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Weekly Market Commentary

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The Budget Bombshell

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Highlights

In one week, President Obama is due to submit his budget. The 2013 budget is already going to have the biggest impact since the end of WWII, even if no action is taken in Washington.

The fiscal headwind under current policy totals over $500 billion, or 3.5% of GDP. The United States has never experienced a deficit cut by more than 2% of GDP that did not end in a sharp decline in GDP.

The risk that a budget deal to mitigate this potential impact does not happen should keep markets from moving steadily higher in 2012, as they have done year-to-date, without a reality check.

In one week, President Obama is due to submit his 2013 budget, which covers the fiscal year beginning on October 1, 2012. The Congressional Budget Act of 1974 requires the President to submit a budget request to Congress on the first Monday in February, but the Administration has scheduled the release instead for one week later on February 13. In addition, Congress must pass a budget resolution by April 15 of every year. However, the President missed the deadline last year and while the House passed a budget resolution last year, the Senate did not. This year is likely to be no different, with no budget being passed. But this does not mean the 2013 budget does not have potentially market moving consequences.

The 2013 budget is already going to have the biggest impact of any budget in decades even if no action is taken in Washington. The fiscal headwind comprised of both tax increases and spending cuts under current policy totals over $500 billion, or 3.5% of GDP.

2013 Fiscal Headwinds (in $ billions)

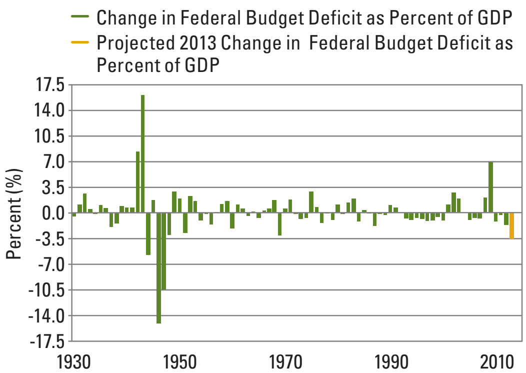
Expiration of Bush tax cuts for middle income earners	205
Expiration of Bush tax cuts for high earners	50
Payroll tax cut for workers	112
Debt ceiling annual spending sequester for defense	55
Debt ceiling annual spending sequester for non-defense	55
Alternative minimum tax annual "patch"	38
Medicare tax of 3.8% on investment income from 2009 Obama health care plan	21
Total	**536**
Total as % of estimated 2013 GDP	**3.5**

Source: LPL Financial, Congressional Budget Office, Office of Management and Budget 02/06/12

The 2013 budget changes, primarily consisting of tax increases, are already in the law and would need to be changed to mitigate or restructure them to be less of an economic drag; if not a return to recession may be looming in 2013.

While the United States economy is not likely to see the big declines in government spending that came after WWI and WWII, the United States has never experienced a deficit cut by more than 2% of GDP that did not end in a sharp decline in GDP. The last time the budget deficit was cut by a similar amount to the 3.5% on tap for 2013, it was 1969. In 1969, the deficit narrowed by 3.1% during the year, and GDP ended up shrinking -1.9% in the

1 Budget Change on Tap for 2013 Largest Since End of WWII



Source: LPL Financial, U.S. Census Bureau, U.S. Treasury 02/06/12

fourth quarter (and by -0.6% in the following quarter) as the U.S. entered a recession. Despite the recession, the efforts to narrow the deficit in 1969 had one pleasant outcome: they balanced the budget. Unfortunately, the budget changes on tap for 2013 will still leave the federal budget far from balanced.

The further apart the parties in Washington appear to be, even on extending the unemployment and payroll tax cuts that expire this month, may make investors increasingly nervous. This may result in the return of market volatility in February after stocks got off to a strong start to the year.

While the President's budget is unlikely to get much attention in Congress, the markets may begin to price in a major budget deal taking place in early 2013 for several reasons:

- the economic impact of the many scheduled tax increases and spending cuts,
- the debt ceiling will be hit again in early 2013 and require legislative action to approve an increase,
- the rating agencies have warned that they will be watching in 2013 for the United States to take actions to return to a path of fiscal sustainability, and
- the President and a newly elected Congress will have maximum political capital to make it happen in early 2013.

But the risk that a budget deal does not eventually happen should keep markets from moving steadily higher in 2012, as they have done year-to-date, without a reality check. With Congress now back in session and the President's budget due on February 13, just a week away, the markets may begin to refocus on the risks to the economy posed by inaction in Washington leading to a return of volatility. ■

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.