate reports, Empirical Research Partners.

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My son recently asked me what I thought was the most important document in US history. There are a lot to choose from, but of all the possibilities, I picked George Washington's Farewell Address, written in 1796. The relevance of Washington's warnings regarding the importance of unity, the threat of political factions, the importance of the separation of powers, the dangers of permanent foreign alliances and the need for public morality and education have not diminished with time. One entire section in Washington's Farewell Address is devoted to the use of public credit, and Washington is quite clear about what he thinks about passing the buck to future generations:

"***As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible…avoid accumulation of debt, not only by shunning occasions of expense, but by vigorous exertions in time of peace to discharge the debts which unavoidable wars have occasioned, not ungenerously throwing upon posterity the burden which we ourselves ought to bear***."

Michael Cembalest
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J.P. Morgan Asset Management

Additional sources to consult on the long-term deficit outlook

- A January 2011 paper from the *Committee for a Responsible Federal Budget*, a group made up of former directors of the CBO, the OMB, the House and Senate Budget Committees and the Federal Reserve Board of Governors
- "*The Financial Condition and Fiscal Outlook of the U.S. Government*", a slide deck from David Walker, President of the Peter G Peterson Foundation and Former Comptroller General of the United States
- An IMF paper from April 2011, "*An Analysis of U.S. Fiscal and Generational Imbalances: Who Will Pay and How?*"
- An April 2011 piece from PIMCO's Bill Gross piece entitled "*Skunked*"
- A speech by Dallas Fed President Richard Fisher in May 2008 entitled "*Storms on the Horizon*"
- Perhaps the most thorough piece of all, a 460-slide behemoth entitled "*USA Inc*", distributed by venture capital firm Kleiner Perkins Caufield & Byers with an introduction from George Shultz, Paul Volcker, Michael Bloomberg, Richard Ravitch and John Doerr
- "*Republicans Repeat Medicare Mistake of 1965*", an editorial from Democratic Senator Bob Kerrey to the New York Times in 1995 on the government's decision to not impose cost controls on Medicare, a policy error Kerrey dates back to 1965, when the American Medical Association insisted on "usual and customary fees" in exchange for their support
- "*Measuring the Unfunded Obligations of European Countries*", Jagadeesh Gokhale, European Commission, European Economy Economic Papers, No. 297, December 2007; National Center For Policy Analysis, Policy Report No. 319, January 2009.

JSCDR	Joint Select Committee on Deficit Reduction
OCO	Overseas Contingency Operations
CBO	Congressional Budget Office
BCA	Budget Control Act
AMT	Alternative Minimum Tax
FEMA	Federal Emergency Management Agency
BIS	Bank for International Settlements

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