Weekly Market Commentary

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Super Committee: Go Big or Go Home?

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Highlights

With no debt ceiling, default or downgrade threat, the market impact of this week's public unveiling of the super committee's recommendations is likely to be muted relative to the debt ceiling debacle of late July and early August.

Congress' record-low 9% approval rating reflects the low bar of expectations for the super committee. The market expects the default cuts of $1.2 trillion will do the bulk of generating the required savings.

Even with no agreement from the super committee, an end-of-year deal may still take place that may pair a smaller deficit reduction package of a few hundred billion dollars with the extension of the expiring payroll tax cut and federal unemployment benefits.

With the congressional super committee's deadline on finding $1.5 trillion in deficit reduction this week, the markets want to know if they will go big or just go home for the Thanksgiving recess.

The debt ceiling debacle that came to a head in early August 2011 left a lasting impression on the stock market. The S&P 500 index plunged 17% from July 22 to August 9, in part driven by Washington's inept handling of the increase of the country's debt limit and the subsequent downgrade of the U.S. credit rating by Standard and Poor's on August 5.

Fortunately, this week's public unveiling of the proposals from the super committee tasked with finding the required $1.5 trillion in deficit reduction over 10 years is unlikely to spark the same violently negative market reaction. There are two key reasons the market reaction is likely to be much more muted:

- **First, there is no debt ceiling or potential default looming this time.** This is because the budget act put in place in August 2011 triggers automatic cuts—also called sequester—totaling $1.2 trillion over nine years beginning in 2013, in the event the super committee fails to come up with $1.5 trillion in proscribed savings. This pushes the time frame when the United States will again bump up against the debt ceiling to early 2013—after the next election.
- **Second, we are unlikely to see a debt downgrade of the United States this time.** In recent months it has become clear through public comments that the major rating agencies are unlikely to downgrade the U.S. credit rating on a failure of the super committee to agree on the deficit reduction as long as they do not remove the sequester that invokes the automatic $1.2 trillion in cuts and do not circumvent the size of the cuts through budget accounting gimmicks. The next credit event is likely not until 2013, under a new Congress. Fitch may move the U.S. credit outlook to negative implying a bias to downgrade and both S&P and Moody's have said a downgrade is likely absent a major fiscal consolidation package in 2013.

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It is unlikely that the cuts triggered by the automatic sequester will actually take place come 2013.

The failure to come to an agreement does not mean that Congress goes home with no plan to take any fiscal action this year.

Credit Rating Agencies comments on the Potential for a Downgrade related to the Super Committee Outcome

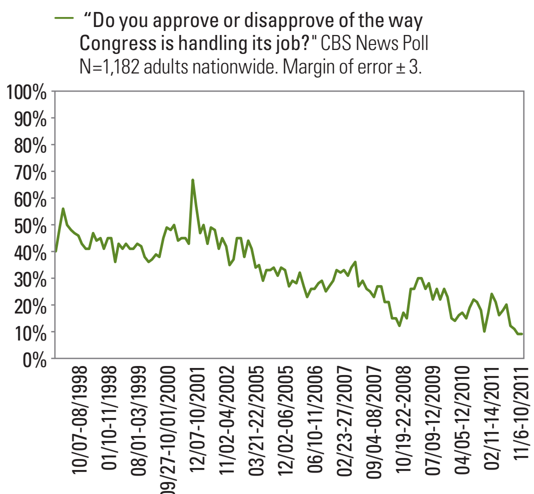
Moody's	"There would be a risk of downgrade if (1) there is a weakening in fiscal discipline in the coming year; (2) further fiscal consolidation measures are not adopted in 2013; (3) the economic outlook deteriorates significantly; or (4) there is an appreciable rise in the US government's funding costs over and above what is currently expected." "However, as $1.2 trillion in further deficit reduction has already been legislated through automatic spending caps if no agreement is reached, failure by the committee to reach agreement would not by itself lead to a rating change."
Standard and Poor's	"The outlook on the long-term rating is negative. We could lower the long-term rating to 'AA' within the next two years if we see that less reduction in spending than agreed to, higher interest rates, or new fiscal pressures during the period result in a higher general government debt trajectory than we currently assume in our base case."
Fitch	"Fitch will review its fiscal projections in light of the outcome of the deliberations of the Joint Select committee (due by end November) as well as its near and medium-term economic outlook for the US by the end of the year. An upward revision to Fitch's medium to long-term projections for public debt either as a result of weaker than expected economic recovery or the failure of the Joint Select Committee to reach agreement on at least USD 1.2 trn of deficit-reduction measures would likely result in negative rating action. The rating action would most likely be a revision of the rating Outlook to Negative, which would indicate a greater than 50% chance of a downgrade over a two year horizon. Less likely would be a one-notch downgrade."

Source: Excerpted from press releases issued by Moody's on November 1, 2011; Standard and Poor's on August 5, 2011; Fitch on August 16, 2011

With no agreement, $1.2 trillion in deficit savings will result from the automatic discretionary spending cuts through program spending caps known as sequestration. However, it is unlikely that the cuts triggered by the automatic sequester will actually take place come 2013. This is because there is likely to be a major deficit reduction package in 2013 under a new GOP-dominated Congress following the 2012 elections. This plan will significantly alter the pro-rata allocation of cuts across discretionary spending programs that would take place under the automatic sequester. This base case results in an outcome for the markets that is muted — especially relative to this summer's reaction.

Congress' 9% approval rating [Chart 1] highlights the low expectations for the super committee to bridge the partisan divide and craft a ground-breaking deal that addresses the nation's debt that crossed the $15 trillion threshold last week. However, the failure to come to an agreement does not mean that Congress goes home with no plan to take any fiscal action this year. An end-of-year deal may still take place that may pair a smaller deficit reduction package of a few hundred billion dollars with the extension of the expiring payroll tax cut and federal unemployment benefits.

1 Congress' Approval Rating Now Below 10%



Source: LPL Financial, Pollingreport.com 11/21/11

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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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