Weekly Economic Commentary

November 19, 2012

Budget Myths

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Highlights

The United States' structural budget deficit looms behind the fiscal cliff.

Waste, fraud, and abuse, domestic discretionary programs and foreign aid receive a great deal of attention in the media, but are not a significant source of the nation's long-term budget woes.

Eighty percent of federal outlays are growing at an unsustainable pace and will contribute the most to our medium- and long-term budget woes in the coming decade.

Please see the LPL Financial Research Weekly Calendar on page 3

As Congress and the President work together to avoid the looming fiscal cliff during the lame duck session of Congress, a more intransient problem remains in the background: the United States' structural budget deficit. In our recent *Weekly Economic Commentary: Budget Debate* (10/29/12), we wrote about how often the budget was mentioned during the campaign season, and we pointed out that the economy and the labor market got more attention than the longer term budget issues facing the country.

In late 2010, three different non-partisan organizations released plans that would put the U.S. budget on a path toward a balanced budget, using a combination of revenue/tax increases and spending cuts to achieve that goal. These organizations are:

- The President's National Commission on Fiscal Responsibility and Reform (commonly known as Bowles-Simpson);
- Bipartisan Policy Center (commonly known as Rivlin-Domenici); and
- Pew-Peterson Commission on Budget Reform.

While each plan differed on certain aspects of the longer term fix for our budget woes, they all generally agreed that there are no easy answers and no quick fixes. Both Democrats and Republicans populated the three commissions. Some hold (or once held) elected office, while others served in the federal government or were on the boards of the many think tanks in and around Washington. All were focused on finding bi-partisan solutions to the problem.

In general, the three commissions concluded that in order to successfully tackle the longer term deficit problem, formerly politically untouchable areas must be on the table in any serious negotiation. These areas include:

- Social Security;
- Defense spending;
- Farm subsidies;
- Medicare;
- Medicaid;
- Personal and corporate tax rates; and
- So-called tax expenditures, more commonly known as personal and corporate tax deductions (e.g., home mortgage interest, state and local real estate tax, or charitable contributions).

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1 Fiscal Cliff: Calendar of Events

Mid-Nov–Jan 2	"Lame duck" session
Late December	Debt ceiling reached, but Treasury will use "extraordinary measures" to extend this date until March 2013
December 31	Fiscal cliff: Bush tax cuts expire, 2% payroll tax cut expires, extended unemployment benefits and "doc fix*" ends
January 2, 2013	Sequester: a series of prearranged across the board cuts to spending-agreed to in August 2011 go into effect
January 3, 2013	New Congress sworn in
January 21, 2013	Inauguration day
Feb–March 2013	Debt ceiling reached
Feb–March 2013	Possible ratings downgrades
March 31, 2013	Possible government shutdown as temporary funding expires

Source: LPL Financial 11/19/12

*Medicare Physician Reimbursement

Even if we eliminated all nondefense discretionary spending—which would literally wipe out whole Cabinet level departments and hundreds of politically sensitive programs championed by both Republicans and Democrats—it would only make a small dent in the overall deficit.

The plans did vary on the amount of revenue increases (via some combination of higher tax rates, fewer deductions, and more income subject to taxation) relative to spending cuts (across all categories of federal spending) needed to achieve a long-term path toward fiscal stability. The outcome of the November 6 election suggests that the ultimate mix of revenue increases and spending decreases that will set the country on that path is likely to be more reliant on revenue increases than spending cuts than if Governor Romney won and/or the Republicans took control of the Senate.

Absent from the list above are several budget items that receive a great deal of attention in the media, but are not a significant source of the nation's long-term budget woes. For example, both the Bowles-Simpson plan and the Rivlin-Domenici plan noted that budgets cannot be balanced by eliminating waste or earmarks, by just cutting domestic discretionary spending, by growing our way out of the deficit, or by only raising taxes or cutting foreign aid—or all of these together. To illustrate why this is the case, we focus on the impact of waste, fraud, and abuse, domestic discretionary programs, and foreign aid have on our budget. In future commentaries, we intend to tackle some of the other items in the budget.

Waste, Fraud, and Abuse: Impact

The libertarian Cato Institute, a Washington, D.C.-based think tank, estimates waste, fraud, and abuse in the federal budget at between $100 billion and $125 billion per year. On an absolute basis, this is an enormous amount of money, and taxpayers and the financial markets would welcome any and all steps to eliminate this from the budget. However, the annual outlays of the U.S. federal government in fiscal year 2012 were $3.5 trillion. So even if somehow the federal government were able to eliminate every dollar of waste, fraud, and abuse in the budget, federal outlays in fiscal year 2012 would still have been well over $3.3 trillion, and the federal deficit in fiscal year 2012 would have been $960 billion instead of $1 trillion.

Domestic Discretionary Spending: Impact

Let us now examine domestic discretionary spending. The federal budget can be sliced and diced several ways. One way to look at the budget is by function or cabinet post, i.e., Department of Labor, Department of the Interior, Department of Defense, etc. Another way is to group the spending categories together by legislative mandate. For example, all mandatory spending (regardless of function) is grouped together, and all non-mandatory spending (also known as discretionary spending) is grouped together. Mandatory spending is all spending that is not controlled through Congress' annual appropriation process. For the most part, mandatory spending is based on eligibility criteria and benefit of payment rules set into law. Examples include Social Security, Medicare, Medicaid, and interest on the public debt. In recent fiscal years, mandatory spending has accounted for nearly two-thirds of all federal spending, and this slice of the pie is set to rise dramatically in the coming decade.

LPL Financial Research Weekly Calendar

2012	U.S. Data	Fed	Global Notables
19 Nov	**Homebuilder Sentiment (Nov)** **Existing Home Sales (Oct)**		
20 Nov	**Housing Starts (Oct)**	Lacker* **Bernanke***	**Greece: Eurozone Finance Ministers decide on Greek aid package** Japan: Central Bank Meeting
21 Nov	**Initial Claims (11/17)** **Markit PMI (Nov)** Consumer Sentiment (Nov) Leading Indicators (Oct)		**China: HSBC Flash PMI (Nov)** Germany: Bond Auction
22 Nov	Thanksgiving Holiday		**Spain: Bond Auction** **ECB President Mario Draghi speaks in Frankfurt** **Eurozone: Leaders' Summit on budget issues** Eurozone: PMI (Nov)
23 Nov			Germany: IFO Index (Nov)

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

Please see this week's Weekly Market Commentary and the one from 10/29/12 for more details and some historical perspective on the lame duck session of Congress.

Discretionary spending is what Congress agrees to spend each year on things like national defense, education, Veterans Affairs, the national park system, etc. In recent fiscal years, discretionary spending has accounted for about one-third of federal budget outlays. Nondefense discretionary outlays ($528 billion in fiscal year 2011) alone account for only 10–15% of total outlays. Thus, even if we eliminated all nondefense discretionary spending—which would literally wipe out whole Cabinet level departments and hundreds of politically sensitive programs championed by both Republicans and Democrats—it would only make a small dent in the overall deficit.

Foreign Aid: Impact

Although not a single line item in the budget, foreign aid receives a great deal of attention in the media. A 2010 poll conducted by the University of Maryland's Program on International Policy Attitudes found that Americans thought that the United States spends 25% of its budget on foreign aid. Foreign aid is mostly part of discretionary spending, but at around $40–50 billion per year accounts for roughly 1% of federal budget outlays, far less than the 25% of the budget the public thinks is spent. These outlays are found in the budgets of the U.S. Treasury, the Department of Agriculture, the State Department, and even the Department of Defense for items such as:

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- Embassy security;
- The Peace Corps;
- Disaster assistance;
- Peacekeeping;
- Direct economic support to foreign nations;
- The World Bank, IMF, and United Nations; and
- Global health initiatives.

Putting It All Together

All together, waste, fraud, and abuse, non-defense discretionary spending, and foreign aid amount to a sizable portion (more than $700 billion), roughly 20% of total federal outlays. But 80% of the budget lies outside of these three areas of the budget. Although there is certainly some merit in taking a hard look at each of these categories as part of a longer term budget reform, the real task lies in the 80% of federal outlays that are growing at an unsustainable pace and will contribute the most to our medium- and long-term budget woes in the coming decade. ■

2 Most of Media Attention on the Budget Is Focused on Waste, Domestic Spending, and Foreign Aid, but the Real Problem in the Budget Lies Outside These Areas

Non-defense discretionary spending	10–15%
Waste, fraud, and abuse	3%
Foreign Aid	1%

Source: Congressional Budget Office 11/19/12

LPL Financial Research 2012 Forecasts

GDP 2%*
Federal Funds Rate 0%^
Private Payrolls +200K/mo.†

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

* 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.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:
- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

INDEX DESCRIPTIONS

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Weekly Market Commentary

November 19, 2012

Fiscal Cliff Causing Investors Grief

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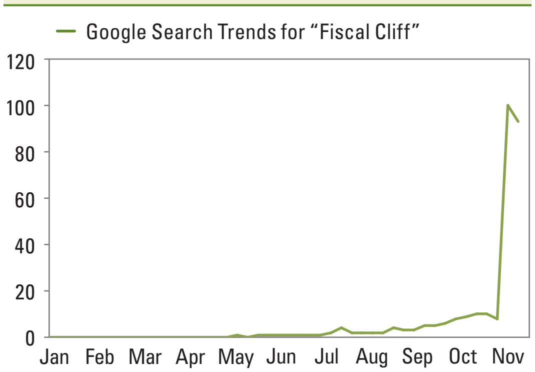
Highlights

There is no doubt the fiscal cliff is causing investors grief with the S&P 500 down by over 7% since the year's high in mid-September.

The five stages of grief are: Denial, Anger, Bargaining, Depression, and Acceptance. We are past the first stage; the second stage has revealed a lot of anger in the selling lately, while the third stage seems to be what we are getting to now. But next comes Depression before Acceptance and a deal.

Cash in portfolios should be a consideration which could help to sidestep the volatility and enable buying the bargains that may emerge as the deal comes together.

1 Interest in the Fiscal Cliff Has Skyrocketed Since the Election



Source: Google Trends 11/18/12

While there are other issues investors are grappling with — such as increasing tensions in the Middle East, meager prospects for earnings growth, and the return to recession in Europe after only three short years of growth — the one most heavily weighing on the minds of investors is the U.S.'s fiscal cliff.

The existence of the fiscal cliff is nothing new. We have long expected that a status quo election outcome would result in a deal on the 2013 budget bombshell package of tax increases and spending cuts known as the fiscal cliff in the last weeks of the year. However, we also expect prospects will darken before a deal finally emerges. The lame duck session began last week (November 11 – 17), and both sides have offered to negotiate, but we think this duck turns ugly before a deal finally emerges as a swan song.

There is no doubt the fiscal cliff is causing investors grief with the stock market, measured by the S&P 500, having slid by over 7% since the year's high in mid-September. That grief is unlikely to end soon. It is generally accepted that the five stages of grief are: Denial, Anger, Bargaining, Depression, and Acceptance.

The Five Stages of Grief

1. **Denial.** While we have been writing about the fiscal cliff all year, markets have only recently begun to make progress in recognizing the threat. For example, online searches for "fiscal cliff" on Google have spiked in the last two weeks [Figure 1]. After a long period of denial, markets are now beginning to come to terms with the risks posed by the cliff.
2. **Anger.** Investors shifted to stage two a few weeks ago and are expressing it by selling, as U.S. stock mutual funds have experienced the largest monthly outflows of the year in the past two months, according to Investment Company Institue. At the same time, the stock market has seen its gain for the year cut in half over the same time period.
3. **Bargaining.** Stage three is just getting underway. Key meetings took place in Washington last week. Both sides agree that there is a problem and, in particular, House Speaker Boehner's comment after his meeting with President Obama indicated a willingness to negotiate and was viewed positively. But the real discussions will not get underway until after Thanksgiving, which sets the markets up for stage four.

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We think this duck turns ugly before a deal finally emerges as a swan song.

4. **Depression.** It is likely to be darkest before the dawn as a winding and contentious path to a deal emerges late in December or even early January, taking investors to stage five.
5. **Acceptance.** No one loves the compromise, but everyone can live with it.

How substantive the deal is will be important to the market reaction. A smaller, short-term deal that merely kicks the can down the road by several months will undermine any confidence that a deal will ultimately be reached. It could lead to ratings agency downgrades of U.S. debt in the first quarter of 2013, along with problems as we reach the federal debt ceiling again in the coming months and with the continuing resolution funding the government that runs out at the end of the first quarter. However, a large, long-term solution would be bullish for equities and the economy because it would take a substantial first step toward fiscal sustainability. It would greatly reduce the risk of a crisis at some point, which is almost inevitable, given how quickly the U.S. is accumulating debt on an annual basis. It would provide long-term clarity on taxes, spending, and likely eliminate annual fights over the debt ceiling or fiscal cliffs for at least the next few years. To the extent that these risks and uncertainties are causing businesses and consumers to stay on the sidelines, these headwinds to economic growth would be lifted, more than offsetting any fiscal drag.

A smaller, short-term deal that merely kicks the can down the road by several months will undermine any confidence that a deal will ultimately be reached.

In the meantime, a defensive stance may be warranted with some cash in portfolios to sidestep the volatility and enable buying the bargains that may emerge in areas like technology and homebuilders. ■

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Information Technology: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

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INDEX DESCRIPTIONS

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.

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