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Beyond the Supercommittee

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by the Schwab Center for Financial Research

After months of negotiations, the Joint Select Committee on Deficit Reduction (the "supercommittee") announced that it could not reach agreement, stating: "we have come to the conclusion today that it will not be possible to make any bipartisan agreement available to the public before the committee's deadline."

The supercommittee had a deadline of November 23 to make recommendations to trim at least $1.2 trillion from the budget deficit, but the law required that the supercommittee post publicly any recommendations at least 48 hours before the deadline, or on Monday, November 21. What's beyond the supercommittee? Schwab answers the key questions.

Why did the supercommittee fail?

The 12 members of the supercommittee struggled to bridge a huge philosophical gap between the two parties in an effort to come up with a plan. The main issue has been the desire of the panel's six Republicans on the committee not to increase taxes, while the panel's six Democrats have opposed significant entitlement cuts without tax increases. This is the same fundamental disagreement that led to the near-shutdown of the government in March, and to the debt ceiling crisis in August. The two sides were never able to come to any agreement.

In the event of a supercommittee failure, automatic spending cuts are supposed to take effect starting in 2013. How large are those cuts and which programs are affected?

Under the law, automatic, across-the-board spending cuts totaling $1.2 trillion will take effect on January 2, 2013, and will be spread out evenly over the next nine years. About $200 billion of that figure comes from savings on interest on the debt, so the total amount of cuts over the nine-year period is about $1 trillion. Half of that amount will come from defense spending and half from non-defense spending. In the latter category, a number of programs are exempt from the cuts, including Social Security, Medicaid, veterans' benefits, children's health programs, and the Earned Income Tax Credit.

Will these spending cuts actually happen, or is there a mechanism for either Congress or the President to intervene?

Because the cuts do not take effect until January 2013, there is more than a year for Congress to undo the cuts. Legislation to exempt more programs could be introduced, approved by both chambers of Congress and signed by the President. A number of members of Congress from both

sides of the aisle have said that they will make attempts in the coming year to reduce or eliminate many of the planned cuts. The President has indicated that he would veto such efforts, but no specific proposals have been put forward yet.

A significant number of tax cuts are due to expire in 2011. What are they, and will they be extended?

Over the next several weeks, Congress will have to scramble to extend tax cuts that are set to expire at the end of this year. Lawmakers were waiting to see what the supercommittee did with some of these tax items, and now that nothing has happened, they must be addressed.
Topping the list is the 2011 payroll tax cut. In 2011, the amount of payroll taxes an employee saw taken out of each paycheck was reduced from 6.2% to 4.2%, but that amount is set to revert to 6.2% on January 1, 2012. President Obama has proposed reducing the payroll tax further, to 3.1% for both employees and employers. That proposal has not yet been considered by Congress, and its price tag—about $245 billion—may make it impossible to get through a divided Congress. Just extending the current law for a year would cost about $100 billion. Congress is expected to consider some kind of payroll tax cut extension in December.

Are there other important provisions of the tax code that must be addressed before the end of 2011?

Yes, there are a host of other tax provisions expiring at the end of this year.
Businesses are particularly concerned about the expiration of the research and development tax credit, and several other expiring business tax provisions.
On the individual side, among the items set to expire are the deduction for state and local sales tax, the deduction for college tuition and the IRA charitable rollover. Also expiring at the end of this year is the Alternative Minimum Tax (AMT) "patch." For more than a decade, Congress has passed a series of patches that increase the amount of income exempt from the AMT. Without this fix, the exempted amount would tumble, potentially exposing an estimated 20-30 million Americans to higher taxes. However, the provision is in place for the 2011 tax year (for which taxpayers will be submitting returns in April 2012), so this does not need to be addressed until sometime before the end of next year.

The Bush-era tax cuts are due to expire at the end of 2012. When will their fate be addressed?

This is the biggest issue. These tax cuts include the reduced income tax rates, the 15% tax rate for capital gains and dividends, the estate tax, and other provisions.
Congress will need to deal with those before the end of 2012. There is a good chance that Congress will wait until after the 2012 elections to address the issue, in what is known as a "lame duck" session of Congress in November/December 2012. That's what happened in 2010, when Congress waited until December 17th before passing a two-year extension of the tax cuts.

The 2012 election is less than a year away. Did either party's chance for gaining ground benefit from the supercommittee failure?

It's hard to say, but our first reaction is that neither party will benefit from this failure. Public reaction is very negative, and there appears to be plenty of blame for both sides.

What are implications of the supercommittee's failure for the stock market overall?

The market action on Monday was grim, but we believe it may have had as much to do with the ongoing eurozone crisis as it did with the failure of the supercommittee to come to an agreement. It does add to the confidence crisis that's been pervasive, however, and the market will remain attuned to the payroll tax cut, which is due to expire at year-end. Failure to extend that cut could cut shave as much as 1% from gross domestic product in the first half of 2012.

In the meantime, the market continues to resemble a see-saw, moving from risk-on to risk-off mode, depending on news flow. After a nearly 10% rally in the first four months of the year, the market suffered a near-20% correction over the next five months, before rallying a big 17% in October. Since then, the market has been consolidating some of those gains.

We continue to believe the market is in a trading range, but with an upward bias—because although the picture is mixed, there are plenty of positives going for both the economy and the market.

What's the bullish case for US stocks?

We believe there are many positives for US stocks right now, including better economic news from the United States and recent moves on the part of global central banks.

Better US economic news:

Recent weekly unemployment insurance claims below 400,000[1]; layoff announcements down; and job postings up (strong Job Openings and Labor Turnover Survey report).

Bank lending up, both among consumers and businesses.

Business and consumer optimism ticking back up after the summer swoon.

Inventories have been cut to the bone, taking growth from the third quarter, but are set to be additive in the fourth quarter, as they are now too low relative to sales growth.

Leading Economic Indicators (LEI) up sharply in latest report, with positive contributions from nine of the 10 sub-components[2].

Core inflation moving lower, which should boost "real" gross domestic product (GDP); gasoline prices near their lowest levels of the year.

Much better housing news: building permits, new home sales and recent National Association of Home Builders housing index all exceeded expectations.

Global central bank and eurozone political leadership capitulations. Although decisive plans to stem the crisis are lacking, the European Central Bank (ECB) and other global central banks have moved into loosening mode, which should help boost growth.
Eurozone recession likely underway, but trade with Europe only accounts for 1.3% of US GDP.
Strong third-quarter corporate earnings: 18% year-over-year growth in the S&P 500, with companies beating expectations by an average of 6%[3].
Cheap stock valuations: The S&P 500 has a forward price-earnings ratio of 12 vs. a median of 16.8 since 1990 (the period through which we have data)[4].
Paltry bond yields: If they begin to rise (while bond prices fall), money could re-allocate from bonds to stocks.
Over the past five years, outflows from equity mutual funds of over $400 billion and inflows to bond mutual funds of over $800 billion: $1.2 trillion spread is by far an all-time record flow in favor of bonds.
Still-pessimistic investor sentiment, suggesting the "wall of worry" markets like to climb is intact.
Market has consistently bounced back quickly after sell-offs, suggesting market players are underinvested and worried about missing out.

What's the bearish case for US stocks?

We believe the bearish case rests on a number of factors.

Spikes in yields have moved from the eurozone's periphery to core countries like Italy and Spain.
Germany and the ECB are (so far) rejecting calls to bail out struggling countries by buying bonds and acting as lender of last resort.
Eurozone is likely already in a recession.
Consumer confidence taking another hit from the supercommittee's failure.
Oil prices are climbing on Middle East tensions flaring again.
Ongoing debt deleveraging by private sector with public sector just starting.
Rampant market volatility is keeping individual investors on the sidelines.
"Stall speed" of economy means recession risk is not eliminated: downward revision to third quarter GDP adds fuel to that view.
The Federal Reserve is pushing on a string; if another round of quantitative easing is coming, it brings unintended consequences, including commodity inflation.
Concerns about a hard landing in China, the world's second largest economy.

Are we more persuaded by the bulls or the bears?

The bulls. Admittedly, the bearish case is the more intellectually powerful and will continue to put pressure on the US economy and markets. But we believe much of it is already built into expectations (and prices). When the expectations bar gets set as low as it has been, the ability for results to hurdle that bar becomes easier. As the market's huge rally in October attests, you don't need a rash of exceptionally good news—just marginally better news than the consensus expects—to pull some of the massive sidelined money back into the market.

Are specific sectors or industries at greater risk in the event the automatic cuts happen?

By far the largest industry at risk is in the defense area, which could see up to $900 billion in cuts over the next decade, according to Strategas Group in their report dated November 21, 2011. Highly placed officials inside the military and members of both parties have criticized the cuts, but the President has said he would veto any attempts to "undo" the automatic cuts triggered by the failure of the supercommittee. Should the cuts go into effect, revenues, profits and ultimately the share prices of companies that are heavily dependent on US defense contracts would likely be impacted negatively.

While not as severe, health care companies that deal with the government, especially with Medicare, also stand to be hurt should nothing be done. In the same report, Strategas estimates $120 billion in cuts for those companies that provide Medicare services.

Obviously, there is a long way to go, but we advise investors to keep an eye on the negotiations and monitor their holdings in the above-mentioned industries, as the impact could be substantial if the cuts proceed as planned.

Is there a chance that Moody's will downgrade US debt as a result of the supercommittee's failure?

There's always a risk, but for now the rating agencies appear to be waiting for further developments. After the supercommittee announcement, all three of the major rating agencies—Standard & Poor's, Moody's Investors Service and Fitch Ratings—reaffirmed their current ratings. S&P, which downgraded longer-term US sovereign debt last August, affirmed its AA+ rating, indicating that the imposition of automatic spending cuts is enough to keep the rating unchanged for now. In our view, Moody's, which has the United States still rated Aaa but on negative outlook, could downgrade the US debt if the automatic spending cuts are canceled. Fitch indicated that it is reviewing its AAA rating with a stable outlook in light of the committee's failure to come up with an agreement. Regardless of the debt rating, Treasury yields continue to trade near 40-year lows and the United States continues to see inflows of foreign capital. Even with downgrades, the market action suggests that the US Treasury market remains the benchmark for global investors. We believe that the market will determine interest rates on US debt, not the rating agencies.

What would happen if there were another downgrade of US debt?

If Moody's does downgrade the United States, we doubt it would have a major impact on the market. Rates fell sharply after the S&P downgrade, showing that the focus is more on economic growth, inflation expectations and the safe-haven status of US Treasuries. Some institutional buyers may need to change investment guidelines to hold US Treasuries if two out of three agencies lower the rating, but it is likely these guidelines have already been changed as a result of the S&P move.

Are US Treasuries still a safe-haven investment?

We continue to view the US Treasury market as the benchmark safe-harbor rate even if there is another downgrade. Most tellingly, Treasury yields fell on Monday, which suggests a greater concern about Europe than the supercommittee's failings.

1. United States Department of Labor.
2. The Conference Board.
3. Thomson Reuters, as of November 14, 2011.
4. FactSet, Standard & Poor's, as of November 11, 2011.