Investment Perspective

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POLITICS OVER A CLIFF

October, 2012

Hope and fear — no change

Stock markets generally rallied in the third quarter, continuing their schizophrenic moves between fear and hope. The stage had been set for a rebound, thanks to the high level of pessimism this year. As the saying goes, the market often acts to confound the most people, and it has certainly been difficult to find many bulls. Further accommodation by both the European Central Bank and the Federal Reserve also heartened investors.

The recovery from the burst housing bubble and the ensuing recession continues to be subdued. Compared to past cycles, the jobs recovery represents the most glaring laggard. Despite extremely low borrowing rates from the Fed's easy money policies, businesses have remained very cautious with their spending and investments. So we have not yet seen the virtuous cycle fully unleashed, with business expansion leading to hiring, which in turn leads to more consumer spending, more orders for business and again more hiring.

Fed goes all in

Some of this caution no doubt follows from the mixed messages and chronic gridlock in Washington. The lack of a coherent and comprehensive fiscal response has not instilled confidence. In a recent speech, Dallas Fed president Richard Fisher took Congress to task for abrogating their fiscal policy role. As Fisher and others have pointed out, there are limits to what monetary policy (manipulating the money supply) alone can achieve, particularly when trying to fight such a deep contraction and sluggish recovery.

And the Fed's cumulative actions seem to be bumping up against those limits. But in mid-September, policymakers announced yet another version of "quantitative easing." Now the Federal Reserve will purchase $40 billion of mortgage bonds per month on top of the $45 billion of long-term Treasuries it is already buying. By doing so, they hope to further bring down mortgage rates and spur borrowing. Unlike previous asset purchase programs, this one has no expiration date. It will be open-ended, persisting until the Fed observes more traction by the economy. Bernanke and company have all their chips in the game now.

Notes from the cliff

As in Europe, it is reasonable to question whether we can afford expansive fiscal policies (spending for growth) to counter the slowdown when running trillion-dollar deficits. But we need to at least have that debate. And at a minimum, Congress should get out of the way and do no harm. The systemic bickering in Washington from the debate over TARP (2008) to that over the debt ceiling (2011) and now the *fiscal cliff* has not encouraged businesses to invest and expand their workforces. Regrettably, these are all issues that should not have been as partisan as they turned out to be.

Monetary policy would likely have been more effective if it had been backed by a rational fiscal policy. Instead of constantly bashing the Fed, pundits should hold our political leaders to task as well. What has Congress done to encourage job creators to use all that liquidity the Federal Reserve has unleashed?

At the moment, though, stock market players still seem to be looking past the looming fiscal cliff, that mix of automatic tax hikes and spending cuts that are scheduled to begin coming into force in January. If there is no intervention by lawmakers, about $380 billion of tax increases and $100 billion of spending cuts will be implemented in 2013. As a result, the vast majority of households face higher income taxes, while spending on defense and other non-discretionary areas will be cut across the board.

Long-term debt vs. short-term growth

According to the non-partisan Congressional Budget Office, the fiscal cliff will shrink the economy by about 3 percent in the first half of 2013 compared to what it would otherwise be under current policy. On the one hand, it is absolutely critical that the United States puts its national debt on a downward path. Our long-term economic survival depends on it. But it is irresponsible to blindly stomp on the brakes with the economy still in such a fragile state.

How did the nation get into this squeeze? It stems from politicians' impasse last year on whether to increase the Treasury's borrowing capacity, or "debt ceiling." In reasonable times this action has been a mere formality. In return for raising the ceiling to allow the Treasury to pay for spending that had been previously mandated by Congress, the parties agreed to establish a "super committee." That group of Democrats and Republicans, senators and congressmen, was charged with agreeing to at least $1.5 trillion in spending cuts over a 10-year period. Predictably, the committee proved not so super. Their failure has triggered the automatic cuts that are scheduled to begin in several months.

So Congress and the Administration face a daunting choice at year end: Either allow the country to go off a recessionary cliff or doom us to large deficits that will retard long-term economic growth and eventually lead to a fiscal crisis. As much as we dislike the timing of this looming restraint, the alternative of extending and pretending would be worse.

A comprehensive compromise

Fortunately, there is a third and more desirable option, although it would be the most difficult in the current political climate. Congress could delay (or offset) some of the abrupt changes that are set to occur, and at the same time come up with a more gradual and comprehensive plan to attack structural deficits. The current "plan" is not thoughtful and fails to address important deficit drivers. Instead, lawmakers need to develop a program that incorporates tax reform, entitlement reform, and particularly targets the unsustainable growth in health care spending. Easier said than done.

For this to happen, all sides need to compromise. The math is such that the deficit cannot be closed through spending cuts alone or, on the other hand, by merely taxing the "wealthy." But with a big election in November, nothing more than a temporary patch — if that — will be enacted this year. Moreover, the backdrop has been one of the American people wanting a free lunch. So far, politicians of both major parties are tripping over each other to serve the meal. They have not been honest with voters about the true choices and resulting tradeoffs we face.

A poll of registered voters conduced for Thompson Reuters in late August hints at the challenge. Simply put, there was no majority view for cutting any of the major areas of government spending. That was still the case when respondents were grouped by party affiliation: Voters of the same party could not even agree among themselves. Sadly, there was not even a majority in favor of cutting the catchall category of "other."

Double duplicity

To one degree or another, the Obama and Romney campaigns have also been less than forthcoming about their solutions for our fiscal challenges. And they play tricks with budget math. It is almost comical how both have recently aligned themselves with the Simpson-Bowles deficit reduction proposal — which, by the way, failed to garner the necessary support of its own members. From the Administration's side, there was little follow-through on the recommendations. And although President Obama often states that his plan has the "balanced approach" of Simpson-Bowles, it is quite different. As for Mitt Romney, running mate Paul Ryan actually served on the commission and voted against the proposal.

Perhaps Congress will work with the Administration so that it will just turn out to be a *curb* to step down rather than a *cliff* to plunge over. But it is difficult to also foresee a realistic deficit-reduction plan anytime soon. We actually think the stock market has become a bit complacent about the risks of a political showdown later this year. In this day and age, it is dangerous to have to rely on politicians to make pragmatic and rational decisions to achieve a desirable outcome.

Low rates enable bad behavior

Indeed, the fiscal cliff represents an apt metaphor for the political dysfunction in Washington and lawmakers' inability to address the nation's challenges. Admittedly, as another saying goes, the market often prefers political gridlock. But today the challenges are too significant, the cost of doing nothing too severe. The Fed, to be sure, has been an enabler of this bad behavior. Talk about unintended consequences. Treasury yields have been driven to such low levels that our debt service costs, even on $16 trillion, are quite manageable.

We all take for granted the United States' preeminence in the global financial arena. Our political representatives certainly do, judging by the cavalier attitude with which they have pursued fiscal confrontation. With the dollar as the world's reserve currency and the Treasury bond the safest investment, we are the center of the universe. People around the world have been persuaded to hold their official government reserves and much of their private wealth in dollars.

From lender to borrower

They were persuaded to do so in the 20th century as the U.S. grew to become the world's dominant economy and largest creditor. But part of the appeal has also been faith that the nation would continue to pursue responsible economic policies that in turn supported a strong dollar. Well, today America remains the dominant economy, although the gap is naturally narrowing. And, having chronically run current account deficits since the 1980s, we are now the world's largest debtor. In this context, politicians must agree to a long-term game plan to get our house in order.

For what will happen when the Fed pares back its purchases of Treasuries and other, especially foreign, buyers start to worry about being repaid their principal? Add a whiff of inflation expectations and yields could surge.

Ironically, if the gridlock continues, particularly with many lawmakers refusing to consider any tax increases as part of a strategy to lower deficits, Treasury yields are likely to initially *fall* as investors flee risky assets. In most other countries, when politicians act irresponsibly, their bond yields go up. Not so here in the United States, still the world's "safe" haven. But for how long?

A partisan atmosphere in DC may well remain a major source of uncertainty for the markets. Much will depend on the outcome of the elections and the message from voters. Either way, we will soon have a better sense for the political backdrop. Over the next several months, we should also have more clarity about the other major macro issues of the day; namely, the path of the euro crisis and the growth rate of China's economy.

Interest in the future

Meanwhile, across the globe, central banks are printing money. This trend will continue to be supportive of stocks in the near-term. But the other side of all this accommodation may ultimately be rising interest rates and inflation expectations. Clearly interest rates have room to move up from abnormally low levels without choking a recovery. But at some point, monetary stimulus must be restrained. It is time for our elected officials in Washington to find compromise on fiscal policy before the financial markets thrust it upon them.

— Christopher J. Singleton, CFA, Managing Director

October 18, 2012