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Financial Markets Perspective

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Extending the Global Safety Net

Less than a year ago, the European economy was in the throes of a major catastrophe. Several nations were on the brink of insolvency as the ability of Greece, Portugal and Spain to finance their national economies through debt issuance was in question. As investors pulled back from buying bonds issued by these countries, interest rates soared. Financial markets stumbled and many pessimists feared that, as the U.S. stock market approached a 20% decline, another 2008 financial crisis was unfolding.

By the fourth quarter of last year, evidence continued to mount that countries with rising budget deficits and weakening economies were in danger of going bankrupt. European leaders appeared to be scuffling over the prospect that one or more weaker countries would have to exit the European Union (EU). Such discussions put additional pressure on the respective governments of these countries and continued to negatively affect financial markets. In early December, the European Central Bank (ECB) made the decision to buy bonds issued by member nations thus providing the public sector a much-needed safety net. This bond buying program is referred to as LTRO or Long-Term Refinancing Operations and essentially makes the ECB the lender of last resort. Although the ECB has the power to create money like the Federal Reserve, it had never acted in this capacity before last year.

Europe's economy has continued to teeter on the edge of recession this year, but was saved in early September when EU member nations signed off on the ability of the ECB to act like the U.S. Federal Reserve and purchase an unlimited amount of bonds of member nations. There were strings attached to these purchases but, in reality, the buying program signaled a new era in the development of the EU. Discussions have emerged about the creation of a central European fiscal authority that would be similar to the U.S. federal government, but any final resolution will likely be a long-time coming—if at all. Financial markets responded to this safety net in a favorable way with stocks approaching all-time highs at the end of September. Fears of an imminent European bankruptcy have diminished.

Safety measures were similarly implemented in the U.S. by the Federal Reserve in mid-September. In response to weakening unemployment statistics and spotty economic data that indicated growth was not as robust as expected, the Fed maintained the commitment to zero interest rates in addition to announcing the third round of quantitative easing (QE3). The policy announced on September 12th indicates that the Fed can buy billions of dollars of mortgage-backed securities to inject additional liquidity into the financial system to sustain the lukewarm U.S. economic recovery. Even emerging China is flooding their economy with liquidity in the

face of a business slowdown. The world is recognizing the importance of using monetary policy to facilitate a transition to an economic growth model.

Many market observers have tagged the Fed's low interest rate policies as potentially inflationary. Yet, with the exception of volatile swings in oil prices that temporarily pushed inflation higher, the core rate (excluding price swings in food and energy) has remained in a reasonable range between 2-3%.

Monetary policy is not the only factor that can make or break an economy. The other key element is fiscal policy i.e., courses of action on taxing and spending at the federal level. As we approach the November election, there is a distinct difference between the philosophy and potential actions that the presidential candidates would take on fiscal policy if elected. Each policy must be viewed from the perspective of (1) will the policy encourage economic growth? And (2) will growth be sufficient to increase employment? Only programs that contribute to economic growth by providing incentives to invest will achieve both of these goals.

One approach espouses policies that will rely on increases in government spending to resuscitate the economy. But this approach has not produced sufficient economic activity to trigger gains in private sector employment over the last four years and economic growth remains anemic in the 1-2% range at best. This approach relies on increased tax rates across the board as well as a substantial increase in taxes on the wealthy. A major reduction in defense spending is also part of this plan to reduce the federal deficit.

The other approach focuses on implementing major reductions in federal spending to lower the federal deficit. To offset the loss of income from spending reduction, this approach relies on tax rate cuts across the board to boost output and closes certain tax loopholes to move toward a balanced budget. Spending on defense would be maintained but emphasis on subsidizing renewable energy sources would be replaced with a plan to maximize the domestic production of fossil fuels.

We remain concerned about the resolution of the so called “fiscal cliff” that would raise taxes by more than $500 billion dollars next year, a record tax increase in a sluggish economy. These increases include: (1) the end of the 2% payroll tax break of the past two years, (2) a new additional 3.8% tax on dividends, capital gains, and interest income and a 0.9% Medicare tax on high earners, (3) lower thresholds for the Alternative Minimum Tax that would affect many more middle-income Americans, (4) a return to the 2000 tax rates on income, dividends, and capital gains, including a top official rate of 39.6% on ordinary income and dividends and 20% on capital gains. According to an analysis by the Tax Policy Center, a non-partisan think-tank in Washington, if Congress fails to take any action by the end of December, each household would have a federal tax increase of $3,500. A typical middle-class household—with income between $40,000 and $64,000—would see its taxes go up by about $2,000. Households in the top 1%—with income of more than $506,000—would see an average increase of more than $120,000.

These tax rate hikes would not only damage the supply-side of the economy, but would subtract hundreds of billions of dollars of income from the private sector. With Congress in recess and the race for the White House in full swing, there are no negotiations to avert this fiscal cliff. Our expectation is that once the new balance of power becomes clear after the election, a series of talks will begin in an effort to reach a compromise, or at least to defer a solution until next year.

There have been several interesting interpretations and predictions of the "fiscal cliff" circulating in the investment community. The "Sky Dive" is one where Obama wins in November and fails to get a deal with the lame-duck session. Tax talks would be pushed into January leading to wrangling over the debt ceiling again in 2013. The "Bungee Jump" is where Republicans sweep the presidency, House and Senate. There is no deal in the post-election lame duck session but a well-telegraphed plan to reverse tax increases in January. And finally there is the "Hard Stop" where Congress agrees to some spending cuts and then moves towards a comprehensive deficit-reduction deal in mid-2013. Our interpretation is "Déjà vu 2010." The Bush tax cuts were to expire on January 1, 2011 but were extended by the new Congress after the 2010 elections. We see a repeat of that decision this year to be revisited in 2013 once the new president and new Congress sit down to work out the details of a new tax law.

Recall that the depression of the 1930s was caused not by one event but several. Starting in 1929, the Great Depression included bank failures, a stock market crash, high unemployment and the implementation of new government programs introduced by President Roosevelt and passed by Congress. By 1936, the economy was in recovery mode and the federal government decided to create the payroll tax to fund Social Security and to raise taxes across the board. At the same time, the Fed tightened monetary policy by raising interest rates. Less than a year later, employment collapsed and the economy slipped back into the depression that wasn't eclipsed until the fiscal stimulus of World War II in 1941. There is a lesson here.

The current Chairman of the Federal Reserve is a self-proclaimed buff of that Great Depression. As a result of his studies, Bernanke has steadfastly remained committed to a monetary policy that will not throw the U.S. economy back into recession or even worse. In addition, his commitment has changed the way in which world central banks conduct monetary operations to prevent financial crises. At least monetary policy is on the right track. However, the uncertainty of fiscal policy has moved to center stage. Europe has failed the test of implementing growth policies to restore economic health while the U.S. teeters on the edge of adopting policies that could overwhelm the valuable contribution made by the monetary safety net. We are hopeful that U.S. politicians will opt for the private sector growth solution.

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