Market Update

Deficit Panel Fails

Background

On Monday, the 12-member Joint Select Committee on Deficit Reduction announced that it failed to identify $1.5 trillion in U.S. deficit cuts. As a result, automatic across-the-board spending cuts totaling $1.2 trillion are scheduled to take effect in January 2013.

Our Perspective

The failure of the so-called Super Committee is disappointing but not surprising. Despite reports from Washington insiders of serious negotiations, we knew it would be difficult for the Democratic and Republican members to bridge the deep philosophical divide between them.

The political deadlock represents a missed opportunity for the U.S. to make much-needed changes to its spending and tax code. Moreover, it creates greater uncertainty and escalates the risk of further downgrades of U.S. government debt. Credit agencies Moody's and Fitch will likely feel increased pressure to follow Standard & Poor's lead, which triggered intense market volatility in August. Any attempts by Congress to change the rules to avert the automatic spending cuts will give the credit agencies an additional reason to take action.

At least for now, the U.S. will likely retain its "safe haven" status. In fact, U.S. Treasury bonds and the U.S. dollar were propelled higher by news of the deal's collapse. Ten-year Treasuries now yield just 1.96%. At some point, though, U.S. policymakers will run out of time. We continue to believe that U.S. fiscal problems are solvable. It's just about getting the math right. In our view, it will require the following two actions:

- reducing government spending over time — especially on entitlement programs (e.g., raising the eligibility age to reflect increased longevity and implementing means testing) as well as defense; and
- restructuring the tax code so that it has less "spending" on deductions, exemptions, and loopholes.

Last year, the Simpson-Bowles commission laid out effective programs that would go a long way toward fixing the country's debt problems. Unfortunately, it appears Congress has decided not to tackle the deficit until after next year's election. As a result, the presidential and Congressional races will likely be emotional and caustic, which could hamper investor sentiment until the outcomes become clearer. Moreover, as time goes by, the risks intensify that the markets will begin dictating changes rather than reacting to them — a painful situation on full display recently in Europe.

This week's developments are the latest disappointment from policymakers, which follow unsettling setbacks earlier this month in Europe, where the sovereign debt crisis remains unresolved. With significant risks on both sides of the Atlantic, we believe prudent policymaker actions will be required to overcome the hurdles that are clouding the economic and investment outlook.

We are maintaining a well-diversified approach positioned for periods of both strength and weakness. This includes significant defensive investments such as bonds, currencies, credit, and elevated cash levels. At the same time, we are focusing on good values in a wide range of growth-oriented investments, meriting our continuing exposure to equities, commodities, and hedge funds, which will likely benefit if worst-case economic scenarios miss the mark as we continue to expect. As we monitor developments around the world and market levels, we remain ready to change our positioning as appropriate.