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Market Commentary Alert

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THE U.S. DEBT CRISIS:

AN AMERICAN PERSPECTIVE

INTRODUCTION

Why can't the Democrats and Republicans come to an agreement on the US debt crisis even with the generous intervention of President Obama and Treasury Secretary Geithner along with the rating agency choir, in a supporting role, singing the refrain of "enough already"?

Q. Why have the major players in this drama each had to "voice" their frustration by either getting up and leaving the talks mid-way (President Obama) or playing the game of giving up in frustration and not returning the president's phone calls (House Speaker Boehner)?

Q. While the headlines are painted as the diametrically opposite goals of increasing taxes versus cutting spending, does anyone have any doubt that the sub-text is really about who wins the next election and "kicking the can down the road" to the next administration?

Q. Do the many, complex solutions being offered by all sides represent good faith negotiations or are they meant simply to daze and confuse the voters with incomprehensible details that obfuscate the real agenda of which political party can claim having crafted the "right" solution for the future of America?

Q. If the debate is just "noise", what is the right solution especially if – as hoped – an elegant compromise is announced in the coming days to avoid the much feared financial disaster of a default by the U.S. on its debt because of the recent "forced" linkage between the budget and the raising of the federal debt limit?

These questions have actually been the subject of heated public and private debate for the past several months since President Obama submitted his 2012 budget in February of this year - which was summarily declined by the Senate by a margin of 0-97 votes.

Simply stated, as the Euro-zone battled its own sovereign debt crisis in the last few months, the U.S. has done the same (almost in sympathy) and the result is one of deep uncertainty - which the markets do not like.

THE BUDGET DILEMMA

The only positive observation that can be made about the current budget debate is that it certainly has crystallized the key issue around the need for the U.S. to focus on cutting spending in order to address the long term fiscal health of the US economy (which enjoys the highest possible AAA ratings - for now) – although growth drivers are still missing.

While the current proposals from the Obama administration and the Republicans differ in their details, the result is the same: there would still be a massive deficit to be incurred for the upcoming 2012 fiscal year due to economic weakness against a backdrop of continuing high levels of spending on social and defense programs.

Furthermore, based on the “current” competing plans – which incorporate up to $3 trillion in aggregate reductions in the deficit over the next decade while at the same time increasing the debt limit to accommodate the near term deficits – the net impact is virtually negligible to the amount of outstanding debt after taking into account the need to increase the debt ceiling to meet near term deficits.

The amount of “deficit reduction” over the next decade depends only on which plan or economic projection one chooses to believe and the timing of spending cuts: i.e., either the Democrat’s plan (sponsored by Senate Majority Leader Harry Reid) or the Republican’s plan (sponsored by House Speaker John Boehner).

The Democrat’s plan incorporates an immediate increase in the debt ceiling of $2.7 trillion to be followed by cuts in the future, while the Republican plan features an increase in the debt ceiling in two phases totaling $3.0 trillion over 2012 to be followed by deeper and earlier cuts in spending. In a notable retreat, President Obama is backing the Reid plan which no longer incorporates increases in revenue. However, the Democrat’s plan raises the debt ceiling until 2013 as Obama insists while the Republican’s plan raises the debt limit for six months in order to force cuts in social programs without an increase in taxes – setting the stage for a repeat of the debt crisis in six months.

Similarly, the economic projections have been changing in their assumptions (recall the daily budget negotiations in the last week) with such dizzying speed, that it is a legitimate question to pose whether the econometric models have any integrity to them regarding the validity of the output.

By this it is meant, can the projections be trusted when the assumptions keep changing so quickly?

It is probably a safe conclusion to draw that economic projections are in and of themselves subject to a high degree of margin of error. Therefore, changes in assumptions while seemingly minor in the details (for example, increasing tax rates on the wealthy and not the middle class), the impact of those assumptions cannot be fully validated until they are "market tested".

For example, time and again, economists will draw on historical changes in tax rates and their impact on economic activity as having the ability to predict future changes in either consumer behavior or corporate investment.

The reality in our view is that there is no silver bullet or single assumption that is going to "save" the U.S. economy and put it back on the path of economic vitality because of the sheer complexity of the economy and the fact that taxpayers have historically demonstrated the ability to adapt very well to changes in tax rates or economic circumstances.

Take Greece for example, if the economy doesn't grow and is being mismanaged, why should taxpayers pay their taxes? That is a reasonable conclusion which has come to pass. Taxpayers adjust.

If, as we have argued previously, regarding Greece (a developed economy in a weakened state), the U.S. or any other country chooses not to focus on "top-line" growth and instead focuses on cutting spending, the response we offer is that this is not a recipe for success.

One cannot "cut one's way to prosperity".

AN ALTERNATIVE SOLUTION

Perhaps there is an alternative, if not radical, solution which American leadership could consider: both sides give in to the other.

Rather than picking apart at the "details" of the competing plans, why not (if one is a Republican for example) let the Democrat's plan pass.

Clearly, some Republicans (if not many, including those among the Tea Party contingent who have vowed not to increase taxes), would have a problem with this proposal.

But let's examine the benefits. What do the Republicans get out of voting for the Democrats to pass their proposed budget?

Simple, the Democrats will own the outcome and voters can decide if their plan worked come next election. The results will speak for themselves.

If the Democrats are right, then the Republicans will have been wrong to have objected.

If the Democrats are wrong, then that should be evident by the 2012 elections as voters will have one additional year of economic activity with which to judge.

As we are fond of saying, Americans vote with their wallets.

We shall see then who was right.

CONCLUSION

So, if Republicans truly believe that default is not an option – and, in fact, allowing a default of the U.S. economy would be reckless and irresponsible - then "compromise" can no longer be viewed as a viable concept. The U.S. - and by extension - the world need Republicans to lower the gauntlet and make some tough choices. If some among the party – for example, the Tea Party contingent – have to swallow their pride, so be it.

Leadership is about doing not only what is right but what is necessary.

That, in and of itself, is a compromise the markets - and voters - can live with.

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