

The US fiscal cliff, debt ceiling & economic outlook

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Key points

- > The US deal to avert the fiscal cliff combination of tax hikes and spending cuts is not the long term “grand bargain” that could have been hoped for to address America’s long term budget and debt problems.
- > Such issues will come up again in February in negotiations to raise America’s debt ceiling, possibly resulting in another bout of market volatility around then.
- > However, by scaling back the bulk of the huge recession threatening fiscal cutbacks that would otherwise have occurred this year, the fiscal cliff deal means that the US economy will likely be able to pick up speed to around 2.5% helped in particular by a housing recovery.
- > This is great news for the global economy and growth assets such as shares.

Introduction

As a result of a last minute bi-partisan budget deal, the so called “fiscal cliff” of tax hikes and spending cuts that threatened to tip the US into recession, with a flow on to the global economy, has been averted. While the deal is not as good as it could have been, given the need for longer term deficit reduction measures in the US and the need yet again to raise America’s debt ceiling in the next two months, the removal of the fiscal cliff threat is great news for the global economy and explains why shares and other growth related assets such as commodities and the Australian dollar have responded positively to the news.

The background

But first some background. The “fiscal cliff” referred to a range of tax hikes and spending cuts that were all due to occur on January 1 this year largely as a result of the expiration of previous stimulus measures and budget savings agreed as part of President Obama’s 2011 agreement with Congress to raise America’s debt ceiling. Taken together these would have taken \$670bn out of the US economy, resulting in a fiscal drag of around 4.3% of GDP. See table.

The US Fiscal Cliff

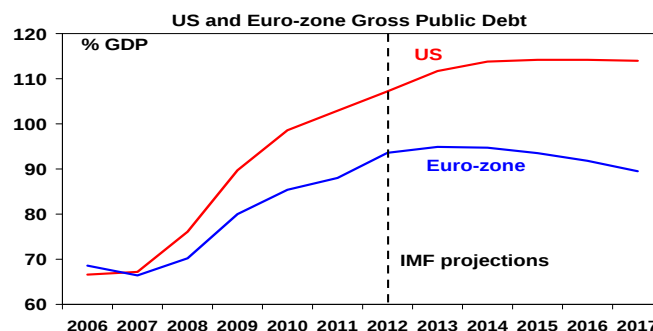
Budget item	\$bn budget saving, 2013	% GDP in 2013
End of Bush tax cuts for wealthy	45	0.3
End of Bush tax cuts for middle income	150	0.9
End of payroll tax cut	116	0.7
Unemployment benefits	25	0.2
Budget Control Act 2011	85	0.5
Payment rate for physicians	20	0.2
Other items	229	1.5
Total budget savings	670	4.3

Source: Congressional Budget Office

Obviously with the US economy growing at around 2%, a 4.3% hit to growth would likely have knocked it off the cliff into recession. In particular average households would have faced an annual \$3500 increase in their tax bill.

At the same time, America is now up against its debt ceiling of \$16.4 trillion as currently agreed with Congress and while it can probably last into late February/early March without having to cut Government spending any negotiations to increase it will naturally go hand in hand with pressure from the Republican controlled House of Congress to reduce the long term budget deficit.

America has a bigger public debt problem than Europe and long term measures to bring it under control are necessary if it is to avoid more downgrades to its sovereign credit rating.



Source: IMF, AMP Capital

While it’s generally agreed that America needs to reduce its deficit over time, both sides of US politics also agreed that a 4.3% of GDP reduction in the budget deficit this year under the fiscal cliff was too fast and that the Bush era tax cuts should be extended for most tax payers.

The fiscal cliff problem had been well known for over a year now but both sides of politics had been reluctant to make the compromises needed to address it ahead of the November elections. Initial negotiations after the election focussed on coming up with a “grand bargain” to spread budget cutbacks over time as part of a long term plan to reduce the deficit and to increase the debt ceiling at the same time.

Republicans under the influence of the Tea Party wanted the continuation of the Bush era tax cuts for all and cutbacks in long term spending on health and social security. By contrast the Democrats wanted the tax cuts to end for those earning more than \$250,000 and no cuts to entitlements.

While President Obama and the Republican House leadership got within a couple of hundred billion dollars of each other in terms of increased revenue and spending cuts over the next decade, negotiations collapsed when the Republican House leadership decided to put a narrow plan to Congress just before Christmas only to realise it did not have enough support even from Republicans.

Consequently, given the lack of time left to negotiate a “grand bargain” the Senate came up with a bi-partisan budget deal that has dealt with the most pressing issue of the fiscal cliff but not the debt ceiling or longer term measures to reduce the budget deficit.

The key elements of the deal to avert the cliff

The key elements of the fiscal cliff deal are:

- the Bush era tax cuts will continue except for individuals earning more than \$US400,000 and married couples earning more than \$US450,000, who will see their marginal tax rate rise from 35% to 39.6%;
- tax rates on dividends and capital gains will be capped at 23.8%, up from 15%;
- the Alternative Minimum Tax will be indexed to inflation;
- a range of tax credits will be extended;
- unemployment benefits will be extended; and
- the "sequester" cuts to health and defence spending (under the Budget Control Act put in place after 2011's debt ceiling deal) will be delayed by two months.

The good news - no fiscal induced recession

This will cut the fiscal drag for the US economy from a previously scheduled \$US670bn or 4.3% of GDP to around \$US250bn or 1.5% of GDP.

To be sure this will constrain US economic growth during the next six months, particularly as the payroll tax hike will still take effect. However, fiscal drag of around 1.5% of GDP is not enough to tip the US economy back into recession. In fact it is what we had been assuming for the US economy this year. Don't forget the US economy has seen fiscal drag of nearly 1% of GDP anyway in each of the last two years.

More importantly the US economy has seen surprisingly positive momentum in a range of economic indicators lately:

- home sales, starts and permits to build new homes and house prices have all been rising steadily pointing to an ongoing housing recovery;
- various business surveys, including the ISM and Markit manufacturing conditions surveys, improved in December;
- durable goods orders, disposable income and real consumer spending have been surprising on the upside; and
- weekly unemployment claims have fallen to a five year low.

This is all occurring against the backdrop of an energy production boom in the US (shale oil and gas) and increasing numbers of companies announcing investment in manufacturing plants in the US (with Ford being the latest announcing it will invest almost \$1bn in Michigan).

The housing recovery alone will add around 0.75 to 1 percentage points to US economic growth over the year ahead and the resolution of uncertainty associated with the fiscal cliff is likely to see a bounce back in business investment and hiring. As such, the break through on the fiscal cliff adds confidence to our view that US growth this year will edge up to around 2.5% after 2% in 2012.

The bad news - the lack of a grand bargain

The bad news of course is that the budget deal was far from the "grand bargain" to increase the debt ceiling limit and solve America's long term budget problems that had seemed attainable only a few weeks ago. These issues will now have to be addressed as part of the negotiations to raise the debt

ceiling in February or early March as the Republicans in Congress won't agree to a debt ceiling increase in the absence of long term measures to contain entitlement spending and Democrats will only agree to this if there are more long term revenue raising measures.

The failure of the grand bargain negotiations in the last few weeks has yet again highlighted the dysfunctional nature of US politics with the Republicans held hostage to a group that doesn't want to consider any tax hikes and the Democrats held hostage to a group that doesn't want to consider any limits on out of control spending on health and social security.

With tax revenue running well below, and Government spending running well above, their long term averages as a percentage of GDP, commonsense indicates both sides of US politics should just meet in the middle on both long term tax and spending measures to balance the budget. However, the failure to agree so far to comprehensive revenue raising measures and spending cuts to bring the long term budget and debt outlook under control means another contentious debate in February that will likely take the US to the brink of a Government shutdown and possible ratings downgrades in ahead of the debt ceiling limit being breached.

This combined with Italian elections and the likely need for Spain to finally seek assistance around the same time could make February a bumpy month for investment markets. February is also normally a soft month after the seasonal strength seen in December and January.

Concluding comments

However, while US budget and debt woes are far from over, the fact that the fiscal cliff has been averted via a just in time bi-partisan deal is a huge achievement and indicates that when push comes to shove most American politicians ultimately get their act together. The same is likely to apply to the debt ceiling negotiations such that while they will likely cause volatility in February, they are unlikely to threaten the US economy for the year as a whole, as agreement will likely be reached, albeit again at the last minute.

Overall, the break through on the US fiscal cliff adds confidence to our view that a pick up in global growth to around 3.25% this year helped by stronger growth in the US, a slight pick up in China and a fading of Europe's recession, combined with very easy monetary conditions will underpin further gains in global share markets.

This removal of the fiscal cliff threat also provides a positive back drop for Australia, where growth may slow to around 2% during the first half of the year as the mining investment boom fades but should pick up during the second half in response to the lagged effect of lower interest rates and the improvement in global growth.

By year end I continue to see the Australian share market rising to around 5000, resulting in a total return for investors of around 12%. This wouldn't be too bad given that Australian shares returned 20.3% in 2012.

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