

Politics, Taxes and the Markets

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by Robert Huebscher

One of the most engaging speakers at last week's Schwab IMPACT conference was Andy Friedman, who offered some provocative predictions about next year's elections and what we can expect from the deficit super committee.



Alec Phillips

Friedman, whose firm, **Washington Update**, provides political analysis focusing on how various outcomes will affect advisors and investors, was paired on a panel discussion with Alec Phillips, US economist at Goldman Sachs.



Andy Friedman

The two discussed a range of current issues and pending legislation, and I will focus on a few highlights: the likely outcomes for deficit reduction, the super committee, taxes and the 2012 election.

Solving the deficit impasse

A single issue has consumed political debate this year, Friedman said: the federal budget deficit. At the end of this year, he said, we will not have addressed any of the key issues – entitlements and taxes – and we will have cut the deficit by only \$2.1 trillion over 10 years, which is \$210 billion annually out of a \$1.3 trillion annual deficit.

"The fact is that we will have done nothing at all," he said.

Friedman predicted earlier this year that nothing will happen with respect to the deficit until a crisis occurs. At the time he said he could think of three such forcing events: a downgrade by one of the major rating agencies, China threatening not to buy more Treasury bonds, or heightened volatility, such as multiple moves of 500 points in the equity markets.

All three have happened, he said, but nothing budged with respect to the deficit.

"This tells me I grossly underestimated the tenacity of Congress to do nothing at all," Friedman said.

Now, the prospects for deficit reduction are in the hands of the Joint Select Committee on Deficit Reduction (better known as the "super committee"), which is charged with cutting at least \$1.2 trillion from the deficit through some combination of spending cuts and revenue increases.

Phillips expects to see something close to the \$1.2 trillion target, but he was less optimistic that it will represent true deficit reduction. Some of the cuts will come from tax increases, he said, but the net may not help the budget.

Phillips said it was unlikely that the super committee will not agree on a deficit package. He forecast a small amount of

revenue increases, not in the form tax rate increases but instead consisting of closing some loopholes.

Both Phillips and Friedman agreed that if they do too much in the way of tax increases, the agreed-upon solution will be unable to pass the House.

Friedman said defense spending alone will fall by \$1 trillion once the super committee's work is finished, which will result in higher unemployment.

Friedman said that if the committee comes through with \$1.2 trillion in spending cuts, or if sequestration (a process whereby automatic spending cuts of \$1.2 trillion are implemented over 10 years) occurs and the same cuts take place, the markets will be fine.

But, he warned, if committee members "play gimmicks" like arguing that ending the wars in Iraq or Afghanistan will reduce the deficit, then there could be a very adverse reaction in the markets. Further, he said that Moody's could react to that scenario by downgrading its rating of US debt even further, as it has already warned it would do.

The outlook for taxes

In the short term, Phillips said the key issue is what happens with stimulus measures. The payroll tax reduction is set to expire at the end of this year, and he expects a decision as to whether it will be extended in the next few weeks. "This is a bigger issue than what happens with the super committee," he said. If measures such as the payroll tax cut are not extended, then Phillips expects fiscal contraction in 2012.

Phillips added we will reach the debt limit again right after the 2012 election, which will also be when the Bush tax cuts will once again expire. Debates will on those issues be simultaneous.

Friedman described a number of what he called "collateral effects" of the impasse on deficit-related issues. Deficit reduction is "anti-job creation," he said. "You can have lower deficits or lower unemployment, but you can't have both in the short term."

Republicans will not agree to additional stimulus measures, he said. If they agree to Social Security cutbacks the president has proposed, there will be higher deficit next year than this year (since those cutbacks come through a reduction in payroll taxes), so that doesn't accomplish much.

With respect to taxes, Friedman said Obama wants to cut spending and raise taxes. But, he said, tax increases won't get through the House.

The president has said if he doesn't get a balanced deal, he will let Bush tax cuts expire at the end of next year for incomes above \$250,000 a year. The president is correct, Friedman said, in that he will be president on December 31, when the tax cuts expire. But he is incorrect that can veto the extension of the tax cuts for only those individuals. If the tax cuts are not extended, he said taxes will go up for everyone in 2013.

Congress will pass no tax legislation before Election Day next year, according to Friedman. Instead Congress will not take up the issue until it comes back for a three-week lame duck session after the 2012 election. Either the president will have just won reelection, in which case he will feel very empowered to act on taxes, or the president will have lost, in which case he will feel he can do whatever he thinks is "right" with respect to taxes, as a lame duck.

Given those assumptions, Friedman said the odds that Congress and the president will come together and extend any of the tax cuts before the end of 2012 are very low.

Who will win in 2011?

The Republicans will take both houses of Congress in 2012, Friedman predicted. They may lose some seats in the House, but will benefit from the fact that 23 of the 33 Senate seats up for election are held by Democrats. He said many incumbents are from traditionally Republican states and were elected as a backlash to George Bush in 2006. But, he said, the Republicans will not get to 60 seats, and the Democrats will have the same power in the Senate to thwart most legislations that the Republicans now enjoy.

Friedman predicted that Romney will be the Republican nominee, and that Obama will win reelection. It all depends on independent voters, he said, who voted for Obama in 2008 but against the Democrats in 2010.

Friedman said that Obama's message will be as follows: For the first two years of my presidency, everything went well. Unemployment went down, the stock market boomed, and gas was \$3 a gallon. Then the Republicans came with their obstructionism, and look what happened. Unemployment shot up, the markets plummeted, and gas prices increased. We had the right plan but it got thwarted.

That resonates with independents, Friedman said, particularly because they agree with the need to raise taxes on at least the wealthiest individuals. Friedman said that Obama will question Romney (who the White House believes will be the nominee) as to at what level tax increases should start - \$250,000? \$1 million? \$5 million? \$10 million? \$20 million?

At some point, independents will be swayed by the need to raise taxes on at least some individuals.

The other problem, according to Friedman, is a lack of identity within the Republican party. If Romney's message focuses issues like less regulation, lower taxes, and letting businesses grow, then Friedman said independents will vote for him. But if the message comes from the more socially conservative faction, focusing on issues such as abortion and gay marriage, he will lose the independent vote. "Those issues are not important to independents," Friedman said, "who care more about the economy."

Friedman, of course, presumes that Romney will not reach the same conclusion and message accordingly.

Phillips was less convinced that Obama will be reelected. He said he expects unemployment to be 9.5% at election time. While some blame will fall to the Republicans, Phillips said, voters may not be as forgiving of the president as Friedman contends. He said it was too early to predict the presidential outcome. He agreed with Friedman that Romney will be the nominee and with Friedman's forecast for the congressional elections.

The media is at fault

Both addressed the broader question of how to reduce the dysfunction within government.

Phillips said that the political parties are further apart than ever before, although that does not reflect the sentiment of the population as a whole. Compromise and progress are increasingly less likely, he said.

He added that Congress does not function well when the two houses are held by opposing parties.

Friedman, however, disagreed that a divided Congress was the source of government dysfunction. In the 1980s, he said, Tip O'Neill and Ronald Reagan were able to pass Social Security reform and the last tax reform.

Now representatives of each party emerge from a meeting and there is a microphone in someone's face, Friedman said, usually from a partisan news organization. "They are angry and they express it." The other side responds to that anger and the positions of the two parties become progressively more alienated.

By the end of several such exchanges the parties' positions are firmly entrenched and, moreover, they don't like each other, Friedman said. The possibility of compromise is remote.

Friedman likened this dynamic to marital conflict. Imagine, he said, if someone put a microphone to one spouse and asked what the problem was, and then went to the other spouse and asked what they thought. "The couple would be divorced in a week," he said.

The only way to stop that is for elected officials to stop spouting off to the media, Friedman said. "Take a deep breath, go back in, and try to compromise."

Successful marriages result from that kind of behavior, and we can only hope that our elected officials can learn the same lesson.