Market Update

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U.S. UPDATE: "Super committee" Super fail - Implications

KEY POINT: The US "super committee" unsurprisingly failed to deliver the $1.2 trillion in deficit reduction it was tasked to achieve by the November 23rd Thanksgiving deadline. This failure means automatic spending triggers will go into effect starting January 2013, which we outline below. Automatic cuts across the board of the federal budget are not ideal, above all because they do nothing to improve the long-term drains on the US deficit, which are the country's major entitlements programs. This failure weighed on markets as it showed the irreconcilable stalemate that exists between the two parties such that even a comparatively smaller figure of $1.2 trillion in cuts cannot be agreed upon, a figure far less than the $5 trillion in fiscal adjustment that is really needed over the next decade and far less than the politically-difficult but necessary reforms needed in Medicare, Medicaid, and Social Security. On the positive side, automatic cuts at least *reduce the increase* in spending (rather than actually *cut* spending as is often mentioned), something evidenced as nearly impossible for politicians to agree on. In this piece we analyze the repercussions of this super committee's failure, including the threat of further downgrades over the next year, market implications, fiscal and debt trajectories, and in the more short-term what this will imply for the US economy.

It has been our view for some time that nothing in terms of real long-term deficit reduction and reform should be expected to come before the November 2012 presidential elections as neither the political incentive, nor will, nor consensus exist to engage in such unpopular cuts and reforms. Both Moody's and S&P affirmed their current ratings and outlooks while Fitch, the only agency with stable outlook, stated the failure "would likely result in a negative rating action" that would be decided by the end of this month. **We expect rating pressure next year to be a virtual certainty given the low likelihood of real reform. This scenario, while bearish equities, is bullish UST's and the USD. As demonstrated by the targets of the automatically triggered cuts (details below), politicians' unwillingness to slow entitlement spending will require shrinking everything else the government spends money on, a phenomenon we see evolving right now.** See the table below to view what the not-so-austere next 10 years will look like with the automatic $1.2 trillion in reduced spending compared to current planned spending increases over that timeframe.

US--Sequester Reality. Source: CBO

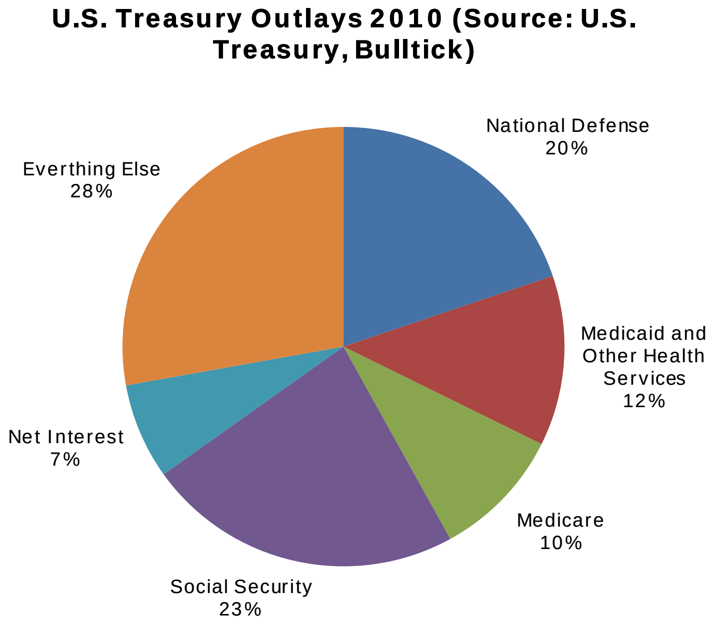
Annual budget authority baseline for federal discretionary spending

US $ Billions

	Current law	With sequester
2013	1047	953
2014	1066	973
2015	1086	994
2016	1107	1016
2017	1131	1040
2018	1156	1064
2019	1182	1093
2020	1208	1120
2021	1234	1146

Roughly half of the required $1.2 trillion in cuts over the next 10 years beginning in 2013 are now set to come from defense. That would be an approximate $600 billion, meaning some 10% in overall national defense cuts. Defense accounts for less than 20% of the 2012 budget but takes a disproportionate half of the sequester cuts. Meanwhile, the rest will come from domestic programs: roads, education, energy and housing (7.5% in cuts as per the CBO with Medicare spending, *mostly payments to providers*, cut by 2%). For investors to have some frame of reference, since 2008, defense spending has grown by 10%, versus

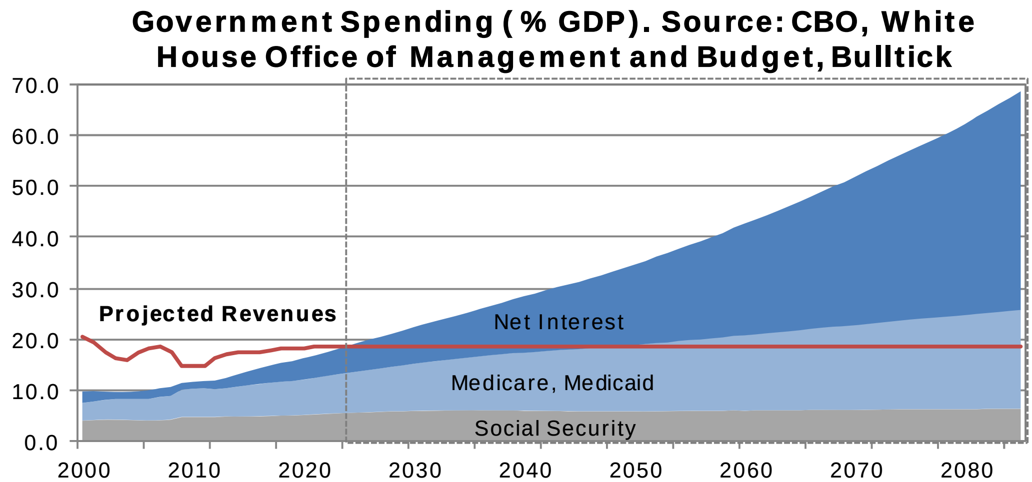
24% for nondefense discretionary, 37% for Medicaid, 70% for education and more than 100% for food stamps. Defense Secretary Leon Panetta called this nearly $1 trillion in cuts in defense draconian and seriously compromising national defense. Immediately after the news release that the automatic triggers would be exercised, leaders initiated discussions on how to re-allocate those cuts so defense would not be hit so hard. However, increasing the uncertainty for markets next year on where these cuts will eventually come from if at all, President Obama, in a speech yesterday after the announcement, stated he would veto any attempt to curb those automatically triggered spending cuts, including to defense.



The ongoing dysfunction of the American political system to agree to and execute changes for the betterment of the country will pressure US sovereign ratings and we think the probability is high at this point that the US faces at least one move downward next year – unless the tone changes by end-2012. Moody's warned it could downgrade by 2013 if no progress was made on tackling the country's long term deficit by that time. Back in August of this year, S&P put the chances of a further downgrade at 1 in 3 while Fitch stated that a failure to conjure up $1.2 trillion in fiscal adjustment would likely cause a revision to negative outlook. Standard and Poor's rating agency, after re-affirming its ratings on the US sovereign, also gave a caveat to its rating stability at AAA negative outlook, stating that in the event the automatic spending triggers were compromised, the US would face further downward rating pressure.

Regardless, next year's volatility will result from pending fiscal issues, including the US presidential election and political posturing will likely mean more pressure on US ratings. **The key point, however, is that regardless of future (and likely) rating action, given the position of the USD as the sovereign reserve currency of the world without any viable alternative – until China opens up its FX regime – means that the USD and USTs will not only be unaffected but rally on this bearish news and investors flock to the global safe haven. The US Treasury market remains the safe haven asset, the deepest, most liquid market in the world. Equities, and all risk assets, will be the asset classes that feel the most pain under this scenario, including emerging markets debt, equities, and currencies.**

In the nearer term, for next year, the failure of the "super committee" means the risk is much higher that key stimulus measures are not extended into 2012. Further uncertainty comes with regards to the "Bush tax cuts", which are set to expire at the end of 2012; Democrats want to let them expire on the "wealthy" and Republicans wish to see them extended for all taxpayers; this was one of the key sticking points on the super committee's ultimate failure. Congress would have to move quickly to extend some of the stimulative programs that are due to expire at this year-end. This includes: payroll tax cuts that allows many to keep an extra 2% of their earnings per paycheck, extended unemployment benefits, and the alternative minimum tax. Further, Medicare doctors could see a reduction in pay from the government (of up to 30% next year), making this program even more flawed as even more doctors could refuse to accept Medicare.



Token discretionary spending cuts, tax increases on top wage-earners will not cut it. Real reform given the magnitude of debt load requires large scale changes. There is simply no political consensus or willingness to tackle those programs that are draining fiscal accounts over the long term ahead of the 2012 elections, which will focus on 1) jobs and 2) deficit/debt trends. **This will be a very important election and the next year will bring US unsustainable fiscal trends to the fore, causing market turmoil as the debt ceiling debate inevitably re-emerges, triggers are re-negotiated or sidelined altogether, and the threat of downgrade re-emerges.**

What is all too clear from the numbers, as we have repeatedly contended, is that unwillingness to slow entitlement spending and reform these programs will require shrinking everything else the government spends money on, something we are seeing evolve right now. In 12 years, total revenues will cover interest payments, Medicare/Medicaid and social security only, nothing else. All other spending will have be financed with debt issuance (see graph above).

Cutting through the political spin, and looking at the numbers, here are the facts:

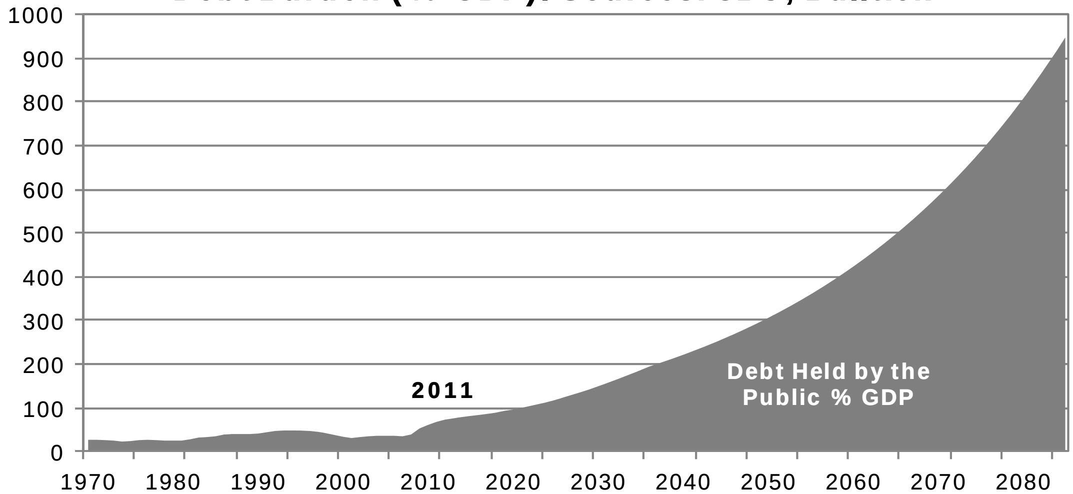
1) This is not (or should not be) a partisan issue. This is a national concern with clear drivers and both parties are responsible for the run-up in debt that the US has seen. The deficit jumped under President Bush before Obama took the reins and pushed fiscal deficit higher. The bottom-line fact is current trends are unsustainable.
2) It will require more than tax increases on top earners or defunding the military to put the US on a sustainable debt trajectory.
3) At current trends, over the next ten years, debt-to-GDP in the U.S. is set to rise from 69% this year to 85% in 5 years (by 2016) and to 101% in ten years (by 2021) and to 300% in 40 years (2051).

	2011	**2021**	**2031**	**2051**	**Historical Average** (1930-2008)
Spending	24%	26%	32%	43%	18.8%
Debt	69%	101%	157%	300%	36%*
Medicare/caid/SS	10.4%	12.4%	15.5%	19%	8%**
Revenues	14.8%	18.4%	18.4%	18.4%	15.8%

** 1970-2008*

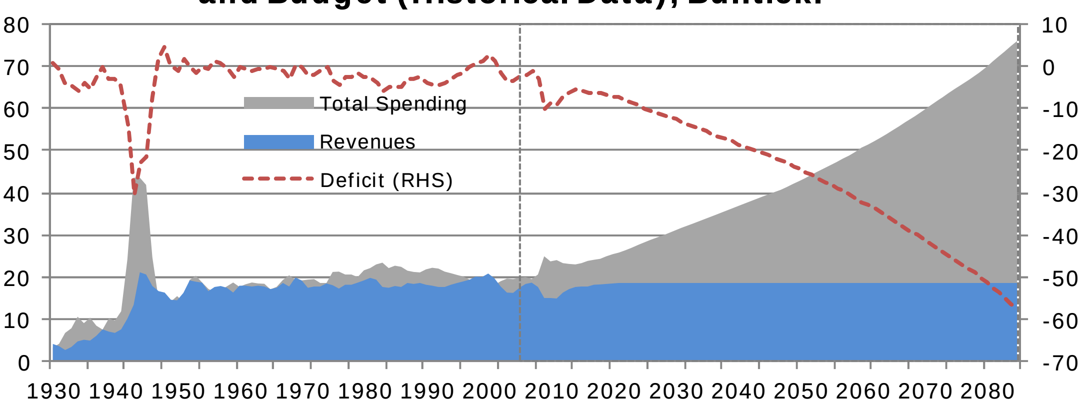
***2000-2008*

Debt Burden (% GDP). Sources: CBO, Bulltick



Drivers of US debt dynamics are not low revenue but rapidly rising spending especially on entitlements. According to our forecast models, by 2024, the sum of Social Security, Medicare/caid and interest payments will exceed total revenues of the US government. The US must focus reduction on long term spending trends and reform to tax code.

Spending v. Revenues % GDP (2011-2085). Source: CBO (Forecasts), White House Office of Management and Budget (Historical Data), Bulltick.



Current revenues as a percent of GDP total 14.8%, slightly lower than historical average of 15.5% but until spending comes back down to its long-term historical average of 18%-19% (1930-2008), from current 24% of GDP, deficits and debt will continue to soar. Only raising taxes on the "wealthy" will not cover deficits or take down debt trends. Fiscal and debt trends will be corrected – the question is will it be by market forces years down the line or on the U.S.'s own time-line and on its own terms. The latter will involve less pain than the former and sustainable entitlement programs rather than unwieldy, explosive drains on U.S. fiscal deficits.

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