ADVISOR PERSPECTIVES

Washington May Be Ready to Take a Break From the Brink

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> - With Washington's dysfunction not in the forefront, the economy could be more unencumbered to grow, with markets trending in a similar direction.
> - The Fed's proactive policies should continue to favor overweight positions in the five-year through 10-year part of the Treasury yield curve and support interest-rate-sensitive sectors of the economy – most notably housing.
> - In the longer term, however, we would advise investors to be cautious: Without meaningful long-term structural deficit reform, real growth will inevitably lag in the U.S.

Since the beginning of the year, the focus in Washington has been on more of the same: governing from crisis to crisis while the country's citizens look on, both fatigued and exasperated by the intransigence coming out of Washington. But is all hope lost? Or are there underlying positive dynamics that will become evident in the next few months?

The headlines detailing the most recent example of Washington dysfunction – the sequester, the across-the-board government spending cuts that neither political party particularly likes – would suggest more of the same. And we would agree that the potentially negative impact of the sequester on growth and confidence should not be underestimated – especially considering that the cuts are in addition to the already substantial fiscal headwind expected in 2013 from the policies agreed to in the fiscal cliff deal. However, if we look beyond the sequester, we actually see a glimmer of hope: In fact, many of the sources of uncertainty that have dominated the headlines over the past three years, not to mention the attention of investors, have been either addressed (the Bush tax cuts and fiscal cliff) or taken off the table (a government shutdown and debt ceiling increase – at least for now). While there is undoubtedly collateral damage to the economy from Washington's dysfunction – namely in the 1.7% of GDP that PIMCO expects in fiscal contraction in 2013, we could well see less policy uncertainty and brinksmanship over the cyclical timeframe in Washington, which has generally positive implications for markets and investors. In the longer term, however, we would advise investors to be cautious: Without meaningful long-term structural deficit reform, real growth will inevitably lag in the U.S.

First things first: the sequester

You likely have heard and read about the sequester ad nauseam – the $1.2 trillion in cuts aimed mostly at "discretionary" spending set to take place over the next nine years that was agreed to as part of the debt ceiling deal in 2011, with $85 billion in cuts in fiscal year 2013 (ending in September). As background, "discretionary" spending accounts for little more than 35% of the government's annual budget and represents the majority of our country's spending on defense programs, education, research funding and programs such as Head Start. What makes this year's cuts associated with the sequester particularly brutal? Unlike those in 2014 and beyond, the 2013 cuts affect discretionary programs across the board and provide little discretion to the government in terms of how to administer the cuts.

What is more, discretionary spending has already been slated to be reduced even further – by about $1.5 trillion over the next 10 years (another product of the 2011 debt ceiling deal), which would bring discretionary spending as a percentage of GDP to 5.5% in 2023, a full three percentage points lower than its 30-year average according to the Congressional Budget Office (CBO).

Some mitigating factors about the sequester

While the above paints a relatively bleak picture, there are some mitigating factors about the sequester in 2013.

For one, there is an important difference between budget authority and budget outlays: Budget authority is the amount of money authorized to spend, while budget outlays represent the amount of money actually out the door.

This is relevant for the sequester, since while the $85 billion in cuts is the figure garnering the headlines, the actual outlays

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are around $44 billion in fiscal 2013 according to the CBO, meaning that even if Congressional leaders don't find a way to replace the sequester this year, the impact would be less than the $85 billion or 0.5% of GDP in 2013. Second, even if they agree with the cuts in theory, neither side of the aisle likes how the 2013 sequester cuts are administered. This means that a compromise, especially once the impact of the sequester is more broadly felt, is likely – even if it means just reapportioning how the cuts are implemented.

So, what is the silver lining?

The question over the Bush tax cuts has been answered: The majority of the cuts were made permanent for most Americans in the last-minute deal to avert the fiscal cliff. The debt ceiling deadline has been delayed until mid-May, and, likely with the use of extraordinary measures, that deadline will be extended until August. And even then, we think a repeat of the debt ceiling drama of summer 2011 is unlikely as members of Congress seem to have realized that threatening default on U.S debt is not only a dangerous strategy, it is a political loser. With eyes to 2014, members of Congress cannot afford to sink any lower in voters' eyes, especially at a time when many Americans view head lice and colonoscopies more favorably than they do Congress.

A possible government shutdown is also unlikely; Republicans and Democrats seem committed to meeting the March 27th deadline – possibly even a week or two early – by agreeing to a six-month government funding bill. Even the sequester, which now has taken effect since policymakers failed to reach a compromise by the March 1st deadline, is somewhat of a known quantity. While we still expect lawmakers to come to a resolution over the next few months to delay or replace the sequester cuts, even if they do not, we believe it's unlikely that a material market disruption would ensue from the sequester implementation.

Overall, while we expect continued partisan bickering over fiscal policy, we do expect to see less brinksmanship and therefore less uncertainty over policymaking, which should be a relief to investors and markets alike.

Investment implications

We believe three main themes should guide investors in terms of incorporating recent fiscal policy developments into portfolio positioning. First of all, short-term political uncertainty is lower now than it has been over much of the last several years – which is short-term supportive for risk assets. Second, the fact that the country's long-term structural fiscal issues have not been resolved in any meaningful fashion will ultimately prove to be negative for real growth potential and risky assets. Finally, the fact that the sequestration, an enforcement mechanism originally designed to be so draconian that no sensible politician on either side of the aisle would conceivably allow it to become reality, has become (at least in part) a reality reinforces the notion that it is monetary policy, rather than fiscal policy, that will continue to have to do all of the heavy lifting when it comes to aiding the economy. Therefore, investors should be very mindful of where they position along the yield curve.

The first investment theme, the reduction of short-term political uncertainty, is at least temporarily supportive of equities and other risky assets. It perhaps seems perverse that investors should rejoice in the knowledge that it is unlikely for the government to default, shut down or leap off of a massive cliff over the next 12 months – those things should be a given for investors in the largest, most liquid and developed marketplace. However, this is the first time in more than three years that it seems highly unlikely for none of those self-inflicted wounds to be of imminent concern.

Market volatility, reflected by the VIX Index, which has been plagued by frequent bouts of political uncertainty, is likely to be less prone to spikes like the ones seen in the summer of 2011 (debt ceiling showdown) and the winter of 2012 (fiscal cliff showdown). We would not be surprised if the VIX tested post-financial-crisis lows in the coming months. Likewise, with less concern over a fiscal mistake, investors are likely to be more emboldened to take risk, and business leaders, with less uncertainty around future tax policy, are more likely to hire and invest. Both are near-term positive for equity markets and other risk assets.

However, before we declare the "all clear" on risk assets markets, we must address our second investment theme – a lack of long-term fiscal reform or bipartisan compromise – which is a counterbalancing force weighing on long-term growth and asset market performance. The best fiscal outcome over the last few months for markets would have been a bipartisan Simpson-Bowles-type "grand bargain," which addressed the nation's structural fiscal issues in a bipartisan and forward-thinking manner. The markets would have embraced a compromise that addressed both entitlement spending and tax reform and that charted a path towards fiscal balance without near-term and draconian fiscal drag. However, the resolutions that we have gotten instead have been more incremental in nature and positive only in that they have narrowly averted fiscal catastrophe. These incremental solutions, while potentially short-term positive, are ultimately not positive for the longer term growth potential of the United States. Thus, investors need to temper cyclical enthusiasm with more secular caution. The risk of imminent government default, shutdown or cliff-diving has been reduced, but the fiscal woes of the

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United States are far from resolved.

While the impact of the first two themes on risk assets is nuanced over time and somewhat ambiguous in its ultimate direction, what is clear is that the Federal Reserve is the only proactive policymaker in town. The fact that recent political question marks were answered in the way that they were – draconian sequestration and no meaningful fiscal reform – will dictate that the Fed stay hyperactive longer than it otherwise would have had to in order to counteract the fiscal drag expected in 2013. We expect the latest round of Quantitative Easing to continue throughout the entirety of 2013 and perhaps significantly longer, and we expect near-zero interest rates to be with us through at least 2015. These policies should continue to favor overweight positions in the five-year through 10-year part of the Treasury yield curve and should continue to support interest-rate-sensitive sectors of the economy – most notably housing. As such, we expect the mortgage market, both agency and non-agency, to outperform.

Conclusion

With some of the larger sources of policy uncertainty either entirely off the table or receding into the background, we are hopeful that the brinksmanship and state of crisis that have characterized Washington and weighed on markets over the past few years will abate over the cyclical timeframe. With Washington's dysfunction not in the forefront, the economy could be more unencumbered to grow with markets trending in a similar direction. But we would temper this cyclical optimism with longer-term caution: While uncertainty might decrease, without bipartisan structural deficit reform, real growth in the U.S. will invariably suffer.

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