MARKET & ECONOMIC COMMENTARY

Super Committee to the Rescue–Not So Fast

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EXECUTIVE SUMMARY

The congressional super committee is a short-term solution to a long-term problem. In our opinion, the potential scenarios are limited to two outcomes: meet or miss the deadline for deficit reduction. We believe the outcome will be that the super committee will do the absolute minimum to avoid the mandatory reductions by meeting the deadline and making the fewest cuts necessary.

THE PROBLEM

Given the mountain of federal debt and massive budget deficits, it is obvious that America's current fiscal path is unsustainable. Spending is rising rapidly, and current revenues are inadequate, causing Uncle Sam to borrow to make up the difference. In 2010, spending was roughly 24% of gross domestic product (GDP), while revenue (i.e., taxes) was 14.9% of GDP. The difference between the two–the budget deficit–was roughly 9% of GDP.

As we have said in other publications, two eighth-graders with a couple pencils and a legal pad can figure out what needs to be done. Spending needs to decline, taxes need to rise, or a combination of both needs to occur. This is not a political discussion, although crafting a solution requires one.

Super Committee Major Deadlines	
November 23, 2011	Deadline for Super Committee vote on a plan to reduce deficits over 10 year budget cycle
December 23, 2011	Deadline for the House and Senate to vote on the Super Committee bill
January 15, 2012	Trigger date to initiate $1.2 trillion of across the board future spending cuts
February 2012	Timeframe when $900 billion of debt ceiling expected to run out
Feb/March 2012	President pre-authorized to increase debt ceiling by $900 billion if no agreement on future spending cuts
October 2012	Beginning of fiscal year 2013, when the automatic cuts would begin to take effect

THE STRUCTURE

The super committee, officially known as the Joint Select Committee on Deficit Reduction, was created on August 2 as part of the compromise in the Budget Control Act of 2011. It consists of 12 members, evenly split between each chamber and party affiliation, with appointments made by party leadership.

The Budget Control Act of 2011 will decrease spending by an estimated $0.9 trillion over the 2012–2021 budget cycle by creating caps on discretionary appropriations. The super committee is tasked with finding at least

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another $1.2 trillion in deficit reduction over that period, although their actual target is a little higher. To give them a sense of urgency, the Budget Control Act of 2011 mandates that if the super committee cannot slash at least $1.2 trillion over the 10-year budget cycle and enact the legislation by January 15, 2012, automatic cuts to both discretionary and mandatory spending are triggered. These automatic cuts, a process technically called sequestration, will begin to take effect in fiscal year 2013, which starts on October 1, 2012, and ends on September 30, 2013.

Although the task would seem straightforward enough in that the super committee can reduce any type of spending to arrive at $1.2 trillion, that is not the case. The Budget Control Act specifically stipulates that 18% be reduced spending for debt service with the remainder split equally between defense (41%) and nondefense spending (41%). It is also important to differentiate between *budget authority*, which is the authority provided by law to incur financial obligations, and *outlays*, which is the actual amount of money spent each year. The biggest difference is timing. For instance, a bridge project might cost $10 million in one budget but the outlays occur over the three years it takes to design, build and complete the project. As you can see, the complexity begins to get overwhelming, particularly when rounding to the nearest billion.

The automatic cuts should result in outlays savings of roughly $1.1 trillion during fiscal years 2013 through 2021, from the following:

- Defense programs, $454 billion
- Nondefense programs, $294 billion
- Nondefense mandatory spending, net savings $136 billion (Medicare savings of $170 billion less $31 billion in Medicare Part B cost increases)
- Debt-service costs, $169 billion

POSSIBLE SCENARIOS

Practically speaking, the potential scenarios are limited to two outcomes: meet the deadline or miss the deadline.

Meet the deadline—If the super committee agrees to the expected $1.2 trillion in spending cuts and enacts the legislation before the December 23 deadline, we believe it would likely be a nonevent for markets. If there were an agreement above the $1.2 trillion required amount, markets would cheer the effort since it would signal an earnest attempt to focus on the larger problems facing the nation. It would also suggest that lawmakers appear willing to compromise without the divisive rhetoric seen during the debt-ceiling debate.

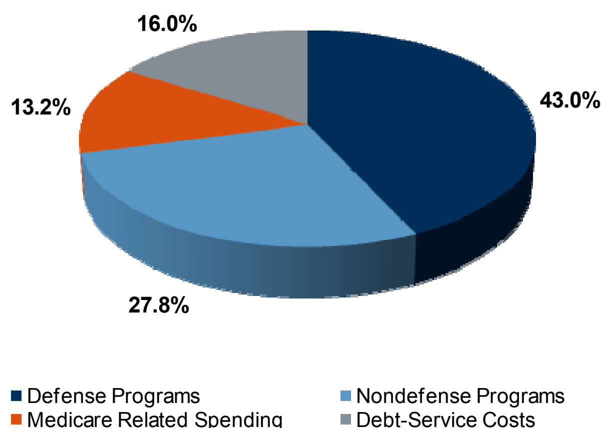
Miss the deadline—If the super committee fails to meet the deadline—either due to being short of the $1.2 trillion target or simply not voting on the legislation in time—the outcome is the same: the mandatory cuts will be made. Should deadline not be met, we expect that the reaction by equity and fixed income markets will be swift and painful. The inability of this small group of seemingly moderate legislators to reach a consensus

Super Committee Structure

	Democrats	Republicans
Senate Members	Max Baucus (MT) John Kerry (MA) Patricia Murray (WA)*	Jon Kyl (AZ) Rob Portman (OH) Patrick Toomey (PA)
House Members	Xavier Becerra (CA) James Clyburn (SC) Chris Van Hollen (MD)	Dave Camp (MI) Jeb Hensarling (TX)* Fred Upton (MI)

* Denotes Committee Co-Chair

AUTOMATIC CUTS



Sources: Congressional Budget Office, Morgan Keegan Market Intelligence Group

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would reinforce the opinion of many that the political system is broken. We also anticipate there would be another downgrade of the long-term sovereign credit rating of the United States by Standard & Poor's (S&P) or perhaps Moody's Investors Service. When S&P downgraded the U.S.'s long-term sovereign credit rating one notch to AA+ on August 8, equity markets tumbled nearly 14% and yields on the 10-year Treasury plunged below 2.0% in the days that followed. Despite the backstop of the mandatory cuts, the inability to hammer out a deal would only reinforce the perception that U.S. lawmakers cannot tackle the larger budget problems. In addition, interest rates demanded by investors to lend to the U.S. would increase, making borrowing to fund deficits more onerous and exacerbating future budget problems.

POLITICS ALWAYS GETS IN THE WAY

Some commentators have opined that the Obama Administration would rather not make a deal on a larger, long-term solution—a so-called grand plan—since it would be harder to campaign against during his 2012 re-election bid. Other pundits have blasted the Republicans for having a tin ear on tax increases seemingly at all cost. Conversely, given the portion of the automatic cuts targeted at defense programs, the Republicans arguably have the most to lose if the super committee fails.

There has been remarkably little substantive news surrounding the super committee. Given the old adage that "bad news travels fast," we view this as a positive sign of progress. In other words, if there were major disagreements, someone would have complained or it probably would have leaked. In any case, given the strong negative reaction to the debt ceiling debacle, it would probably be political suicide to be on the super committee and not reach *some* sort of agreement, particularly for the six House members, all of whom will stand for re-election in 2012 (unless they retire). Of the senators, only Jon Kyl is up for re-election in 2012.

CONCLUSION

With or without an agreement, budget cuts will be made. The only question is if the cuts will be by compromise or by force.

We believe the likely outcome will be that the super committee will do the absolute minimum to avoid the mandatory reductions by meeting the deadline and making the fewest cuts necessary. If so, the resolution will likely be shrugged off by markets.

Our confidence is bolstered by the understanding that these spending reductions will occur over the 10-year budget cycle. Over such a long period, it is highly likely that these cuts and changes will be blended, chopped, mixed, folded, fused and amalgamated by legislators in coming years. Given the turnover in the House and Senate after the last election cycle, it is likely that the composition of those debating these changes will be very different in future years from the current mix.

That said, the debate and outcome from the super committee is highly anticipated. Any compromise would signal to those watching that U.S. lawmakers are, in fact, attuned to the desires of their constituents. While it would not solve the problem, it would indicate their willingness to tackle the larger problems. Conversely, failure to reach a compromise would signal that lawmakers cannot even come together long enough to "kick the can down the road."

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