NUVEEN ASSET MANAGEMENT

U.S. Fiscal Cliff: Taking the Easy Way Out

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In the wake of the 2012 election, President Barack Obama and Congressional Republicans are signaling their intentions to avoid the potentially painful combination of tax increases and spending cuts set to take effect January 1, 2013.

OUR CONSENSUS VIEW: NO AGREEMENT BY YEAR END

Nuveen Asset Management asked 23 of its portfolio managers, research analysts, strategists and other investment professionals, "Which of these four scenarios do you believe is the most likely outcome to the fiscal cliff negotiations?" Here's how they responded:

- **Grand Bargain: 0%.** A comprehensive package of revenue increases, spending cuts and tax/entitlement reform will be negotiated and passed before December 31.
- **Partial Solution: 26%.** A limited number of compromises will avoid the most painful components of sequestration and expiration of the tax cuts. But it will fall far short of a comprehensive solution.
- **Kick the Can Down the Road: 57%.** No agreement will be reached on taxes, spending and tax/entitlement reform, but the status quo will be extended for another year.
- **Over the Cliff: 17%.** Congress and the President will become entrenched and fail to extend the deadline for the automatic spending cuts and expiration of tax cuts. Those who chose this scenario see the economic impact as severe but short-lived, as politicians will then elect to kick the can down the road.

WHY DO WE BELIEVE THIS?

The majority of Nuveen Asset Management investment professionals do not expect Congress and the President to reach any solution to the fiscal cliff debate. This outcome will likely lead them to undertake the most politically expedient option: waiting until some future date to undertake the difficult task of deficit reduction. Many of our respondents also expect additional downgrades of U.S. government debt. Following are selected responses supporting each chosen response:

Partial Solution

"Some provisions have bipartisan support, notably the payroll tax cut and the AMT patch, which partially reduces fiscal drag. However, the can will be kicked down the road on Bush tax cuts, which appear to garner the most attention due to the polarized Congress."

"The Republicans may budge some on taxes, but not much. Getting the Democrats to agree to meaningful spending cuts will be difficult. It is highly probable that the result will not prevent Fitch and Moody's from their threatened downgrades. The Standard & Poor's downgrade was embarrassing, but had no real financial or political impact. I think most of Washington will say 'So what?' to the additional downgrades."

Kick the Can Down the Road

"The President is less likely to concede to spending cuts and entitlement reform following his re-election and a larger Senate majority coming in January. House Republicans see no mandate for the President, noting that they were also re-elected as validation of their priorities. Both sides recognize that the automatic cuts and tax cut expirations are too painful and opt for the most politically expedient option: putting off the hard choices. In this scenario, it's highly likely the U.S. government debt sees downgrades from Moody's and Fitch – matching Standard & Poor's earlier action."

"Kicking the can down the road allows both sides to blame each other for failing to come to a consensus. They can argue: 'We haven't improved anything, but it would be worse if the other side got their way.' It's weak and disappointing, to say the least."

"A downgrade of the U.S. debt is now inevitable. The House Speaker has re-affirmed the GOP's mandate for no new taxes, while President Obama and Senate Democrats will surely fight to maintain their entitlement programs and other expenses. Compromise may come from the fear of a self-inflicted recession and the deficit continuing to grow unchecked. However, the ability to go over the cliff and blame the other side might prove too politically tempting if a compromise can't be reached. I see Republicans as more willing to pull the country over the cliff because they will get large expenditure cuts along with tax increases that are likely in most scenarios anyway.

"There appears little choice left but to push the discussion into next year. It would take great effort in such a short time to reach any meaningful reform on taxes, spending and tax/entitlements. But the ramifications of not reaching an agreement would be so damaging. A slowly improving economy and recent evidence of public support for less partisanship may foster a more accommodative environment to realize concessions from both parties in 2013."

Over the Cliff

"There is no reason for President Obama to compromise. The Republicans are already known to turn down an agreement of 10-1 spending cuts to tax increases, and this group is more conservative. Obama campaigned on and clearly wants higher taxes. Once you go over the cliff, it is much easier to cut a deal. The Republicans don't want to go back on their pledge to maintain tax rates. So, we go over the cliff and then kick the can down the road."

"It's going to get ugly, and both sides will have to bleed a little to get a solution. It only takes a small number of Tea Party holdouts to force us over the cliff, even though more mainstream Republicans likely want compromise. I think some actually want the pain to force action. Republicans came to the brink before raising the debt ceiling and received nothing in return from the President or the Democrats. The President will not give an inch."

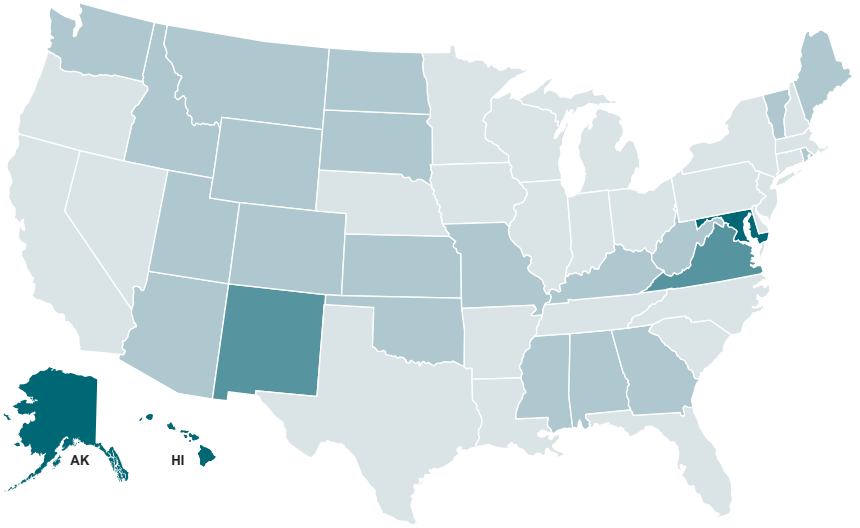
WHAT IF WE GO OVER THE CLIFF?

If the President and the Congress fail to reach an agreement or postpone the tough decisions for another day, automatic spending cuts and tax increases will take effect January 1, 2013, that are projected to reduce the U.S. deficit by $560 billion. The Congressional Budget Office claims the cumulative impact would reduce U.S. gross domestic product (GDP) by 4% in 2013, sending the country into another recession.

It is very difficult to ascertain which municipal issuers would be most impacted, as the cuts are spread across thousands of programs and differ in severity. As a limited proxy, Nuveen Asset Management studied labor data to determine the level of federal government employment on a state-by-state basis.

For most states, federal government employees represent less than 4% of non-farm employment. Both Maryland and Virginia, which border the District of Columbia, are home to a larger proportion of federal employees. While federal employment is not a perfect indicator of the potential state-by-state impact of going over the fiscal cliff, it measures the significance (or lack thereof) of the federal government within each state's respective labor force.

Federal Employment Measures the Significance of the Federal Government in a State



Percent of Nonfarm Employment Represented by Federal Government Employment

- 0 – 1.9%
- 2.0 – 3.9%
- 4.0% – 4.9%
- 5.0%+

Source: U.S. Bureau of Labor Statistics.

CONCLUSION

The consensus of Nuveen Asset Management investment professionals is that the President and Congress will remain entrenched and fail to achieve even a modest compromise in the face of the fiscal cliff. Given the potential negative economic impact, however, both sides are expected to push off the automatic spending cuts and tax increases to a later date. This action will leave the U.S. deficit unaddressed for the near term, clearing the way for further downgrades of the U.S. government debt.

RISKS AND OTHER IMPORTANT CONSIDERATIONS

This report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any investments or related securities. The analysis contained herein is based on the data available at the time of publication and the opinions of Nuveen Research. Information is current or relevant as of the date indicated and such information may become outdated or otherwise superseded at any time without notice. This analysis is based on numerous assumptions. Different assumptions could result in materially different outcomes.

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SOURCES

Survey of Nuveen Asset Management professionals

U.S. Bureau of Labor Statistics

"Economic Effects of Reducing Fiscal Restraint That is Scheduled to Occur in 2013," Congressional Budget Office, May 2012

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