

Market Outlook

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'Tis the Season for Sharing (Sacrifice)

On November 9th, the bipartisan deficit commission empanelled by President Obama released a preview of their ideas for cutting the nation's deficit. The deficit, now at \$1.294 trillion, has become the front and center issue of 2010. It has helped fuel the rise of the Tea Party in national politics, and was no small boost to the fortunes of Republicans in their sweep of the mid-term elections. The independent panel, brought together in early 2010 and charged with seeking bipartisan solutions to dealing with the seemingly insurmountable growth of deficit spending in America, produced a no-holds-barred preview of their final report, due out December 1st.

The preview had something for everyone to hate, which indicates they left no constituency alone in formulating solutions. As Alan Simpson, co-chair and former Republican senator from Wyoming said, "We have harpooned every whale in the ocean, and some of the minnows." The document makes five basic recommendations: First, to "enact tough discretionary spending caps" and find \$200 billion in savings by 2015. Second: tax reform "that dramatically reduces rates, simplifies the code, broadens the base and reduces the deficit." The third step addresses reforms of Medicare and Medicaid. Fourth: mandatory savings from farm subsidies and civilian and military retirement costs. And fifth: reforms to Social Security to ensure its solvency "while reducing poverty among seniors."

The chairmen say these steps could reduce the deficit to 2.2% of gross domestic product by 2015, and achieve \$4 trillion in deficit reduction by 2020.

Howling Polarized Bears

Within 24 hours of the proposal's release, howls of protest could be heard from all corners. Democrats balked at changes to Social Security and Medicare. Republicans choked on proposals to increase taxes. (Their reluctance to endorse the proposal all the more puzzling as it was a promise to deal with the deficit that led to their big gains in the midterms.) Proposed changes to military budgets, tort reform, student loan programs, farm subsidies, and other entrenched constituencies too numerous to name would all feel the pain under the proposal. The PR machines for each group launched into overdrive to make the case why their members shouldn't bear *any* burden of solving the problems that we have, collectively, created for ourselves. If maximum impact

was what the commission was seeking, it got it, as it left almost no constituency unscathed.

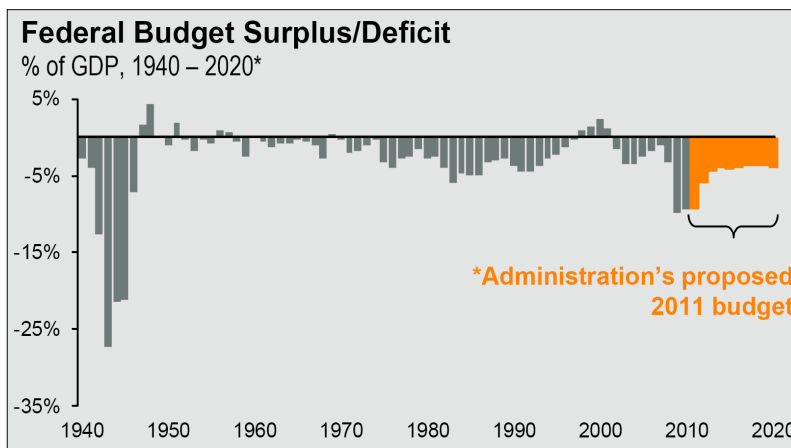
The only groups left smiling were the deficit hawks in Washington, who felt it was time the problem was dealt with head-on. The proposal "represents a commendable, comprehensive, aggressive and good-faith effort to address our nation's structural deficit," said David Walker, a former Comptroller General of the US who is now CEO of the Comeback America Initiative.

Lost Message

Lost in the ear-splitting din of protest over the panel's blunt and very specific recommendations are these passages from the introductory "Guiding Principles and Values:"

- "We have a patriotic duty to come together on a plan that will make America better off tomorrow than it is today."
- "Throughout our history, Americans have always been willing to sacrifice to make our nation stronger over the long haul. That's the promise of America: to give our children and grandchildren a better life."
- "A sensible, real plan requires shared sacrifice –and Washington should lead the way and tighten its belt."

The message of shared sacrifice has been bulldozed by each

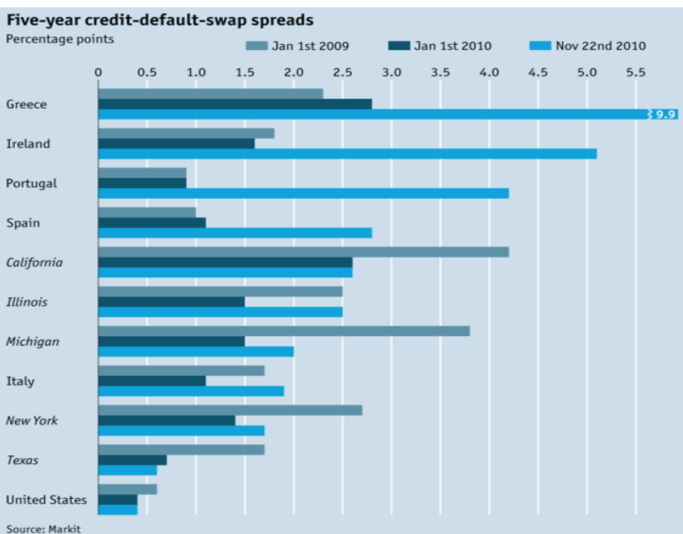


constituency protesting their reasons for *not* having to sacrifice, aided by quasi-political media networks. The knee-jerk responses have provided little time for reflection upon the scale of the problem, and the idea that we all share some responsibility for creating it. Those applauding the attempts at reform sound like very lonely voices in a very cold forest.

Yet, in the course of conversations with clients and peers alike, the need to begin work on solutions is obvious to everyone. In our heart-of-hearts, we individually recognize that current budgetary trends are unsustainable. Whether Democrat, Republican, or independent, people are revealing their native common sense (along with some justifiable anger) and accepting that sacrifice must happen, in order to benefit the greater good. Sadly, polarized lawmakers in Washington, egged on by both conservative and liberal media extremists, have staked their claim with their supporters and refused to consider the dire consequences of maintaining the status quo. Individually, it seems, we're ready to accept some

sacrifice, but institutionally the crisis is not severe enough to trigger painful compromises.

We have only to look at Ireland and Greece for small scale



examples of what can happen to countries that get mired in a vortex of debt and denial. Ireland, Europe's latest (but probably not last) victim of the credit bubble, accepted an EU bailout in late November. Terms of the bailout imposed even greater sacrifice on the part of the Irish than imposed by their tough austerity budget passed in early 2010.

Can it also happen to the US? It may happen at state levels, if credit default swaps on US municipal debt are any indication (chart above). The higher the swap "spread," the less faith the market has that default can be avoided. On this basis, California, Illinois, and Michigan are seen as less likely to default than Spain, but more likely than Italy. Sharply higher interest rates, falling stock prices, and continued real estate deflation are some of the consequences we can expect from doing nothing. Setting aside the question of *who* would bail out the US, it is clear today that some sort of systemic breakdown is possible if deficits and debt issuance continue at current levels.

Interestingly, during times of national distress Americans like to point to our greatest historical triumphs as evidence of American resolve, strength, and adaptability. These have also been, ironically, the moments of greatest shared sacrifice. World War II is the most salient example, but the Great Depression and recovery after the recessionary 1970s also deserve mention. Shared sacrifice is proof of our strength, we like to say, and yet when faced with the critical need to pull together today, we are allowing political extremism to push us apart. We have projected the fear of major, yet tolerable, changes into society-threatening cataclysmic collapses. We have been brainwashed into thinking that the only way to get ahead is at the expense of another group.

It's time to reframe the question from "What should the other guy have to sacrifice?" to "What am *I* willing to sacrifice?" in order to avert an Ireland-like result. This will take some soul-searching and some brutal honesty on each individual's part to

answer. To that end, we have included the [Deficit Commission's draft proposal](#) as released. It is in outline format, so fairly easy to read, yet provides enough detail to get you thinking.

The psychological phenomenon of "Social Proof" has contributed to the political polarization we see today. Social Proof describes the human tendency to look at the behavior of others in order to guide us during times of uncertainty. Our "leaders" in Congress are providing the social cues for the public, and they are clearly not cues to cooperate. By digging in their heels on the conservative or liberal agenda, they are ensuring that neither side makes the first move toward solutions. (Dethroned House Speaker Nancy Pelosi's flat refusal to consider Social Security changes is a perfect example of how delusional they've become.) Social Proof seems to give this approach legitimacy, since "everyone is doing it." The fallacy is that by clinging to their benefits, each constituency is somehow making the future brighter for themselves, when in fact the reverse is true.

We must break this cycle of stubborn refusal to collaborate. Studies of Social Proof have noted that during emergencies (a car crash, for instance), if one passerby takes charge of the situation, the survival odds of the victim is much higher. Other passersby will cooperate with the person "in charge" as they get clear clues as to how to behave in this uncertain situation. This is the situation we find ourselves in today.

So, I'll go first. What am I willing to sacrifice to make some of the Deficit Commission's recommendations a reality?

- 1) I would be willing to pay a higher personal tax rate (either higher marginal rate and/or fewer deductions). This is a stab in the heart to the conservative bloc, but an increase of 3-5% in my marginal tax rate is not going to kill me, and certainly won't make me work *less*, as supply-side economists claim would be "inevitable." If anything, I'll work harder to ensure that my after-tax income roughly equates to today's level. I would also be willing to pay the commission's proposed \$0.15/gallon gas tax increase.
- 2) I would be willing to defer receiving Social Security benefits to my late 60s/early 70s. Given my age 50, I have the luxury of time to plan and save for that change. Mentally I have been assuming that for years, and advising clients of my vintage to do the same. Clearly, people in the 60-65 age bracket have little time to adjust to such a change, and their Social Security should be left as is.

These are but two examples of where I'm willing to sacrifice. Don't assume I'm filled with the spirit of altruism as Christmas approaches. I'm not; I believe these sacrifices will make the future better for me and my family. The financial markets can impose great costs on all of us if we do nothing; costs that will pale in comparison to the shared sacrifice we impose upon ourselves in the near term.

This seems as apt a moment as ever to recall a quote from President Obama: "*If we aren't willing to pay a price for our values, then we should ask ourselves whether we truly believe in them at all.*"