Having a clear plan is critical for markets to move past the fiscal cliff

The fate of the US economy lies in the hands of a cantankerous Congress that has a questionable track record of compromise – that’s the pervasive message that investors are hearing as we approach the Jan. 1 fiscal cliff deadline. The rhetoric is so charged – and the issues are so complex – it’s not surprising that investors are questioning their strategies and their plans for the future.

I recently met with several Invesco investment leaders to discuss the fiscal cliff, and the conversation was refreshingly optimistic. To be sure, the markets could have a volatile December if the cliff negotiations come down to the wire. But the most important thing the markets crave is clarity, and the consensus among these investment leaders is that one way or another, we will get clarity.

The stakes of falling off the cliff

On Jan. 1, up to $600 billion of spending cuts and tax increases will occur unless policymakers intervene. The resulting drop in federal deficits is what’s known as the fiscal cliff.

The fallout from falling off the fiscal cliff could be summarized in one word – recession. Invesco Chief Economist John Greenwood estimates that US gross domestic product (GDP) could fall 1.5% in 2013 if we fall off the cliff. “Of course that’s a very simplistic view, but that’s basically what’s involved,” Greenwood said. “So it’s very important that the administration and both sides of the Congress get together and come up with some alternative set of plans that eases the transition.”

Short-term solutions from a lame duck

A sweeping overhaul of tax and spending policy may be the ideal solution, but a smaller compromise could immediately prevent the US from falling off the cliff. And, since the newly elected Congress doesn’t convene until Jan. 3, a short-term fix may be all that this “lame duck” Congress is able to achieve.

“The market has taken a pretty sanguine view of the cliff here in the short run, and the thought is that it’s going to be OK on the other side of this if we can just buy some time to get some certainty in the laws,” said Ron Sloan, chief investment officer of Invesco’s core domestic equity team. “CEOs are paid to react, they’re really not paid to anticipate, so they just want to see some certainty in the ground rules, and I think we’ll be OK.”

Sloan estimates that the S&P 500 Index will trade around 1350 to 1450 as the market comes to grips with whatever strategy Washington formulates for avoiding the cliff. “There’s not a lot of downside risk in the market from here,” he said, “but I don’t see a lot of upside either.”

Greg McGreevey, chief executive officer of Invesco Fixed Income, expects that the lame duck Congress will achieve an initial package of spending cuts and tax increases for the wealthy totaling \[\text{equation}\]
between $175 billion and $200 billion, versus the immediate $600 billion impact of the fiscal cliff.

“We think the market would respond favorably if Congress is able to, in the lame duck session, put those things in place,” McGreevey said. “It would stop the fiscal cliff, create some time for the new Congress to act and provide a longer-term comprehensive debt reduction pathway — all the things that would bring some certainty to the market, which is really important.”

Perceptions count
If the fiscal cliff negotiations become too contentious and protracted, it could damage the perception of our political process — and such perceptions could have market consequences. In 2011, Washington went through heated discussions over raising the federal debt ceiling. Even though the US raised its debt ceiling right on deadline, Standard & Poor’s downgraded the country’s long-term credit rating from AAA to AA+ partly because of the “prolonged controversy” surrounding the negotiations. The downgrade triggered a 6.7% fall in the S&P 500 Index.¹

“For equities, things could get messy if the ball is dropped and we end up in a rerun of the debt ceiling situation — markets would definitely take a lot of fright at that in the very short term,” said Nick Mustoe, chief investment officer of Invesco Perpetual in the UK. “Technically, the negotiations could all go wrong right up to the very end. So I suspect we might have a choppy December as everyone really focuses in on this.”

If Moody’s or Fitch were to downgrade the US to the AA+ level, as S&P did in 2011, the markets could easily absorb that with minimal impact to the Treasury markets or to credit spreads, McGreevey said. A downgrade into the single-A category would have a much more significant impact, but that would be an extreme move and is highly unlikely to occur, he said.

In the real estate sector, the continued economic uncertainty has helped keep speculative construction relatively low, which has in turn improved occupancy rates of existing properties, said Joe Rodriguez, senior portfolio manager and head of Invesco Global Real Estate Securities. Recently the housing sector has been a bright spot for the economy, showing increasing signs of a broadening recovery. However, if the fiscal cliff damages consumer sentiment, single-family housing sales would probably take a hit, and apartment occupancies could rise further. “We would say that overweighting apartments is probably the least risky way to achieve good results in this environment,” Rodriguez said. “If we don’t get a good fiscal cliff compromise outlined, industrials, warehouses and hotels will feel an immediate negative impact on share prices.”

Longer-term solutions are needed
As difficult as it may be for investors to look past the immediate issue of the fiscal cliff, that’s just the first in a line of issues facing the US, Greenwood pointed out. “Not only do we have the fiscal cliff, but immediately coming up behind that is an argument over a further increase in the debt ceiling that will probably come to a head in February or March,” he noted. “And in a broader, longer-term context, there is a big, much more partisan fight over the medium-term fiscal austerity program. That is, when is the US federal government going to switch to some degree of fiscal discipline to gradually get the budget deficit down?”

Gross US debt is more than $16 trillion, and it’s growing by more than $1 trillion per year.² In 2012, the US debt held by the public equaled 73% of GDP.³ If the US falls off the cliff, that figure would be 58% in 2022.³ While falling off the cliff could be shocking to the economy, putting off a long-term debt reduction plan presents its own problems. If Washington simply puts the brakes on the upcoming tax increases and spending cuts, the country would be on path for the debt held by the public to hit 90% of GDP in 2022.³

“When countries reach a too-high debt-to-GDP ratio, it typically takes a very long time to work their way out of such issues,” McGreevey said. “And countries typically experience long periods of very low growth that can be difficult and very painful for economies to go through. That has an impact on the rates market, and it has an impact on investment income at a time when the aging demographics in the US continue to increase.”
Invesco’s view
Given the high stakes of inaction, chief executives of 80 companies, including Invesco CEO Martin Flanagan, recently issued a statement urging Congress to adopt a comprehensive solution to reduce our debt meaningfully - but gradually.

The group advocates a bipartisan approach that would reform all areas of the federal budget and include comprehensive, pro-growth tax reform that would increase revenues. The goal would be to reduce our $16 trillion debt by $4 trillion over 10 years.

At Invesco, we believe the government needs to balance short-term growth and long-term stability – and do it in such a way that avoids acrimony. Working together to enact a sound plan would help businesses and individuals feel more confident about investing for their future and help alleviate the growing debt burden for future generations.

1 Source: Yahoo Finance
2 Source: fixthedebt.org. “Gross debt” refers to debt held by the public as well as intragovernmental holdings.
3 Source: Congressional Budget Office

*Invesco Fixed Income, Invesco Global Strategies, co-chair of the Investor’s Forum and Global Trading

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