

Q&A

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Election 2012 and the fiscal cliff

With analysts Jeff Brown and Michael Thawley

Political analysts Jeff Brown and Michael Thawley share their perspectives on the economic and financial implications of the U.S. election results, including their views on the looming fiscal cliff requiring automatic tax increases and spending cuts as well as the longer-term debt problems the country faces.

Do you expect the results of this election to increase the odds of a compromise on deficit reduction and other fiscal issues facing the country?

Jeff: Yes. President Obama would like to pivot more toward deficit reduction and related issues in the next few years. It appears that House Speaker Boehner would like to get a deal done, but will he be able to bring along the rest of the Republican caucus? In the Senate, I believe that there are enough Republicans that would peel away from their party in order to reach a compromise.

The White House is leaving this election thinking it has a mandate, and the House Republicans also believe they have one — that is what we are faced with. But I don't think that Obama wants his legacy to be massive budget deficits.

What might a compromise on the fiscal cliff look like in terms of the quick deals that can be made versus the longer-term agreements that will be needed?

Jeff: There is no time for Congress to negotiate a complex deal now, unless maybe the stock market forces their hand. I think they will at least minimize the impact of the fiscal cliff by late December. Members of Congress don't want to go home for the holidays saying that they just allowed the greatest tax increase in U.S. history.

There are several key components that are low-hanging fruit. At first Congress will attempt to patch the Alternative Minimum Tax, and the most likely result will be other taxes staying in place until a grand bargain is negotiated. The question is whether Obama will be flexible on \$250,000 in household income defining the wealthy. Most other Bush-era tax cuts can stay in place — Congress is not in a rush to raise the capital gains tax.

Then, they will delay or at least lower the size of the sequestration for some period of time while negotiating to more broadly tackle debt reduction in 2013. These efforts could keep us from fully going over the fiscal cliff, reducing the drag on the economy to 1% or less of GDP rather than the 4% that has been projected by several economists. The government has to contain entitlement spending, particularly health care costs over the long term. Everyone in Washington knows that this must be done.

Michael: The President and the Speaker have both focused on the importance of tackling the long-term problems of the budget deficit and tax reform, which is welcome news. The President, in his speech on election night, said that he would focus on reducing the nation's deficit and reforming its tax code. Boehner has also expressed a willingness to discuss a solution that would involve raising revenue through broad reform, including removing tax concessions, loopholes and rebates. I think that there will be some understanding reached to avert falling off the fiscal cliff because of the damage it would do to the economy.

Both parties have also said that they would like to adjust the impact of the sequestration on the defense budget, which will be part of the negotiations in Congress during the lame duck session. The Budget Control Act calls for automatic spending cuts of \$1.2 trillion over 10 years, with defense spending cut by 10%. This could have a damaging impact on defense contractors because the Pentagon might have limited flexibility in deciding how and where these cuts are made. I expect a deal will be reached to prevent this from happening as both parties are interested in finding a way around it.

How worried are you about a second showdown over raising the debt ceiling and the potential for another downgrade to the U.S. sovereign credit rating?

Jeff: I don't think lawmakers realize that the uncertainty they cause is the problem. When I talk to people on Capitol Hill, they don't get that. A grand bargain including major tax and entitlement reform is at best a 50-50 probability. Obama and Boehner came close to an agreement in 2011 but were unable to reach a deal. When the debt ceiling becomes an issue early next year, that may force another crisis and Moody's could downgrade the U.S., as Standard & Poor's did last year.

Michael: It's obvious that there are immense difficulties in reaching an agreement and that the issue of raising the debt ceiling will re-emerge in the next few months. The Republicans have said they will not approve raising the debt limit without a reduction in expenditures and see it as leverage in negotiations over a budget and tax reform package. The Democrats will want

a commitment to raise the debt ceiling from the Republicans as a part of any deal. If they can reach an early compromise, that would likely prevent another standoff over the issue.

With the President winning re-election and the Supreme Court already having ruled in favor of the Affordable Care Act, what changes can we expect on that front?

Jeff: The biggest winners in the election were hospitals. Health insurers have been hurt and that will likely continue, for obvious reasons. But at the same time, more people will be covered. While profit margins will be slimmer for health insurers, they will have more customers. Beyond that, it appears that the Affordable Care Act will be implemented in due time, including higher taxes on investment income and earned income.

Do you expect monetary policy to remain the same, with the Federal Reserve continuing on its path of quantitative easing, and if so what are the implications?

Jeff: Fed Chairman Ben Bernanke has signaled that he will retire when his term expires in January 2014. However, the leading contenders for his job are both insiders, Janet Yellen and Roger Ferguson, respectively the current and former vice chair of the Fed's board of governors. They have already been through the confirmation process, so it would be harder for the Senate to derail their nominations. Bringing in an outsider would be more difficult. Yellen and Ferguson share the President's focus on employment and growing the economy; they are also both dovish in terms of inflation, so quantitative easing will likely continue if either of them replaces Bernanke.

The Fed has purchased 80% of Treasury bond issuance this year. If that trend continues, the central bank is essentially financing the federal deficit and the executive branch. There is no way out of that situation in the short term, so expect open-ended quantitative easing to continue, even with a new chairman in 2014. The Fed will continue to keep interest rates artificially low, which is bad for savers but good for the stock market.

In light of the regulations put in place by the government after the financial crisis, will there now be even more bank oversight? What about other industries, such as energy?

Michael: I expect to see the Obama administration continue to tighten constraints on systemically important financial institutions, including through the implementation of capital requirements under Basel III regulations, to prevent them from failing and triggering another financial crisis. The administration could also turn to the issue of further regulation of money market funds.

On the environmental side, I think that it will be difficult to get bipartisan support for major carbon emissions legislation. More likely, we'll see the Obama administration turning to regulation to achieve its aims in that area.

Jeff: The recent gridlock in Congress tells us that we will see more regulation than legislation. The administration will likely continue to implement its agenda, moving ahead with health care and the Dodd-Frank Act as well as its efforts on clean energy. The President has said he wants energy independence by 2020, and he will try to achieve that through supporting the natural gas industry and green technologies.

There was a major sell-off in the stock market the day after the election. Does this worry you, and what do you expect the long-term implications will be for investors?

Jeff: Presidential elections have little long-term effect on the stock market. President Obama's most lasting legacies will likely be his Supreme Court and Federal Reserve appointees, not the taxation of dividends and capital gains. Ultimately, from an economic standpoint, the private sector is the one that makes the difference. If politicians really knew how to fix the country's economic problems, they would have done it. But history has shown that if the government does not do anything foolhardy — like crashing the economy or not raising debt ceiling — stocks are going to do fine in the long run.

In fixed-income markets, we're locked into low bond rates for a while, and with excess capacity in the economy, inflation is not a big risk. The Fed has said that it expects to keep short-term rates low for some time, so long-maturity rates will probably also stay low. We have used the government's balance sheet to leverage our way out of the financial crisis; now it has to be deleveraged. Consumers and companies have been doing it, but the government has to follow.

Do you expect market volatility to continue given all the uncertainty around the world?

Michael: We will probably continue to see some volatility due to the euro zone's problems, which are likely to last for some time. In China, as the leadership transition evolves, we'll see more signs of the economic policy changes they are preparing to make to ensure sustainably high rates of growth — even if those rates

are not as high as in the past decade. For all its uncertainty, the U.S. market will still be regarded as a safe haven, provided that the administration and Congress seem to be working on long-term budget sustainability. Neither party will want to snuff out what looks to be a slow but steady recovery in the U.S. economy. Either way, one has to remember that the stock market does not always follow the economy and often continues to rise even during periods of modest economic growth. ■

The fiscal cliff: living on the edge

"Fiscal cliff" is a term coined by Federal Reserve Chairman Ben Bernanke to describe a combination of tax increases and spending cuts that automatically take effect at the beginning of 2013. The Congressional Budget Office estimates that the effect of higher taxes and lower government expenditures will send the U.S. economy into recession.

Fiscal cliff implications for 2013

Expiration of Bush-era tax cuts	\$224 billion
Expiration of payroll tax holiday	115 billion
End of "extenders" tax breaks for individuals/businesses	75 billion
Expansion of Alternative Minimum Tax to more households	40 billion
Higher estate taxes	31 billion
End of 2009 stimulus measure tax breaks	27 billion
New health care reform taxes	24 billion
Budget Control Act sequestration*	109 billion
Total	\$645 billion

*Fiscal year 2013.

Sources: Tax Policy Center, Office of Management and Budget.

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